Corpsec Hotline

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ODIS – THE FINAL PUNCH

The much awaited and followed development in recent times in respect of foreign portfolio investments in to Indian capital markets came to light yesterday. SEBI Chairman, Mr. Damodaran announced certain policy decisions in respect of investments through Overseas Derivative Instruments ("**ODIs**") and eligibility criteria for registration as FII at a press conference held immediately after its Board meet yesterday. Certain measures are implemented with effect from October 25, 2007. Broadly, the policy measures that were part of the draft policy paper issued by SEBI on October 16, 2007 are now put in to effect as follows:

- FIIs and their sub-accounts shall not issue/renew ODIs with underlying as derivatives with immediate effect. They are required to wind up the current position over 18 months, during which period SEBI will review the position from time to time. It was also clarified by SEBI that there was no proposed bar on ODI contracts, expiring this month or in the following months, being renewed, provided the renewal does not go beyond 18 months.
- Further issuance of ODIs by the sub-accounts of FIIs will be discontinued with immediate effect. They will be required to wind up the current position over 18 months, during which period SEBI will review the position from time to time. As regards P-Note issuing sub-accounts who have applied for registering as FIIs, SEBI has clarified that such sub-accounts will be treated as if they were FIIs as on the date decided for calculation of the Assets under Custody in India (**"AUC"**), which shall be September 30, 2007.
- The FIIs who are currently issuing ODIs with notional value of ODIs outstanding (excluding derivatives) as a percentage of their AUC in India of less than 40% shall be allowed to issue further ODIs only at the incremental rate of 5% of their AUC in India. SEBI has clarified that 5% incremental issuance allowed to such FIIs would be applicable on an annual basis, till such time that the percentage reaches 40%, after which the entity will abide by the proposal applicable to entities above the 40% limit.
- Those FIIs with notional value of PNs outstanding (excluding derivatives) as a percentage of their AUC in India of more than 40% shall issue PNs only against cancellation / redemption / closing out of the existing PNs of at least equivalent amount.

In addition to the above policy measures that have been put in to force, SEBI with a view relax certain eligibility criteria currently prescribed under the FII Regulations has made the following changes to the registration criteria:

Broad-based criteria - The "broad-based" criteria shall now be modified to include entities having at least 20 investors and no single investor holding more than 49% (instead of 10% at present).

Track record of the applicant - Track record of individual fund managers will be considered for the purpose of ascertaining the track record of a newly set up fund, subject to such fund manager providing its disciplinary track record details.

Issuance of ODIs – ODIs would be issued to only "regulated" entities and not "registered" entities.

Perpetual registration - FII and sub-account registrations will be perpetual, subject to payment of fees.

Certain FII Applicants exempted from being 'regulated' – SEBI has exempted FII applicants that are Pension Funds, Foundations, Endowments, University Funds and Charitable trusts or societies from being "regulated" by an appropriate foreign regulatory authority.

It is expected that the above changes will be put in force by SEBI as law by formally amending the FII Regulations in due course.

Impact and Analysis:

1. The most significant change seems to be in respect of eligibility criteria of entities to whom ODIs can be issued. In the draft policy paper issued on October 16, while there was a complete ban (i) on issuance of ODIs by FIIs and sub-accounts having underlying exposure to derivatives and (ii) on issuance of ODIs by sub-accounts, SEBI had also proposed quantitative limits on issuance of ODIs by FIIs having underlying exposure to cash segment. There now seems to be an additional limitation in terms of further restricting issuance of such ODIs only to 'regulated' entities and not merely to 'registered' entities. Though this move of SEBI stems from the need of ensuring transparency there is likelihood that not many current subscribers to ODIs would be 'regulated' and would thus may not be eligible to renew existing ODIs or subscribe for new ODIs thereby restraining the foreign capital flow in to the Indian capital markets in the near to mid term. SEBI had previously by way of circular dated February 19, 2004 listed out deemed regulatory bodies. As stated by the Chairman, this circular is expected to be rendered ineffective and ODIs can now be issued only to entities that are regulated by "relevant regulatory authority in the countries of their incorporation or establishment, subject to compliance of know your client

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requirement" in terms of Regulation 15A of the FII Regulations. It would therefore mean that the FII will have to ensure that the entity to which it issues ODIs is 'regulated' in terms of Regulation 15A. In our view, in light of the possibility of the withdrawal of the circular, the test for determining if an entity is regulated or not should be laid down by SEBI more elaborately as that will give clear guidance to the FIIs issuing ODIs..

2. The other outstanding issue in respect of which some clarification was expected was allowing hedge funds/managers to directly register as an FII. Many of these hedge funds/managers are not required to be registered with the appropriate securities authority but nevertheless are subject to some level of regulation under the applicable local laws. Since now the unregulated hedge funds are ineligible to even subscribe for ODIs the route to make portfolio investments in India now practically seems to be closed for such hedge funds, unless SEBI comes out with any further relaxations in due course. The Chairman has indicated that the FII Regulations shall be examined afresh with three objectives viz., (i) permitting access to Indian markets (ii) increase universe of products for investments and (ii) cost competitiveness of the India market. Therefore one may hope that the changes to the FII Regulations sooner than later would be necessary.

3. Another important change is in the relaxation of FII registration criteria. Firstly, the "broad base" criteria shall now mean at least 20 investors and no single investor holding more than 49% (instead of 10% at present). This is a welcome relaxation particularly for funds that have smaller corpus size with core investor whose holding may be more than 10%. There are instances where the General Partner or the promoter/sponsor may have made initial investment in the fund by way of seed capital in order to attract other potential investors to invest in the fund. Such funds should not find it difficult to comply with changed definition of "broad base" criteria. Secondly, for the purpose of the requirement of track record in respect of an FII applicant, being a newly set up fund entity, the 'disciplinary' track record of the individual fund managers will be considered. The word 'disciplinary' essentially assumes that the fund manger is 'disciplined' by some authority and it therefore indicates that the fund manager should be subject to regulation or supervision by some authority. It is not clear if the fund management entity itself is regulated by some authority would the individual fund manager also need to be separately regulated. Further, if the authority regulating the fund management entity certifies 'disciplinary' track record of the individual fund managers that are the employees of the fund management entity would that be a sufficient compliance.

4. Entities like Pension Funds, Endowments, University Funds and Charitable trusts or societies can now seek FII registration without fulfilling the requirement of being "regulated". Earlier there was a possibility of such entities turning down the idea of getting themselves registered as an FII on the ground that they could not satisfy the requirement of being "regulated". SEBI having recognized that these class of entities by there very nature of activities that they carry on, do not need to be regulated by any regulatory authority, and therefore seems to have taken pragmatic view of the matter by craving out such entities from complying with the requirement of being "regulated". It was expected that SEBI would relax FII registration criteria to allow more classes of investors and in particular unregulated hedge funds/managers but it seems this issue and other outstanding issues like use of third party FII, FII applicants with real estate focus / background, investment by Non Resident Indians and Overseas Corporate Bodies etc are reserved to be taken up in next round of policy review.

5. It is proposed to grant perpetual registration to FIIs and sub-accounts subject to payment of renewal fess. Currently, an FII and sub-account registration is valid for a period for a period three years after which SEBI reexamines, on an application being made for renewal, whether or not to renew the registration. Thus the application for renewal was more or less at par with application for FII/sub-account made in the first instance. It seems that going forward, subject to the payment of renewal fees, SEBI will not reexamine the position of the FII/sub-account. This change seems to be made with a view to reduce the number of applications that require SEBI screening and the resultant delay in the FII/sub-account registration process.

6. Further, the Chairman seems to have deliberately avoided clearly defining what would constitute 'AUC'. The Chairman has however clarified that at present custodians are required to file monthly reports with SEBI in respect of AUC and such filings of AUC will be considered to determine exposure by the FIIs to ODIs. However, the concern seems to be in respect of hedge funds wanting to invest in followon public issues and Initial Public Offerings (**IPOs**) by way of ODIs through FIIs that do not have any head room available for subscribing to such followon public issues and IPOs. SEBI needs to clarify if investment by the FII in to followon public issues and IPOs, as underlying for issuance of ODIs, would be considered to be part of AUC.

7. Lastly, in respect of those sub-accounts (in the business of issuing ODIs) that have opted to convert themselves as FIIs there seems to be some confusion in respect of calculation of AUC. SEBI would need to clarify if for the purpose of calculation of AUC in respect of the sub-account that converts itself in to FII, the AUC of the FII under which is was earlier registered as a sub-account would also be considered or not.

Conclusion:

In our view there are some grey areas as highlighted above that need to be addressed at the earliest by SEBI. As indicated by the Chairman one can expect further changes to the FII Regulations with a view to provide further access to Indian markets. It is evident that the above changes are with an objective to make Indian markets cleaner and transparent. So with this or the time being, the ODI controversy would come to rest: at least for the time being.

Source: The Press Note

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