

Consultation Paper on investment by Foreign Investors through Segregated Portfolios/ P-notes/ Offshore Derivative Instruments

1. OBJECTIVE:

Investments made by foreigners via Offshore Derivative Instruments (erstwhile P-notes) or through segregated portfolios of Foreign Portfolio Investors (FPIs) are currently not subject to the same set of disclosure and other regulatory requirements as regular FPIs under the SEBI (Foreign Portfolio Investors) Regulations, 2019 (“FPI Regulations, 2019”). This includes the additional disclosure requirements on objectively identified FPIs under the SEBI Circular dated August 24, 2023. The proposals in this paper seek to address this regulatory arbitrage. Public comments are invited on these proposals.

2. EXTANT FRAMEWORK:

- 2.1. In terms of Regulation 2(1)(o) of the FPI Regulations, 2019, Offshore Derivative Instrument (“ODI”) means any instrument which is issued overseas by a FPI against securities held by it in India as its underlying. While the ODI issuer (i.e. the FPI) remains the owner of the underlying securities, the economic benefits of such holdings are transferred to the ODI subscriber.
- 2.2. The current norms for issuance of ODIs under FPI Regulations, 2019 provide that ODIs can be issued subject to certain eligibility conditions and reporting requirements. In terms of Regulation 21 of the FPI Regulations, 2019, *inter alia*, ODIs can be issued by Category I FPIs to persons eligible for registration as Category I FPIs after compliance with Know Your Client (KYC) norms. Transfer of ODIs is permitted subject to consent of the ODI issuing FPI.
- 2.3. Further, with respect to ODIs, Part D of the Master Circular for Foreign Portfolio Investors, Designated Depository Participants (“DDPs”) and Eligible Foreign Investors dated May 30, 2024 (“FPI Master Circular”) provides for additional conditions for issuance of ODIs, KYC norms for ODI subscribers, reporting of suspicious transactions, periodic review of systems, investment limits and monthly ODI reporting etc.

2.4. Also, FPIs invest through sub-fund structures or separate classes of shares or equivalent structure with segregated portfolio for such sub-funds or separate classes of shares or equivalent structures. In terms of the FPI Master Circular, FPIs with segregated portfolio(s) are required to provide BO declaration for each fund/sub-fund/share class/equivalent structure that invests in India. Further, in case of addition of fund / sub fund / share class /equivalent structure with segregated portfolio that invests in India, the FPI is required to provide BO information prior to investing in India through such new fund/sub fund/share class/equivalent structure.

3. Background and evolution of ODI Framework

3.1. In the erstwhile Foreign Institutional Investors (FII) regime prior to 2014, foreign investors issued Participatory Notes (P-Notes) to foreign investors who wanted exposure to Indian markets, without the complexities of direct registration with SEBI. P-notes enabled investors to take exposure in a single security as well as in baskets of Indian securities. Also, P-note issuers could offer such exposure on a leveraged basis. However, in the absence of any registration requirement and the consequent regulatory obligations, P-notes presented a scope for regulatory arbitrage.

3.2. The regulatory approach in this regard has been to facilitate investor participation, while reducing opacity. In 2001, SEBI mandated reporting of issuance/ renewal/ cancellation/ redemption of derivative instruments such as Participatory Notes, Equity-Linked Notes, Capped Return Notes, Participating Return Notes etc. by Foreign Institutional Investors (“FIIs”). In 2003, the extant SEBI (Foreign Institutional Investors) Regulations, 1995 (“FII Regulations, 1995”) were amended to mandate FIIs to disclose information concerning the P-notes/ ODIs issued by them or their sub-accounts, as and when required by SEBI. In 2004, the FII Regulations, 1995 were again amended to provide that ODIs could be issued/ transferred only to regulated entities and subject to compliance with KYC requirements. In 2017, SEBI prohibited ODIs from being issued against derivatives for speculative purposes. However, an exception was made for those derivative positions that were taken for hedging the equity shares held by the ODI issuers. In 2019, FPIs were restricted from issuing

ODIs referencing derivatives as well as from hedging their ODIs with derivative positions on stock exchanges in India. However, the following was permitted as an exception, through a separate FPI registration of an ODI issuing FPI:

3.2.1. Derivative positions that are taken on stock exchanges by the FPI for 'hedging of equity shares' held by it in India, on a one to one basis; and/ or

3.2.2. An ODI issuing FPI may hedge the ODIs referencing equity shares with derivative positions in Indian stock exchanges, subject to a position limit of 5% of market wide position limits for single stock derivatives. The permissible position limit for stock index derivatives is higher of INR 100 crores or 5% open interest.

3.3. SEBI has also prescribed that ODI subscribers should be eligible for Category I FPI registration, and mandated ODI issuers to maintain KYC and BO details of ODI subscribers.

3.4. The trend in Assets Under Custody ("AUC") for FPIs and value of outstanding ODIs is shown in table below:

Table 1: Trends in Value of ODIs vs Total FPI AUC

Period	Total value of ODIs/ P-Notes (INR crore)	AUC of FPIs (INR crore)	Total value of ODIs/ P-Notes as % of AUC of FPIs (%)
2006-07	2,42,839	5,47,010	44.4
2007-08	2,50,852	7,36,753	34.0
2008-09	69,445	3,91,954	17.7
2009-10	1,45,037	9,00,869	16.1
2010-11	1,75,097	11,06,550	15.8
2011-12	1,65,832	11,07,399	15.0
2012-13	1,47,905	13,36,557	11.1
2013-14	2,07,639	15,93,869	13.0
2014-15	2,72,078	24,11,810	11.3
2015-16	2,23,077	22,24,537	10.0
2016-17	1,78,437	27,05,729	6.6

2017-18	1,06,403	31,48,349	3.4
2018-19	78,110	33,42,680	2.3
2019-20	48,006	24,90,223	1.9
2020-21	89,100	44,62,903	2.0
2021-22	87,979	50,97,012	1.7
2022-23	88,600	48,70,792	1.8
2023-24	1,49,120	69,53,988	2.1
2024-25[#]	1,34,633	71,87,455	1.9

as on May 31, 2024

3.5. As can be seen from Table 1 above, the total value of ODIs as a percentage of the AUC of FPIs has dropped from 44.4% at the end of FY 2007 to 2.1% at the end of FY 2024. Since the notification of the FPI Regulations, 2019, the total value of ODIs as a percentage of the AUC of FPIs has consistently remained below 2.5%.

3.6. The monthly reports submitted by ODI issuers also show that out of the total 309 ODI subscribers, 99 (i.e. 32%) are already registered as FPIs. In terms of the value of outstanding ODIs, 40% of the outstanding ODI positions are held by such subscribers.

4. Regulatory concerns and proposed solutions:

The regulatory measures, mentioned in above sections, have led to increase in transparency in use of ODIs by foreign investors. Similarly, as mentioned above, identification of BOs takes place even at the level of segregated portfolios held through sub-fund structures. Over the years, the value of outstanding ODIs has also been decreasing; however, potential regulatory arbitrage still exists between investments made through ODIs/ FPIs with segregated portfolios with sub-fund structures vis-à-vis the regular FPI route. The issues arising from such regulatory arbitrage and proposed solutions are as under:

4.1. Applicability of additional disclosure framework directly to ODI subscribers / FPIs with segregated portfolios

4.1.1. In recent years, certain FPIs were observed to have concentrated equity portfolio that raised concerns regarding possible misuse of the FPI route for circumventing regulatory requirements such as that of

disclosures under Substantial Acquisition of Shares and Takeovers Regulations, 2011 or maintaining Minimum Public Shareholding in the listed company. In this regard, vide amendment dated August 10, 2023 to the FPI Regulations, 2019 and circular dated August 24, 2023 (“August Circular”), SEBI has prescribed additional disclosure requirements for certain objectively identified FPIs. The said circular provides that granular details of all entities holding any ownership, economic interest, or exercising control in the FPI, on a full look through basis, up to the level of all natural persons, without any threshold, shall be provided by FPIs that fulfil any of the criteria mentioned below to the respective DDPs:

- a. FPIs holding more than 50% of their Indian equity Assets Under Management (AUM) in a single Indian corporate group (“concentration criteria”);
- b. FPIs that individually, or along with their investor group, hold more than INR 25,000 crore of equity AUM in the Indian markets (“size criteria”)

4.1.2. In case of non-compliance with the said disclosure requirements within specified timelines, the FPI(s) is required to liquidate its securities and exit the Indian securities market.

4.1.3. However, the above requirements are directly not applicable to ODI subscribers, i.e. the concentration criteria and size criteria in equity investments are not considered at the ODI subscriber level. This enables a foreign investor to potentially get around the granular disclosure obligations by taking exposure through ODI route.

4.1.4. The potential for similar regulatory arbitrage is also seen in case of FPIs with segregated portfolios. As of July 2024, 35 FPIs hold investments through multiple segregated portfolios with different sub-funds/share-classes. Out of these, 8 FPIs have 10 or more sub-funds each, through which such segregated portfolios are maintained. One of these FPIs has as high as 86 sub-funds/share classes. It may be

noted that while FPI Regulations provide for registration of funds with segregated portfolios, such funds are required to identify beneficial owner(s) separately for each segregated portfolio. However, for the purpose of August Circular, the concentration criteria and disclosure requirements in case of breach of concentration criteria are applied at the fund level and not at each segregated portfolio(s) level.

4.1.5. Proposed solution: It is proposed to make the disclosure requirements specified under the August circular applicable directly to (i) ODI subscribers, and (ii) segregated portfolio(s) of FPIs with sub-funds or separate classes of shares or equivalent structure(s). Accordingly, the concentration criteria and size criteria shall be applicable directly to ODI subscribers, to be monitored by ODI issuers and their DDPs/ Depositories. Further, for computing breach of concentration criteria by an FPI with segregated portfolios, the Indian equity AUM of each of those segregated portfolios shall be considered independently. The FPI issuing the ODI or having segregated portfolio shall be required to ensure compliance in this regard.

4.1.6. To ensure compliance with the regulatory requirements, the following monitoring mechanism shall apply:

4.1.6.1. For concentration criteria, monitoring shall be done at each ODI subscriber level by the ODI issuer and DDP of the respective ODI issuer. The details of positions taken by the ODI subscriber(s) shall be submitted by the ODI issuer to its respective custodian/ DDP on a daily basis.

4.1.6.2. For size criteria, monitoring shall be done by ODI issuers, their DDPs and Depositories across ODI subscribers and group entities (i.e., ODI subscribers with common ownership of more than 50% or common control) taking positions through one or more ODI issuers and group entities registered as FPIs. In order to enable monitoring, the following is proposed:

- 4.1.6.2.1. The information required to ensure clubbing of investments across FPI and ODI subscribers shall be collected by the ODI issuer from ODI subscriber(s) prior to issuance/transfer of ODIs. ODI issuer shall also be required to obtain data from subscribers regarding any changes thereto on an ongoing basis, as applicable to FPIs.
 - 4.1.6.2.2. The clubbing information and details of positions taken by the ODI subscriber(s) shall be submitted by the ODI issuer to its respective custodian/ DDP on a daily basis.
 - 4.1.6.2.3. The DDP/custodian shall in turn submit this information received from the ODI issuer to Depositories.
 - 4.1.6.2.4. The Depositories shall monitor the size criteria in terms of the August Circular across FPIs and ODI subscribers.
- 4.1.6.3. ODI issuers shall obtain granular disclosures as required from ODI subscribers in breach of concentration criteria or size criteria, and in turn make the disclosure to the respective custodians/DDPs. The consequence of non-disclosure, as prescribed in the August circular, shall also apply to the defaulting ODI subscriber(s) and ODI issuers will need to ensure that defaulting subscribers redeem their ODIs within the specified timelines (180 days). Further, such subscribers shall not be eligible to subscribe/hold any positions through ODIs, and ODI issuers shall ensure compliance with the same.
- 4.1.6.4. Similarly, for monitoring the breach of concentration criteria at the segregated portfolio level, FPI shall be required to provide investment details for each segregated portfolio to the respective DDP on an ongoing basis. The DDP shall monitor the same in line with the extant monitoring framework applicable for FPIs.

Questions for public comments

- 1 Do you agree with the proposal to make the additional disclosure framework, provided under the August Circular, applicable to ODI subscribers directly?
- 2 Do you agree with the proposal to mandate submission of ODI subscriber information including the positions held by ODI subscribers, by ODI issuer to the respective custodian/ DDP for onward transmission of the same to the Depositories for monitoring of the size criteria as per the August Circular?
- 3 Do you agree with the proposal to make the additional disclosure framework, provided under the August Circular, applicable directly at segregated portfolio level of the FPI?
- 4 Do you agree with the proposal to make ODI subscriber ineligible for subscription/holding any positions through ODIs, for non-disclosure in terms of the August Circular and to make the ODI issuer responsible for ensuring compliance with the same?

4.2. Use of derivatives by ODI issuers

4.2.1. Owing to concerns related to use of derivatives by ODI issuing FPIs, SEBI vide Circular dated July 07, 2017 prohibited ODI issuance with derivative as underlying, with the exception of those derivative positions that are taken by the ODI issuer for hedging the equity shares held by it, on a one to one basis.

4.2.2. In 2019, SEBI had constituted a Working Group on FPI Regulations (“Working Group”) to revamp the 2014 FPI regime. The Working Group in its report dated May 24, 2019, *inter alia*, recommended changes for strengthening the ODI framework. In this regard, while dealing with compliance issues related to the said July 07, 2017 circular, the Working Group noted the following:

“There is lack of clarity in the market on the term “ODI with derivative as underlying”. The reason is that underlying can

be interpreted either as “securities linked to ODI” or “securities with which ODI is hedged in India”.

SEBI’s concern for introducing said restriction was to discourage build-up in derivative segment in India by ODI issuing FPIs on the back of ODIs issued overseas. Thus, intend is to restrict acquiring derivative position in India with the objective of issuing ODIs.”

4.2.3. Pursuant to receipt of public comments on the report, the recommendation of the Working Group in this regard was as follows:

“SEBI circular dated July 07, 2017 had placed restrictions that ODI issuing FPIs shall not be allowed to issue ODIs with derivative as underlying, with the exception of those derivative positions that are taken by the FPI for hedging the equity shares held by it, on a one to one basis.

As the market participants have reported that it is difficult to monitor the above requirement, an alternative approach may be as follows:

a. If an ODI issuing FPI takes a separate FPI registration for directly or indirectly hedging the ODIs, such FPIs shall be permitted to take derivative position in Indian stock exchanges and the applicable position limit for the purpose of same shall be 5% of market wide position limits.

b. If an ODI issuing FPI does not seek separate registration for issuance of ODIs, such FPI can only issue ODIs by hedging with cash equities or Debt securities. Further, ODI issuing FPIs shall give a declaration that ODIs are not hedged, directly or indirectly, with its proprietary derivative position.”

- 4.2.4. The aforesaid recommendation was accepted by the SEBI Board in its meeting held in August 2019 and was suitably incorporated in the Operational Guidelines for FPIs and DDPs.
- 4.2.5. From the above discussion, it is noted that use of derivatives for issuance of ODIs has been a concern for SEBI and an exception was given in 2017, only in respect of derivative positions taken for hedging the equity shares held by the FPI, on a one to one basis. Further, in view of difficulty faced by market participants in monitoring this requirement, an alternative approach, requiring separate FPI registration for hedging the ODIs, was given. The alternative approach was further subject to a restricted position limit of 5% of Market Wide Position Limits (MWPL) as against the limit of 20% of MWPL otherwise available to Category I FPIs.
- 4.2.6. Additionally, in cases where an ODI is hedged using derivatives, there are concerns regarding multiple levels of leverage. As mentioned earlier, ODIs allow foreign investors to take a leveraged position in securities market. Further, derivative positions in India allow investors to take a leveraged position in the Indian market. Thus, a leveraged position undertaken using an ODI, which is further hedged using derivative, may potentially lead to multiple levels of leverage. In any case, ODIs hedged with derivative positions in India leads to shifting of leverage from the ODI issuer-subscriber level overseas to the Indian clearing ecosystem.
- 4.2.7. Proposed solution: It is proposed to discontinue the existing exceptions related to use of derivatives by ODI issuers. ODI issuers shall be prohibited from (i) issuing ODIs with derivatives as reference/underlying and (ii) hedging their ODIs with derivative positions on stock exchanges. Accordingly, ODIs shall only have cash equity/ debt securities/ any permissible investment by FPI (other than

derivatives) as underlying and shall only be fully hedged with the same securities on a one-to-one basis, throughout the life of the ODI.

- 4.2.8. Existing ODIs with derivatives as underlying/reference shall be required to be redeemed within a period of 1 year from the date of issuance of the proposed framework in this regard. Further, existing ODIs with cash positions as underlying but hedged with derivatives shall either be required to be redeemed or hedged with the said cash positions on a one to one basis, within a period of 1 year from the date of issuance of the proposed framework in this regard. It is seen from reports submitted by the ODI issuers for the month of May 2024 that there are no outstanding ODIs with derivatives as underlying/reference. Further, only 4 ODI issuers have outstanding ODIs worth INR 3,075 crores that are hedged with derivatives.

Questions for public comments

- 5 Do you agree with the proposal to discontinue the exceptions for ODIs with derivatives as reference/underlying?
- 6 Do you agree with the proposal to discontinue the exceptions for ODIs hedged with derivatives?
- 7 Do you agree with the proposal to provide a time period of 1 year for redemption of existing ODIs with derivatives as underlying/reference?
- 8 With respect to existing ODIs hedged with derivatives, do you agree with the proposal to provide a time period of 1 year for either redemption or hedging with the actual referenced cash securities on a one to one basis?

4.3. Issuance of ODIs through separate registration

- 4.3.1. The extant regulatory framework for FPIs provides for separate registration by ODI issuing FPIs. Reports submitted by the ODI issuers for the month of May 2024 show that 86.33% of the total outstanding ODIs have been issued through dedicated FPI-ODI accounts. Further, it is noted that certain FPIs that have taken separate registration for issuance of ODIs use their proprietary FPI accounts to issue ODIs.

Therefore, it is noted that there is no uniform market practice with respect to the use of a separate account for issuance of ODIs.

4.3.2. We have proposed above that ODIs shall only be referenced to securities other than derivatives, and shall be fully hedged with the same securities on a one-to-one basis throughout the life of the ODI. Where ODIs are issued by an FPI that holds assets on behalf of other investors, there is a possibility of co-mingling of such investments with the assets held for hedging the ODIs. In other words, the Fund Manager of the FPI may be taking undisclosed net positions on individual securities, against the positions taken across her fund investors and ODI subscribers. This poses a challenge in monitoring compliance with the proposed one-to-one ODI hedge requirement mentioned above, besides keeping the ecosystem open to undisclosed risks.

4.3.3. Proposed solution: In order to ensure adherence to ODI one-to-one hedging requirement as referred above, disclosure of positions, and for ensuring adequate monitoring of compliance requirements, it is proposed to mandate issuance of ODIs only through a separate dedicated FPI registration where no proprietary investments shall be permitted.

Questions for public comments

9 Do you agree with the proposal to permit issuance of ODIs by FPIs only through a separate dedicated FPI registration?

5. Public Comments

5.1. Considering the implications of the aforementioned matters on the market participants, public comments are invited on the above-detailed proposals. The comments/ suggestions should be submitted latest by August 27, 2024, through the following link:



<https://www.sebi.gov.in/sebiweb/publiccommentv2/PublicCommentAction.do?doPublicComments=yes>

5.2. Any technical issue in submitting your comment through web based public comments form, may be communicated through email to afdconsultation@sebi.gov.in with a subject: *"Issue in submitting comments on consultation Paper on investment by Foreign Investors through Segregated Portfolios/ P-notes/ Offshore Derivative Instruments"*

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