SEBI’s Recent Move Against P-Notes Will Hurt P-Note Writers And India’s Derivative Market

by Payaswini Upadhyay @PayaswiniLLB

Updated on July 13, 2017, 12:18 pm
Published on July 13, 2017, 12:18 pm

In a recent move that may further dent the popularity of overseas derivative instruments such as participatory notes, market regulator SEBI has restricted issuance of this instrument where the underlying asset is a derivative.

Starting July 7, foreign portfolio investors can no longer issue P-notes with derivatives as the underlying asset unless the derivative position is to hedge equity shares owned by the investor.

P-notes currently amount to 6.3 percent of the assets under custody for FPIs versus 9.2 percent a year ago.

Securities and Exchange Board of India’s intent is to curb speculation in the derivatives market emanating from offshore derivative instruments, said Richie Sancheti, head of funds practice at law firm Nishith Desai Associates.

The RBI, SEBI, and the finance ministry – all the regulators combined are not very enthusiastic about P-notes as a product. Around 2008–09, their hands were completely tied as P–notes formed 50 percent of all cash fl.ows coming into India. But overtime, they have worked towards curbing this route that has a lot of anonymity attached to it.

Richie Sancheti, Head - Funds Practice, Nishith Desai Associates

This is a move to gradually reduce the exposure through the P-note route and it is going to hurt the investment banks issuing this instrument badly, Bhavin Shah, a financial services partner at consultancy firm PwC told BloombergQuint.

This has led to clients already placing requests to set-up sub-accounts to invest in the Indian market directly and not through the P-note route, he added.

What Happens To Existing Contracts?

Not only will this SEBI restriction hurt the P-note writing business, experts BloombergQuint spoke with believe it will also impact volumes in the Indian derivatives market for the next three months.

Because as per the SEBI circular, any such naked derivative positions have to be liquidated once the P-note matures or by December, 2020; whichever is earlier.

Approximately 30 percent of all P-notes issued, amounting to a notional value of Rs 47,674, have derivatives as the underlying asset. Of that 60-70 percent are estimated to be naked derivative positions and hence will need to be unwound, the spokesperson of a custodian bank told BloombergQuint requesting anonymity.
Most P-notes have a maturity date of a month or three months; you will see most contracts being wound up this month itself and so, it’s not clear what the rationale is for the December 2020 date, Shah said.

The Hedging Angle

SEBI's move will substantially impact future issuance of P-notes as well.

Issuance of P-notes with the underlying asset as derivatives will be permitted only if the derivatives are hedged to equity shares on a one-to-one basis.

But, Shah argued, hedging doesn't take place currently on a one-to-one basis. Investors typically hedge a sector, for instance say the financial services sector, or buy a stock in the spot market and hedge the position by creating a derivative position by buying another stock in the same sector, Shah said.

He interpreted one-on-one to mean that a hedge will only be allowed against the same scrip and quantity.

> *Hedging, currently, is not scrip-wise; it is sector wise or basket wise. So now, if you want to issue a P-note with the underlying as a derivative , you have to hedge that position at the scrip level and volume level as well.*

Bhavin Shah, Partner, PwC India

Sancheti added that this would lead to change in investor strategy as certain class of investment products will no longer be available.

> *There are different investment strategies - there is a long-short fund where derivatives is a sizeable chunk, a short only fund that takes short positions in certain securities , and then there are funds with long-hold strategy where derivatives are a slightly smaller part of the portfolio. Now those investors whose strategy involved a good amount of derivative exposure will have to change their strategy. A derivative only strategy may not work going forward.*

Richie Sancheti, Head - Funds Practice, Nishith Desai Associates

Also Read: SEBI Proposes New Rules To Develop Equity Derivatives Markets

There's also lack of clarity on the one-on-one mapping front; is it the P-note issuing FPI who needs to hold the equity in its books or is it the investor subscribing to the instrument, he added.