Market regulator may liberalise norms for offshore derivatives

Participatory notes with derivatives as underlying could see light of the day

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The Securities and Exchange Board of India (Sebi) may liberalise norms for issuing offshore derivative instruments (ODIs), allowing foreign portfolio investors (FPIs) to issue these instruments with derivatives as underlying if they take up a separate registration specifically for ODI issuances.

The new norms may revive the moribund ODI route in India and bring cheer to foreign investors who will not need to register as FPIs to take derivative bets in India. The FPIs will be able to take derivative positions up to 5 per cent of market-wide position limit without the need to hedge their underlying positions. Sebi, for its part, will be able to monitor the activity of these FPIs more closely as they will come under a separate category, said people in the know.

"There was a section of investors who were looking to take exposure to derivatives as ODI subscribers without registering directly as FPIs. They will benefit from the move," said Richie Sancheti, partner, Nishith Desai Associates. "Investors that employ long-short strategies and require derivatives exposure, but cannot prove that it is for hedging purposes, will also benefit. Such strategies can now be activated."

FPIs issuing ODIs that opt not to register separately will only be able to issue ODIs by hedging with cash equities or debt securities. These FPIs will also have to give a declaration that ODIs are not hedged with their proprietary derivative positions.

ODIs are instruments used by the foreign investors to invest in India's securities markets without directly registering with Sebi. In 2017, Sebi had prohibited these instruments from being issued against derivatives, except those used for hedging equity positions on a one-to-one basis. A one-to-one position means derivatives that have the same underlying as the equity shares. ODIs against a basket of shares such as the Nifty or Sensex, or same-sector indices, were not allowed. The regulator had said all existing unhedged positions would have to be squared off by the end of 2020 or date of maturity of the instrument, whichever was earlier.

VALUE OF ODIs IN INDIA

	Notional value of P-notes (₹ cr) On equity, debt, derivatives (A)	On derivatives	A as % of FPI assets
Jan '19	75,693	827	2.4
Feb '19	73,428	108	2.4
Mar '19	78,110	119	2.3
Apr '19	81,220	123	2.4
May '19	82,619	193	2.4
Jun '19	81,913	821	2.4

Source: NSDL

Sebi's concern for introducing the said restriction was to discourage build-up in the derivatives segment in India. This had led to the dwindling share of participatory note (P-note) issuances and had encouraged foreign investors to register directly with Sebi. A large number of hedge funds, for instance, have opted to register themselves directly as FPIs rather than invest through the P-note route.

The notional value of P-notes on equity, debt and derivatives stood at ₹81,013 crore as on June 30, 2019, which is a mere 2.4 per cent of the assets under custody of FPIs. The notional value of P-notes on derivatives stood at ₹821 crore, down 98.5 per cent from ₹55,779 crore at the end of January 2017.

FPIs have, in the past, told the regulator that it is difficult for issuers to discern between speculative and hedging positions of individual investors, and to ascertain the exact number of open positions held by them. This is especially the case if the investors deal with multiple P-note issuers.

"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"," the May 24 draft of the Khan Committee report on FPIs had noted.