

Corpsec Hotline

August 14, 2006

PARTICIPATORY NOTES TO BE MORE PAINFUL?

Proposed Changes

The Securities and Exchange Board of India (“SEBI”) Chairman, Mr. M. Damodaran raised concerns that the route of investing through offshore derivative instruments could be utilized for insider trading and routing of unaccounted money into the market by the overseas investors, and said further that the SEBI is re-looking at the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995 (the “FII Regulations”) pertaining to the stages of reporting required while investing through offshore derivative instruments.

Current Regulations

Regulation 15A of the FII Regulations allows a Foreign Institutional Investor or sub account (“FII”) to issue, deal in or hold, offshore derivative instruments such as participatory notes, equity linked notes or any other similar instruments (“PNs”) against underlying securities, listed or proposed to be listed on any stock exchange in India, in favor of those entities which are regulated by any relevant regulatory authority in the countries of their incorporation or establishment, subject to compliance of “know your client” requirement. Further, regulation 20A of the FII Regulations requires the FIIs to fully disclose information concerning the terms of and parties to the PNs, as and when and in such form as the Board may require.

Implications

With the current reporting requirements under the FII Regulations, the SEBI is finding it difficult to track the ultimate beneficiary of the PNs and that too, on an immediate basis, as the reporting is required to be done on a monthly basis. The SEBI may, therefore, propose to bring changes that would require the FIIs to name the ultimate down-line beneficiary immediately upon the issuance of the PNs.

As the ultimate PN-holders are generally not registered with the SEBI, they are outside the purview of the SEBI rules and regulations and possibly learning from its UBS experience, it appears that the regulator proposes to change the disclosure requirements to make the KYC norms for the FIIs issuing the PNs more stringent. What, however, this would mean for FIIs is more challenges since the degree of look-through for the KYC purposes was always open ended and this school of thought at the regulator would make the PNs that much more difficult and possibly dearer. In our view, as a counter measure to this, the regulator must refine and liberalise to an extent, the options for direct access to markets through more liberalised FII and sub account registration norms.

- **Kishore Joshi & Siddharth Shah**

You can direct your queries or comments to the authors

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