

## Corpsec Hotline

May 29, 2008

### SEBI UNWINDS NORMS FOR INVESTMENTS THROUGH OFFSHORE DERIVATIVE INSTRUMENTS

The Securities and Exchange Board of India ("SEBI") has issued a circular on May 27, 2008 ("New Circular") amending the undertaking required to be given by Foreign Institutional Investors ("FIIs") while reporting the particulars of the Offshore Derivative Instruments ("ODIs") issued by it and its sub-accounts.

As per the revised undertaking, an FII or its associate cannot issue ODIs directly to Non-Resident Indians ("NRIs") or Indian residents and reference to OCBs and PIOs is omitted. Further, the New Circular now entails the FIIs to disclose the assets under its custody as of last monthly reporting period.

In the Indian context, ODIs are issued by FIIs to those overseas investors which do not have direct access to the Indian capital markets or are ineligible to register themselves as FIIs or sub-accounts with SEBI. The New Circular issued by SEBI modifies the earlier circular issued by it on April 02, 2004 ("Present Circular") regarding such undertaking to be furnished by FIIs issuing ODIs. By virtue of the Present Circular, the FIIs are required to undertake that they directly or through their associates, have not issued or subscribed or purchased any of the ODIs directly or indirectly from Indian residents/NRIs/ PIOs/OCBs.

#### Analysis & Implications:

By way of a circular dated October 31, 2001, SEBI, for the first time required the FIIs to report issuance / renewal / cancellation of the ODIs every fortnight (and was changed to monthly under the Present Circular). Further, by way of circular dated August 08, 2003 SEBI amended the reporting format and introduced an undertaking which reads as follows:

"We undertake that we/associates/clients have not issued / subscribed / purchased any of the offshore derivative instruments directly or indirectly to/from Indian residents/NRIs/PIOs/OCBs during the Statement Period."

For analyzing the changes introduced through the Present Circular, we have reproduced the revised undertaking as prescribed under the New Circular which reads as follows:

"We undertake that we / our associates have not issued / subscribed / purchased any of the offshore derivative instruments directly to / from NRIs / Indian residents."

From a plain reading of the revised undertaking above, it is evident that the expression "indirectly" has been omitted. Further, reference to the expression PIO's and OCB's is also dropped in the revised undertaking.

The exclusion of the expression "indirectly" may imply that with effect from May 27, 2008, the undertaking furnished by FIIs would be restricted primarily at the ODI subscriber level only. The Present Circular restricted not only the direct issuance of the ODIs to Indian residents/NRIs/PIOs/OCBs but also the "indirect" issuance of ODIs to such categories of investors. However, under the New Circular, the FIIs are restricted from issuing the ODIs only "directly" to the NRIs and Indian residents. Thus, by excluding the expression "indirectly" in the New Circular it can be inferred that the restriction on the ODI subscriber to issue ODIs further down the chain to NRI's / Indian residents, may no longer be applicable. It is a known fact that many ODI issuing FIIs were facing administrative inconvenience in giving the existing undertaking as they had to ensure that any down line issuance of ODI by the ODI subscriber complied with the undertaking. Further, the existing undertaking by the use of expression "indirectly" sought to apply on a look through basis up till the ultimate investor level in the entire chain of ODI subscribers thereby necessitating the FII which issued ODIs to procure similar undertaking from the ODI subscriber.

Further, the New Circular excludes the investors in the nature of OCBs and PIOs from the restricted entities to whom the ODI's could not be issued by the FIIs under the Present Circular. Importantly, by the specific deletion of the expressions OCB's and PIO's from the wording of the New Circular, it appears that ODI's can now be issued to OCB's as well. In this context it is pertinent to note that SEBI has, with effect from October 25, 2007, by way of a policy announcement, imposed certain restrictions on the extent of issuance of ODIs and has mandated that any issuance of ODIs should be made only to "regulated entities". For analysis of the policy announcement please refer to our hotline titled "ODIs – The Final Punch" dated October 26, 2007.

The New Circular essentially attempts to liberalize the undertaking required to be given by FIIs on two counts, namely: (i) facilitating issuance of ODIs "indirectly" to NRI's / Indian residents and (ii) permitting issuance of ODIs "directly" to OCB's as long as OCB's are "regulated entities".

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Further, the Regulations specifically restrict NRIs / OCBs to invest as sub-account or FII. Accordingly, the revised undertaking could prove to be a boon to NRI and OCB investors as they can now invest in the Indian capital markets indirectly.

### Goldman Sachs Ruling

The New Circular appears to be issued pursuant to the recent decision of the Securities Appellate Tribunal (“**SAT**”) in the appeal filed by Goldman Sachs Investments (Mauritius), a registered sub account, against the order of SEBI. In this case the primary issue was whether SEBI could, in the absence of a express prohibition in the Regulations, ask the FIIs to furnish an undertaking to the effect that they or their associates had not issued ODIs to Indian residents/NRIs/PIOs/OCBs. The SAT allowed appeal of Goldman Sachs inter alia directing SEBI not to insist on the undertaking prescribed by the Present Circular mainly on the ground that there was no restriction under the Regulations under which issuance of ODIs to Indian residents/NRIs/PIOs/OCBs could be prohibited.

### Concluding Remarks:

By issuance of the New Circular, SEBI seems to have liberalized the requirements pertaining to issuance of ODIs by watering down the undertaking required to be furnished by FIIs issuing ODI's. Though the new undertaking appears to be a fall out of the SAT ruling in Goldman Sachs case, there seems to be a new avenue for investors that are in the nature of Indian residents/NRIs/PIOs/OCBs to invest in the Indian markets “indirectly” through ODI route.

Sources: *SEBI Circulars*

- <http://www.sebi.gov.in/circulars/2008/ficir2808.html>(New Circular)
- <http://www.sebi.gov.in/circulars/2004/ficir152004.html>(Present Circular)

**- Advait Sethna & Suneet Barve**

You can direct your queries or comments to the authors

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