

EY Regulatory Alert

SEBI Circular introducing additional measures to address regulatory arbitrage for Offshore Derivative Instruments (ODIs) and Foreign Portfolio Investors (FPIs) with segregated portfolios vis-à-vis FPIs

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Executive summary

This alert summarizes a recent Circular released by the Securities and Exchange Board of India (SEBI), dated 17 December 2024 (Circular)¹ which introduces measures to address regulatory arbitrage for Offshore Derivative Instruments (ODIs) and Foreign Portfolio Investors (FPIs) with segregated portfolios vis-à-vis FPIs. The Circular is in furtherance to the consultation paper² (CP) released by SEBI for public comments on 6 August 2024. The Circular makes changes to the existing conditions for issuance of ODIs and mandates applicability of granular disclosure framework [released by SEBI vide Circular³ dated 24 August 2023 and subsequent amendments thereto (August Circular)] to ODIs and FPIs with segregated portfolios.

¹ Circular 'SEBI/HO/AFD/AFD-POD-3/P/CIR/2024/176'

² Consultation Paper on investment by Foreign Investors through Segregated Portfolios/ P-notes/ Offshore Derivative Instruments

³ SEBI/HO/AFD/AFD-POD-2/P/CIR/2024/104



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Background

- ODIs are instruments issued overseas by FPIs against securities held by it in India, as its underlying.
- As per the SEBI (FPI) Regulations, 2019, ODIs can be issued by Category I FPIs to persons eligible for registration as Category I FPIs after compliance with KYC norms and other conditions as may be specified by SEBI. In this regard, the Master Circular⁴ dated 30 May 2024, provides for additional conditions for issuance of ODIs, KYC norms for ODI subscribers, investment limits, reporting requirements, etc.
- Further, owing to concerns relating to use of derivatives by ODI issuing FPIs, SEBI had prohibited issuance of ODIs with derivatives as underlying, except in certain specific instances.
- Further, to ensure that FPIs do not (a) concentrate a substantial portion of their equity portfolio in a single investee company/ company group thereby circumventing regulatory requirements under Substantial Acquisition of Shares and Takeovers Regulations, 2011 (SAST Regulations) or circumventing the requirement of maintaining Minimum Public Shareholding (MPS)⁵; or (b) circumvent the restrictions imposed by Press Note 3⁶, the August Circular was issued by SEBI.
- The August Circular requires FPIs that fulfil certain prescribed criteria to provide 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.
- Hitherto, the August Circular is not applicable to ODI subscribers and to each segregated portfolio of FPIs (where FPIs invest through segregated portfolios).
- In this regard, (a) to rationalize the conditions relating to issuance of ODIs and (b) to reduce the potential regulatory arbitrage that exists between investments made through ODIs/ FPIs with segregated portfolios with sub-fund structures vis-à-vis the regular FPI route, SEBI released a CP on 6 August 2024 for public comments. The above proposals in the CP were approved by the SEBI Board

at its meeting held on 30 September 2024.

- SEBI has now released the Circular on 17 December 2024 introducing the changes proposed in CP. This alert summarises the amendments made by the Circular.

Conditions for issuance of ODIs by FPIs

- Presently, the conditions for issuance of ODIs by FPIs (as prescribed in Part D of the Master Circular⁴ dated 30 May 2024) are as follows:
 - FPIs are neither allowed to issue ODIs with derivatives as underlying nor hedge the ODIs with derivative positions on the stock exchanges, except in the following cases:
 - Derivative positions taken on stock exchanges by the FPI for 'hedging of equity shares' held by it in India, on a one-to-one basis.

'Hedging of equity shares' means taking a one-to-one position in only those derivatives, which have the same underlying as the equity share held by the FPI in India.
 - An ODI issuing FPI may hedge the ODIs referencing equity shares with derivative positions, subject to a position limit of 5% of market wide position limits for single stock derivatives.
 - The above is permissible only through a separate FPI registration with ODI as a suffix.
 - FPIs shall be required to segregate ODI derivative investments from propriety derivative investments.
- The Circular has replaced the above conditions with the following amendments:
 - FPI registration for ODI investments shall have "ODI" as suffix under the same PAN.

⁴ SEBI/HO/AFD/PoD-2/P/CIR/2024/70

⁵ The Securities Contracts (Regulation) Rules, 1957 read with Regulation 38 of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 make it mandatory for entities who have listed their equity shares on a stock exchange to maintain MPS of 25%. This ensures balance of promoter and public shareholding and reduces volatility in the market.

⁶ Press Note 3 dated 17 April 2020 provides that investment by an entity from a country which shares land border with India or where the beneficial owner of an investment into India is situated in/ citizen of any such country, shall only be under the Government route. Press Note 3 currently does not apply to FPI investments.

However, the same shall not be required where ODIs are issued with Government securities as underlying.

- FPIs shall not issue ODIs with derivatives as reference/ underlying.
- FPIs shall not hedge ODIs with derivative positions on stock exchanges in India. Further, ODIs shall be fully hedged with the same securities on a one-to-one basis, throughout the tenure of the ODI.

Applicability of Additional Granular Disclosures

For ODI subscribers

- As per the Circular, it will be mandatory for ODI subscribers to provide granular details of all entities holding any ownership⁷, economic interest⁸, or exercising control⁹ in the ODI subscriber, on a full look through basis, up to the level of all natural persons, without any threshold, if they fulfill the following criteria:
- Criteria (a) - ODI subscriber having more than 50% of its equity ODI positions through the ODI issuing FPI in ODIs referenced to securities of a single Indian corporate group; or
- Criteria (b) - ODI subscriber having 'equity positions' of more than INR 250 billion in the Indian markets.
- Equity positions include:
 - Equity ODI positions taken by the ODI subscriber through one or more ODI issuing FPIs
 - Equity ODI positions taken by ODI subscribers (through one or more ODI issuing FPIs) having common ownership, directly or indirectly, of more than 50% or common control with the ODI subscriber
 - Equity holdings of such ODI subscriber as a registered FPI
 - Equity holdings of FPIs having common ownership, directly or indirectly, of more than 50% or common control with the ODI subscriber
- ODI positions of ODI subscribers and holdings of ODI

issuing FPIs corresponding to the same underlying/ reference shares shall be counted only once so as to avoid double counting.

- Exemption from providing additional disclosures as currently applicable to FPIs shall also apply to ODI subscribers. This inter-alia includes:
 - Government and Government related investors.
 - Public retail funds, exchange traded funds (with less than 50% exposure to India and India-related equity securities), entities listed on specified exchanges.
 - Pooled investment vehicles meeting prescribed conditions.
 - University funds and university related endowments meeting the following conditions:
 - Indian equity ODI positions being less than 25% of Global Assets Under Management (AUM)
 - Global AUM being more than INR 100 billion equivalent
 - Appropriate return/ filing to the respective tax authorities in their home jurisdiction to evidence the nature of a non-profit organisation exempt from tax.
 - ODI subscribers/ entities identified on look through basis meeting specified conditions. These conditions are similar to the conditions applicable for exemptions given to FPIs vide the August Circular including exemption applicable with respect to Criteria 'a' i.e. additional disclosure shall not be required if the apex company of the corporate group has no identified promoter.
 - ODI subscribers breaching Criteria (a) and Criteria (b) shall not be required to make additional disclosure requirements, if their positions are realigned as per the below timelines:
 - For breach of Criteria (a) - within 10 trading days from the date of breach
 - For breach of Criteria (b) - within 90 trading

⁷ Ownership interest means ownership of shares or capital of the entity or entitlement to derive profits from the activity of the entity.

⁸ Economic interest means returns from the investments made by the entity.

⁹ Control includes the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of shareholding or management rights or shareholders agreements or voting agreements or in any other manner.

days from the date of breach

Obligations of ODI issuing FPIs

- Where additional disclosure requirements are applicable, the ODI issuing FPIs shall collect the details from the ODI subscribers within 30 trading days from expiry of the above timelines and submit the same to the Depositories within 5 trading days.
- Non-disclosure by ODI subscribers shall render them ineligible to subscribe/hold any ODI positions through any ODI issuing FPI. ODI issuing FPIs shall redeem all ODI positions held by such ODI subscribers within 180 calendar days from the date of such ineligibility. A list of such ODI subscribers shall be made public by the Depositories and ODI issuing FPIs shall ensure that no ODIs are issued to these entities.
- Detailed mechanism for independently validating conformance of the ODI subscribers with the conditions, exemptions and format for disclosures

shall be spelt out in a Standard Operating Procedure (SOP) framed and adopted by Depositories, Custodians and ODI issuing FPIs in consultation with SEBI.

For FPIs with segregated portfolios

- With respect to FPIs with segregated portfolio(s), the criteria of the FPI holding more than 50% of their India equity AUM in a single corporate group shall apply individually to each segregated portfolio of the FPI and each segregated portfolio of such FPI shall be treated as separate FPI for the purpose of compliance with additional disclosure requirements.

Transitionary measures for smooth operationalisation

Timelines for certain ODIs to be redeemed			
Sr. No.	ODIs issued and outstanding as on date of Circular i.e. 17 December 2024	Timelines to redeem the same	Remarks
1	ODIs with derivatives as underlying	1 year from date of Circular i.e. 17 December 2024	No renewal of such ODIs shall be permitted.
2	ODIs with securities (other than derivatives) as underlying and hedged with derivatives	1 year from date of Circular i.e. 17 December 2024	Permitted to be redeemed or hedged with same securities as the underlying on a one-to-one basis
Timelines for the Circular to come into force			
Sr. No.	Provisions of this Circular	Effective Date	
1	Changes relating to conditions for issuance of ODIs	Immediate effect	
2	Changes relating to additional disclosures	5 months from the date of this Circular. SOP to be issued within 2 months from the date of this Circular.	

Comments

Issuance of ODIs or P-Notes by FPIs to foreign investors who seek exposure to Indian markets, without the complexities of direct registration with SEBI and tax obligations has been permitted by SEBI since more than 2 decades. Since then, SEBI has progressively tightened the rules relating to issuance of these instruments, hedging mechanisms and introduced greater disclosure requirements, with the objective to reducing opacity and systemic risks in the Indian capital markets.

SEBI's Circular dated 24 August 2023 mandating disclosure of granular details of 'high risk' FPIs (identified via concentration and size criteria) was a significant step in the direction to bring increased transparency of ownership of FPIs. Suitable exceptions and detailed SOPs were issued for implementation of the provisions of the said Circular. The current Circular now seeks to harmonize the disclosure requirements of the Circular dated 24 August 2023 and extend them to ODI subscribers as well as to FPIs with segregated portfolios. In this regard, detailed guidance is provided on aggregation of FPI's own positions in Indian markets and indirect positions through the issuance of ODIs for the purpose of calculating the concentration and size thresholds. These changes will come into effect from 17 May 2025.

In addition, SEBI has also prohibited hedging of ODIs with derivatives as underlying with the stated intention to curb overleveraging and systemic risks posed by the use of derivative products. Existing exceptions related to the use of derivatives by ODI issuers have been done away with. This change is effective immediately for new ODI contracts whereas existing ODI contracts with derivatives as underlying have been given time until 16 December 2025 to unwind.

Issuance of a detailed SOP to be framed by DDPs in consultation with SEBI is awaited and should provide further clarity, where needed.

SEBI's measures relating to ODIs over the years has resulted in the total value of ODIs as a percentage of FPIs Assets under Custody declining from 44% in 2006-07 to 2.1% in 2023-24¹⁰. Despite this, given the attractiveness of the Indian capital markets, interest amongst foreign investors to avail of the ODI route continues to remain buoyant. It remains to be seen if the latest round of restrictions and disclosure requirements will impact the volume of ODI transactions. While SEBI's new changes should eventually increase transparency and assist in tracking foreign investments in the Indian capital markets more effectively, it will not be without its set of challenges. The new requirements may likely increase the operational burden on ODI participants as well as prime brokers (specifically relating to validating the disclosures reported by their clients) and DDPs who are required to monitor the various disclosure norms. Besides confidentiality concerns relating to ODI subscribers having to provide their ownership data to the level of last natural person could likely pose a challenge, at least in some cases.

From a tax standpoint, the revised norms relating to one-to-one hedging shall require further analysis and review of investment structures to assess the tax impact.

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¹⁰ Based on data provided in Consultation Paper dated 6 August 2024

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