Monday, June 12, 2017

CUTS International

Submission of Comments to Securities and Exchange Board of India (SEBI)

On

Consultation Paper on Streamlining of Process of Monitoring of Offshore Derivative Instruments (ODIs) or Participatory Notes (P-Notes)

1. Background

Securities and Exchange Board of India (SEBI) had issued a Consultation Paper on Streamlining of Process of Monitoring of Offshore Derivative Instruments (ODIs) or Participatory Notes (P-Notes) on 29 May, 2017 inviting comments from interested stakeholders.

Consumer Unity & Trust Society (CUTS, www.cuts-international.org) is a non-profit, non-government vigilant institution working in the area of economic regulation, financial sector, consumer protection, competition, trade, and investment since last 33 years.

2. CUTS Suggestions:

a. Broad Suggestion

1. As per the **Financial Sector Legislative Reforms Commission**, a well-structured regulation making process should be adopted with appropriate system of 'Checks and Balances'. The **Financial Stability and Development Council (FSDC)** (comprising financial sector regulators) on October 24, 2013 had decided that all regulations after Oct. 31, 2013 and all other subordinate legislations (including circulars, notices, guidelines, letters, etc.) issued after Dec. 31, 2013 shall comply with the following requirements[1]:
   a. No subordinate legislation may be published without a Board resolution determining the need for such subordinate legislation.
   b. All draft subordinate legislation should be published with statement of objectives, the problem it seeks to solve, and a '**Cost-Benefit Analysis' (using Best Practices)**.
   c. Comments should be invited from the public and all comments should be published on the web site of the regulator.

[1] (2013). *Handbook on adoption of governance enhancing and non-legislative elements of the draft Indian Financial Code.* New Delhi: Department of Economic Affairs, Ministry of Finance, Government of India .

It has been observed that despite a mandate from Financial Stability and Development Council (FSDC) that all the proposed regulations shall be supplemented with an analysis of the Costs and Benefits of its impacts, SEBI has been falling short on the same. According to a study, it has conducted only one Cost-Benefit Analysis in the period of June, 2014 to July 2015[2].

Also, in the aforementioned Consultation Paper, there is no information on such an assessment done for the proposed regulations.

Therefore, it is a strongly recommended that SEBI conducts an analysis of the costs and benefits of both its proposed regulations, i.e.

(i) Imposing a Regulatory Fee on the Offshore Derivative Instruments (ODIs);

(ii) Prohibition on issuance of ODIs against derivatives for speculative purposes.

b. Specific Suggestions

The specific suggestions regarding the above broad suggestion are as follows:

Sr. No.	Pertains to C.1. / C.2.	Suggestions	Rationale
1.	C.1.	To conduct an **analysis of the Costs and Benefits to the relevant stakeholders** pertaining to imposing a **regulatory fee** in order to cover the costs of the Monitoring System for ODI investment	1. The impacts of the past regulations (and monitoring) could be seen through reduced proportion of ODI in the overall investments by FPIs[3]. **However, there is no assessment available on the Costs and Benefits of imposing a regulatory fee** which shall demonstrate the impacts of the Monitoring Systems for the ODI route on the overall capital markets. Therefore, there is an inability to analyse: a. whether the regulatory fees is sufficient enough for covering the costs of monitoring the investments coming from ODI route; b. what impacts it shall have on the **genuine investors who use ODI route**; c. It is also not known whether SEBI attempts to cover the monitoring costs entirely or partially.

[2] As per Ajay Shah's Blog

[3] As per the consultation paper on streamlining the process of monitoring of offshore derivative instruments ODIs/ participatory notes dated May 29, 2017

			A cost and benefits analysis helps to look at the aptness of the proposed regulatory fee.
2.	C.2.	To conduct an **analysis of the Costs and Benefits to the overall Indian Capital Markets** associated with prohibition on issuance of ODIs against derivatives for speculative purposes	1. Although, prohibition of issuing ODIs against derivatives for speculation purposes is well intended, however, **it is difficult to trace the difference between Speculative and Hedging practises**. 2. Citing the **recent order dated 24th March, 2017 against Reliance**, SEBI had put forth that the transactions made by Reliance in 2007 through third parties in its subsidiary (Reliance Petroleum) were speculative in nature and Reliance made a submission that the transactions were done to hedge against the risks[4]. Therefore, defining the scope of speculation can be very tricky for SEBI. **In such a situation, conducting an assessment of what costs could be incurred and what benefits could be gained from prohibition of speculation shall help in demonstrating the net impact of the proposed regulation.**
3.	C.1.	In order to keep a check on the misuse of ODI route, it is suggested that SEBI comes out with **other distinct regulatory mechanisms rather than imposing a regulatory fee**	1. The indirect aim of imposing regulatory fee is to make the P-Notes (or ODIs) ineffective and that all the investors directly register themselves as an FPI such that the ODI route is not misused. 2. It is believed that the average ticket size of an ODI subscriber is around US$ 20-25 million and there are 1500 such subscribers[5]. 3. The notional value of ODIs on Equity and Debt for the month

[4] As per the order of SEBI dated 24th March, 2017. Accessed at file:///D:/PRP/SEBI/court%20oders/1490368260664.pdf

[5] Business Standard, May 30, 2017

			of April, 2017 was INR 128,380 crores[6] and as per NSDL, on a daily basis, around INR 2813.33 crores of net investments are done through P-Notes[7]. There are 8779[8] FPIs registered with SEBI. So, on an average one FPI may be having a 'Net Investment' of INR 0.3 crores in ODIs. Some of the investors have even invested around US$100 million each[9] **The regulatory fee of US$1000 may prove to be ineffective to change the behaviour of the ODI investors and curb the misuse of this route. Therefore, a different approach could be used to control the misuse of the route and yet ensure that genuine investors do not feel the pinch.**
4.	C.1.	Distinct Regulatory Mechanism rather than imposing a Regulatory fee	1. The existing regulations have been successful enough to drastically reduce the notional value of ODIs (in equity, Debt and Derivatives) from once 50% to 6% in the overall FPI investment[10]. 2. Considering this minor share of ODIs in the overall FPI investments, the regulatory fee may have negative implications on genuine investors who use ODI route for legitimate investments. 3. Therefore, an all accommodative regulatory mechanism is needed that does not drive away the genuine investors from the market. **It would be important to see if SEBI is over-regulating the ODI route which**

[6] As per the consultation paper on streamlining the process of monitoring of offshore derivative instruments odis participatory notes dated May 29, 2017
[7] As on June 08, 2017; data available on https://www.fpi.nsdl.co.in/web/Reports/Latest.aspx
[8] As per https://www.fpi.nsdl.co.in/web/Reports/RegisteredFIISAFPI.aspx
[9] As per Mint on Feb 19, 2017
[10] As per the consultation paper on streamlining the process of monitoring of offshore derivative instruments ODIs participatory notes dated May 29, 2017

			may be pushing the genuine investors out of the market.
1.	C.1.	To **provide further information on** how the **registration process for FPIs** could be **further simplified** for the ODI investors	1. The main reason that many investors choose the ODI route is that it has less regulatory compliance for them. **Streamlining the FPI registration norms is necessary to incentivise ODI subscribers to register directly as FPI.** 2. Registering oneself as an FPI has significant compliance cost on foreign investors[11]. Apart from the eligibility criteria and huge documentation requirement for registrations, the FPI also has to engage with a designated depository participant, appoint a custodian of securities, appoint a designated bank, deal in foreign exchange and bear its risk, etc.[12] 3. It would have been better if SEBI could provide more information on how the FPI registration process shall be simplified for the ODI subscribers.

****

[11] Business Standard dated October 6, 2016
[12] As per Sections 25, 26 and 27 of SEBI (FPI) Regulations, 2014