INVESTMENT FUNDS ALERT

SECURITIES AND EXCHANGE BOARD OF INDIA AMENDS POLICY MEASURES ON OFFSHORE DERIVATIVE INSTRUMENTS

INTRODUCTION

In response to the turmoil in the U.S. financial markets, the Securities and Exchange Board of India (SEBI) announced in a press release issued on Monday, October 6, significant changes to Indian regulations governing foreign institutional investors (FIIs) and unregistered foreign investors who intend to invest in the Indian securities market. In order to encourage the inflow of foreign capital into India, SEBI has removed the restrictions placed on the use of offshore derivative instruments (ODIs)—often referred to as “participatory notes” or “p-notes”—to invest in the Indian market.

BACKGROUND

On October 26, 2007, SEBI had announced regulations designed to limit the issuance of ODIs by FIIs. First, FIIs were restricted from issuing or renewing ODIs that use other derivatives as the underlying assets, i.e., second or third derivatives. All such investments were required to be concluded by March 31, 2009. Second, FIIs could issue ODIs so long as the total notional value of all such ODIs in their portfolios was less than 40 percent of their total assets under custody (AUC). The issuance of ODIs would be limited, however, to a valuation of no more than five percent of their AUC in India in any 12-month period, so long as they stayed below the 40 percent cap. Third, if FIIs had already issued ODIs with a value greater than 40 percent of their AUC, such FIIs could only issue additional ODIs if they cancelled or redeemed their existing ODIs and stayed below the 40 percent cap. Fourth, these ODIs could only be issued by “regulated” FIIs (i.e., FIIs regulated by regulators that, in SEBI’s belief, provided appropriate oversight and reporting) and were no longer issuable by FII sub-accounts. Lastly, the purchasers of ODIs were likewise limited to those investors that were “regulated” under the same SEBI standard as for issuance of ODIs.

These restrictions were designed to limit the participation of hedge funds in the Indian capital markets. SEBI viewed foreign hedge funds cautiously because of the potential volatility that large inflows and outflows of capital could cause to India’s capital markets. This fear, coupled with the rapid growth of the p-note market in Indian securities in 2006 and 2007, motivated SEBI to require foreign hedge funds investing in India to register directly with SEBI as FIIs.
ANALYSIS

According to SEBI’s announcement made on October 6, FIIs may now issue ODIs that have derivatives, such as futures and options, as underlying assets, and the cap of 40 percent of AUC is removed. SEBI’s press release was silent regarding (i) whether such ODIs could only be issued by “regulated” FIIs or whether they could be issued by FII sub-accounts, and (ii) whether or not ODIs could now be issued to those investors that are not “regulated”. Presumably, these restrictions are still in play.

It is also important to note that SEBI’s recent changes do not preclude the advantages of registering as an FII for funds investing substantial amounts of their assets in India. FIIs still have substantially more flexibility to buy and sell listed securities than other entities such as foreign venture capital investors (FVCIs) and foreign direct investors (FDIs). FIIs can also invest in certain types of debt and government securities in which FVCIs and FDIs cannot invest, and they have simplified procedures for foreign exchange issues. However, yesterday’s changes make investing in Indian capital markets much more viable for funds seeking exposure to Indian securities but unwilling to register with SEBI as FIIs. We anticipate that investment banks operating in India will start offering p-notes to their foreign clients within the next few days.

Those wishing to take advantage of this relaxation in the rules regarding the issuance of ODIs are urged to contact us if they have questions regarding their status as “regulated” (and their eligibility to purchase ODIs) under SEBI’s regulations. In addition, significant uncertainty continues to exist for those investors possessing an FII license that also wish to avail themselves of ODIs.

These last few weeks have brought with them once-in-a-lifetime scenarios that most securities regulators could not have contemplated a year ago. Like many regulators, SEBI does not wish to limit the inflow of capital to India at a time when it is most needed. SEBI often takes an incremental approach to its regulations and this may not be the only change prompted by the global financial crisis. We will remain updated on any further developments as they happen.

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