5 questions on SEBI and recent directive on Offshore Derivative Instruments (ODI) or P Note

SEBI has over the years made various amendments to reduce the quantum of outstanding ODI or participatory notes as they are popularly called.

Why do Institutions issue participatory notes?
There are lot of formalities to be complied with when NRI or an institution wants to participate in the Indian markets. Hence, instead of directly taking part, certain instruments are issued, which are a lookalike to actual investment. For instance, if you wish to buy Nifty in the Indian market, the Foreign Institutional Investor or FII will issue a participatory note, which represents the Nifty of the quantity that the investor desires to buy. The investor gets the rate and quantity locked in. It was presumed that the P notes would be represented by underlying security, which means there must be supporting stock or derivatives contract to support the P note issued.

How does investor exit the P Note?
Once the investor decides to exit, the price difference is settled. The difference in rate on the date of purchase and that on date of sell is taken. If there is profit, it is paid to the investor and if there is loss, it is recovered. Normally, there is daily or periodic mark-to-market of these transactions.

What is the risk associated with such P Notes?
The first risk is of KYC. We do not know who the person participating in our market is, though indirectly. This has been minimized by SEBI by asking FIIs to disclose the KYC details of P notes holders. Second, the FII may or may not cover the position in local markets. Hence, the FII is trading on proprietary account and such positions can have losses, which are not disclosed to Indian authorities.

What is the current change by SEBI?
SEBI has now mandated that no P Notes will be issued for purpose other than hedging. Hedging means if you have bought a Nifty stock, you will sell Nifty index so that if there is fall in your purchase price, the Nifty, which is sold will also go down and you will get a positive cash flow. Hedging is also limited to cash holding. Thus, if you have 1000 shares, hedging can be done. It appears that short selling was done by institutions on P notes. In India, delivery is not mandatory for short sold contracts. The transactions just get off the floor on expiry by settling in cash. If delivery was mandatory, the short selling would get covered in the market and it would stabilize the market. In absence of delivery pressure, markets can go one way. Second, since there is no reporting of quantum of short selling, the risk in markets are higher since the real market outstanding is not revealed. You do not know whether the market is over bought or sold.

How will this directive impact the market?
Short sellers who have unhedged position will have to exit the markets by covering their short positions and buying in the market. Of course, lot of time has been given to liquidate the instrument, it should be liquidated on maturity or by 31st December 2018. Data shows that lot of these instruments are short dated. Hence, the impact of covering can be seen in the next 2-3 months. The rally in market can be attributed to this circular since many will buy thinking that FII will be covering their shorts and the FII investors may also not want to wait until maturity and exit their positions.

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