



SEBI PROPOSES CHANGES TO THE P-NOTES REGIME TO CHECK MONEY LAUNDERING

Introduction

On May 19, 2016, the Securities and Exchange Board of India (the “**SEBI**”), in its board meeting, specified certain additional measures to enhance transparency and control over the issuance of offshore derivative instruments (“**P-Notes**”). These measures will come into effect through appropriate amendments in the existing regulations.

Background

The SEBI (Foreign Portfolio Investors) Regulations, 2014 (the “**FPI Regulations**”), set out the current regime for the issuance of P-Notes. The FPI Regulations define offshore derivative instruments or P-Notes to mean any instrument issued overseas by a foreign portfolio investor (“**FPI**”) registered under the FPI Regulations against securities held by the FPI (which are listed or proposed to be listed). Under the FPI Regulations, only specified FPIs may issue P-Notes to persons regulated by an appropriate foreign regulatory authority, and FPIs must ensure that any transfer or sub-issuance of P-Notes is also made only to persons regulated by an appropriate foreign regulatory authority. Moreover, the prescribed “know your client” (“**KYC**”) norms have to be complied with.

The SEBI requires an issuer of P-Notes to report and disclose all information concerning the terms of issuance, parties names, etc. in a prescribed format.

Outcome of the SEBI Board Meeting

As it was felt that the existing P-Notes regime needed to be tightened further, the SEBI has proposed to implement the following measures to better regulate the P-Notes regime.

Indian KYC norms to apply: Currently, an issuer of P-Notes can conduct the KYC check either under the KYC or anti-money laundering norms applicable in India or in the jurisdiction of the beneficial owner of the P-Notes. The SEBI has now proposed that the KYC check should be done by applying only Indian KYC and anti-money laundering norms. Further, the P-Notes issuer will now have to identify and verify the beneficial owner(s) of the subscriber entity if the beneficial owner(s) owns a stake in the subscriber entity in excess of the threshold specified under Rule 9 of the Prevention of Money-laundering (Maintenance of Records) Rules, 2005, (i.e., in excess of 25% in case of a company and 15% in case of a partnership firm or trust).

KYC review: The SEBI has proposed that the KYC review should be conducted based on the risk criteria determined by the P-Notes issuer, i.e., at the time of onboarding and once every three (3) years for low risk clients; and at the time of onboarding and every year for all other clients.

Prior permission for transfer of P-Notes: At present, the subscriber of P-Notes does not need the permission of the P-Notes issuer for transfer or sub-issuance of the P-Notes to another offshore investor. The SEBI has now proposed that such transfers should be effected only with the prior permission of the P-Notes issuer.



Reporting of transfer of P-Notes: A P-Notes issuer will now be required to provide details of all transfers of P-Notes in its monthly reports to the SEBI under the FPI Regulations. Under the existing regime, information on transfers is only required to be made available to the SEBI on demand. _

Reporting suspicious transactions: A P-Notes issuer will now have to file a suspicious transaction report in relation to P-Notes issued by it with the prescribed authority in this regard.

Reconfirmation by P-Notes issuers: A P-Notes issuer will have to reconfirm its P-Notes position on a semi-annual basis. Separately, a P-Notes issuer will have to carry out a periodic review and evaluation of its controls, systems and procedures with respect to P-Notes.

Our Comments

Some time back, India's Supreme Court appointed a special investigation team to check on potential misuse and round-tripping of Indian money through the use of P-Notes. The SEBI is now beginning to implement the recommendations of the special investigation team's report. In our view, the SEBI's strategy seems to be to avoid a complete clampdown on P-Notes, but yet make the product less attractive. It is unlikely that these proposed changes will result in a knee-jerk reaction in the stock markets, but in the long term, funds coming in through the P-Note route will be affected, as the responsibility for compliance (and any liability for non-compliance) has largely been imposed on the issuer. Morgan Stanley, Goldman Sachs, JP Morgan and Credit Suisse, who are among the biggest P-Note issuers in the Indian market, have been quoted by the press as saying that the changes will not only make the route difficult to access the India market, but will also make it more expensive.