Sebi to tighten KYC, transfer norms for P-Notes

Acting upon recommendations of the Special Investigation Team on black money, market watchdog Sebi plans to tighten due diligence requirements for issuance and transfer of controversy-ridden P-Notes and put the onus on investors to ensure compliance with anti-money laundering law.

While Sebi (Securities and Exchange Board of India) has been of the view that the regulations have already been strengthened to check any misuse of this route for money laundering like activities, it has decided to put in place additional safeguards as suggested by the SIT.

The regulator plans to put in place six specific changes to the KYC (Know Your Client) norms and transferability of Offshore Derivative Instruments (ODIs) -- commonly known as Participatory Notes or P-Notes -- in this regard.

The proposed changes have been finalised after discussing with concerned stakeholders including some major issuers of P-Notes and they have broadly agreed to the suggested measures in the interest of the markets, a senior official said.

These include mandating the issuers of P-Notes to file Suspicious Transaction Reports (STRs), if any, with the Indian Financial Intelligence Unit (FIU) in relation to the ODIs issued by them.

On the KYC norms, while current regulations also mandate that ODIs can be issued only after compliance to the KYC requirements, the issuer entities have been adopting either the Indian AML (Anti Money Laundering) norms, norms in the jurisdiction of the issuer or the norms in the jurisdiction of the end beneficial owner or the ODI subscriber.

As per the proposal, Indian AML norms would need to be followed by issuer entities for carrying out customer due diligence of the ODI subscribers.

Officials said the regulations have been very robust to check any misuse of P-Notes and the proposed changes might not affect the flow of funds in a big way as they are mostly procedural in nature and do not drastically change the regulatory framework.

P-Notes are typically instruments issued by registered foreign institutional investors to overseas investors, who wish to invest in the domestic stock markets without registering themselves directly in India, but still need to go through a proper due diligence process.

P-Notes make up for about 10-12 per cent of the total FII inflows, as against over 50 per cent at the peak of stock market bull run in 2007. Rules have been tightened several times in recent years to check any misuse of this route, but P-Notes have still continued to court controversies.

The Supreme Court appointed SIT on black money last year had suggested that Sebi should further strengthen its norms to keep a tab on beneficial ownership of P-Notes as they were widely used by foreign investors and could be prone to misuse.

The slew of measures that have now been proposed by Sebi in this regard would require the ODI issuers to identify and verify the persons with exposure in excess of a pre-defined threshold in the subscriber entities -- which could be 25 per cent in case of a company and 15 per cent in case of partnership firms, trusts or unincorporated bodies.

The KYC review would need to be carried out as per the risk profile of the subscribers.

The issuer would also need to do reconfirmation of the ODI positions on a semi-annual basis, while such reconfirmation reports, along with any breaches and the remedial actions, would need to be reported to Sebi.

In current norms, there is also a lack of uniformity amongst the issuer entities when it comes to identifying the persons controlling the operations of the subscriber entities.

This gap would be taken care of through periodic reporting to Sebi, as per the risk classification of the subscriber.

On transfer of ODIs, the current regulations state that any further issue of transfer of any ODI is made only to persons regulated by an appropriate regulatory authority.

It has been proposed now the issuer entities would ensure that the transfer of OFIs is done to only such entities that are eligible to invest in ODIs and have been pre-approved by the issuer entities.

However, the transfers are as such very rare as such and are mostly related to the rebalancing of portfolios.

Recently, Sebi Chairman U K Sinha had said strong measures have been put in place to check any misdemeanors including misuse of P-Notes, as he sought to put to rest concerns that these instruments were misused to bring back black money into the country.

He had said sufficient safeguards have been put in place to check any possible gaps and Sebi is now in a position to identify and check details of beneficiary owners of such funds to the second, third and even fourth levels.

In case of any irregularities, Sebi can take penal action and also share the details with the tax department and other authorities for further action on their part.

Earlier it was difficult to identify the end-users of such instruments, but since 2014 Sebi has limited the rights for who can subscribe to these instruments to only two of the three classes of Foreign Portfolio Investors. These are sovereign funds and regulated entities, while others are already debarred others from using P-Notes.

"It has been said that PNs are a big source for bringing black money into the country. Prior to 2011, we did not know who were subscribers of P-Notes and who were the subsequent beneficiary owners. Now, by regulations, every month Sebi is getting the information who are the latest beneficiary owners of the P-Notes," Sinha had said in an interaction.

(Business Standard)