

## **An Analytical Review of the Regulation and Trend of Participatory Notes in the Indian Financial Market**

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### **ABSTRACT**

India allowed Foreign Institutional Investors (FIIs) to buy stocks listed on Indian exchanges. However, all investors, whether institutions or individuals, were required to register themselves with the capital markets regulator, SEBI. To get around these restrictions, FIIs started to issue so-called participatory notes. This paper attempts to review the problems, regulations, growth and the recent trends in PN investments.

### **INTRODUCTION**

Participatory Notes (PN) — a general name used for the investment by Foreign Institutional Investors (FIIs) through Offshore Derivative Instruments (ODIs) such as Participatory Notes, Equity-Linked Notes, Capped Return Notes and Participating Return Notes — have created a storm in the stock market, with SEBI coming out with a draft for discussion to regulate them, the RBI suggesting that they be phased out, and the Finance Minister assuring that the Government is not going to phase them out.

First things first. Let us clearly understand the fundamental issues. The PNs are a slap on the face of every citizen who is an investor. For a person to invest even in one share, several KYC (know your customer) forms have to be filled up, and PAN numbers and proof of address, etc., provided. For the PN investor the system is totally silent on even elementary information. The FIIs issue PNs to funds/companies whose identity is not known to the Indian authorities.

Hence, the PN system is blatantly discriminatory and seems to favour ghost investors. Any self-respecting market, if it discriminates at all, does so against outsiders. But we have done the unthinkable.

### **SEBI REGULATION ON PN**

1. Participatory notes are the financial instruments through which individual foreign investors or hedge funds who do not want to disclose their identity can invest in Indian markets, otherwise registration with Sebi is a must to get an exposure into Indian equities.
2. Registered foreign institutional investors (FIIs), foreign banks and brokerages based in India issue P-notes to foreign investors and invest in Indian stocks on their behalf. Any dividends or capital gains collected from the underlying securities go back to the investors.
3. While a common investor has to fill up several KYC (know your customer) forms, provide PAN number and proof of address, etc, a P-Note investor can invest anonymously. This makes it a 'legal' way to route unaccounted wealth in Indian equities, thus feeding the black money monster.
4. Other than politicians, bureaucrats or business-persons, even terror financiers are feared to misuse the P-Note route to fulfil illegal objectives.
5. A Special Investigation Team (SIT) appointed by the Supreme Court, a few months ago, came out with a report on black money and exposed the links between Indian stock market and international tax havens.
6. A flurry of suggestions SIT made to tackle the black buck menace, including cancelling the participation in the Indian markets by way of P-notes altogether.
7. Taking cues from the suggestions, Sebi has now made it mandatory for the P-Notes holders to adhere to Indian Know your customer (KYC) or anti-money laundering (AML) norms.
8. Sebi has also put curbs on the transfer-ability of P-notes between two foreign investors. Further, it has also increased the frequency of reporting by P-notes issuers.
9. Brokerage Angel Broking said the new set of rules is likely to tighten the round tripping of money by Indian investors, but might see some slowdown in the incremental funds flow in to Indian markets.
10. The brokerage, however, believed foreign investors with a long term horizon in India should have no issues adhering to the new set of norms.

### **ROOT FOR UNACCOUNTED MONEY**

In 1992, India allowed Foreign Institutional Investors (FIIs) to buy stocks listed on Indian exchanges. However, all investors, whether institutions or individuals, were required to register themselves with the capital markets regulator, Sebi. To get around these restrictions, FIIs started to issue so-called participatory notes (or PNs) to investors who, for various reasons, wanted to remain anonymous. PNs were essentially Overseas Derivative Instruments (or ODIs) that had Indian stocks or derivatives as their underlying securities, with the holder entitled to the income or capital appreciation from such investment. The practice was sort of legitimized during the tenure of D R Mehta as Sebi chairman, after a High Level Committee on Capital Markets in 2002 allowed sub-accounts of FIIs to issue such contracts. Since PNs tracked the value of Indian stocks, their values rose or fell according to the movement of the markets. Initially, nobody complained, as FIIs generated a lot of business from monies routed through them and their accounts. These monies fuelled the market boom from the early period of liberalization. At their peak during 2007, the value of PNs constituted well over 50 per cent of the outstanding assets in the custody of FIIs.

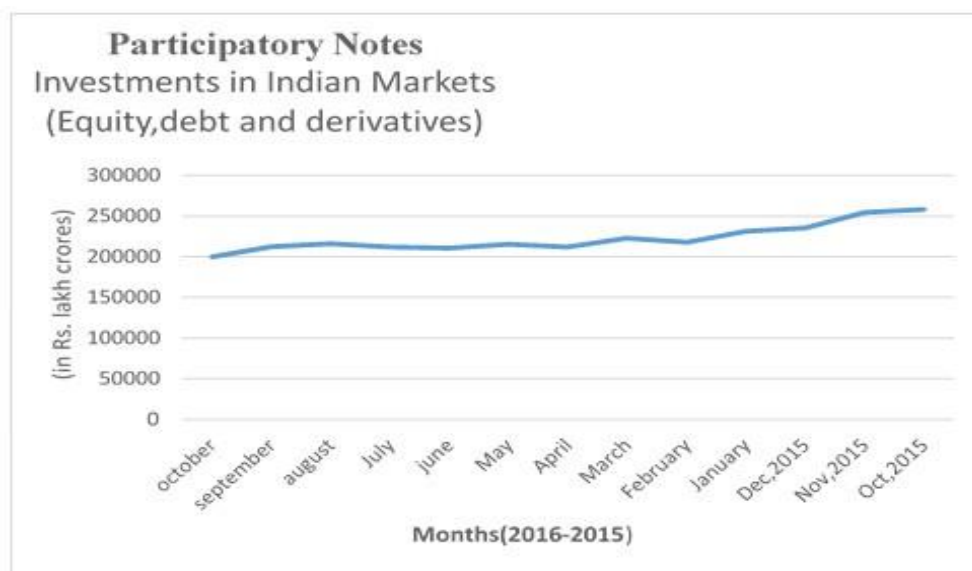
The first category is the real PN expects the returns and goes as per regulations.

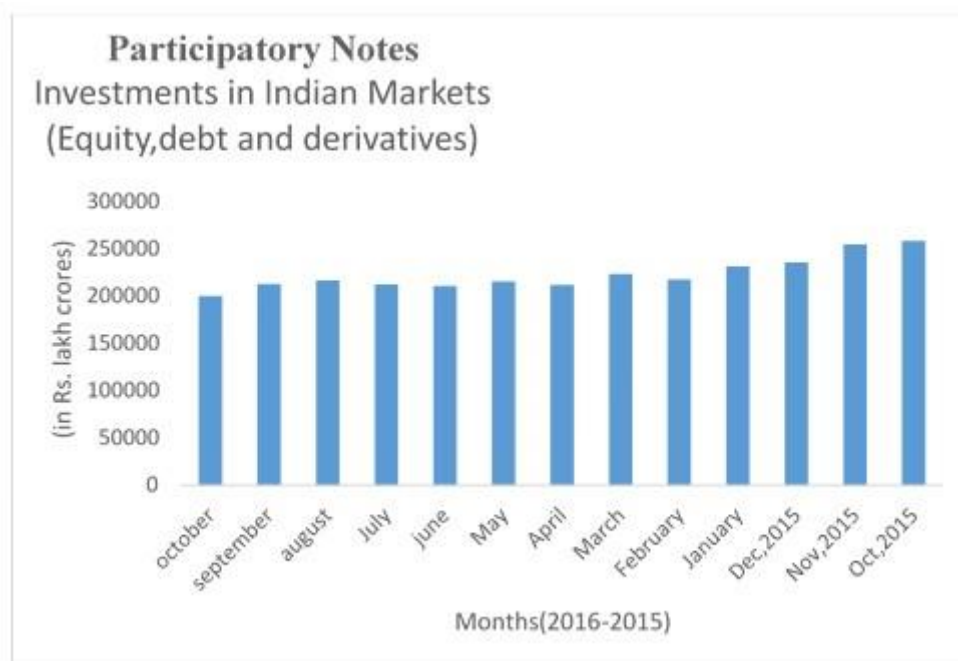
The second category is prodigal money returning. It is not a secret that a large number of politicians/bureaucrats/business-persons have accumulated wealth abroad. This has been accumulated by under-invoicing/over-invoicing, by corruption in contracts and gifts from abroad; and by not bringing in legitimate receipts.

The third category is those foreign governments/entities who would like to acquire/control Indian entities by taking them over.

The fourth category is the terror financiers who could find this route attractive and simple. The first category does not have any reason to use the “anonymous” route since the aim is to earn returns /repatriate and benefit out of interest rate and currency value arbitrage. They enter and exit as per these calculations and are not shy about the greed for maximum returns. They pay the taxes applicable and laugh all the way to the bank with bonus incentives. The only issue is that currently the stock market is the only route for investing while several other “unlisted” sectors, such as trade, transport, restaurants and other services are starved of funds. Maybe methods should be evolved to get these regular global funds to invest not just in the top ten shares of the stock market but in the needs of the large non-corporate or “unlisted” segments of the economy, through NBFCs. That would ease the volatility in the market since currently large funds are chasing too few shares of the Sensex or Nifty.

**RECENT TREND OF PN**





P-Notes are typical instruments issued by registered foreign portfolio investors (FPIs) to overseas investors who wish to participate in Indian markets without registering themselves directly in the country to save time.

## CONCLUSION

The total value of P-Notes investment in Indian markets has fallen since October 2015 and the trend continued till February this year. However, it saw a slight increase in March but again dipped in April. Concerns have been expressed over anonymous investors who are beyond the reach of Indian regulators or taxmen, and over indications that wealthy Indians, including promoters of Indian companies, have been using this route to bring back unaccounted funds and to rig their stocks. After Demonitization took place in the month of November instead of block money inflow in the markets, there was decrease in PN investments. It is needless to say that serious steps to be taken for the real PN inflow and restrict the block money laundering through PN.

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