Participatory Notes

All those who want to invest in the Indian securities need to be registered with the SEBI. A foreign institutional investor, established outside India, who intend to make investments in India, works in a programmed environment and acts in accordance with the SEBI (Foreign Institutional Investors) Guidelines, 1995. One has to adhere to many regulations in order to be registered with the SEBI to invest in the Indian securities. Using *participatory notes* that act as easy solution from being registered with the SEBI, one need not register with the SEBI and thus may maintain anonymity. Read on to know more about these *notes*...

All those who want to invest in the Indian securities need to be registered with the SEBI, the regulatory body that overviews the markets. Foreign institutional investors (FIIs) are entities that are established or incorporated outside India, and which intend to make investments in India. FIIs work in a very taut and programmed environment, and act in consonance with the guidelines suggested and cased by the SEBI (Foreign Institutional Investors) Guidelines, 1995. Also, FIIs have to act in accordance with the regulatory notifications of the RBI, as the RBI has the final say on matters specifically concerning foreign exchange. These FIIs need to get registered with the SEBI. Entities or funds that are permitted to be registered as FIIs include pension funds, mutual funds, insurance companies/reinsurance companies, investment trusts, banks, international or multilateral organisations or agencies thereof or a foreign government agency or a foreign central bank, university funds, endowments (serving broader social objectives), foundations (serving broader social objectives), and charitable trusts/charitable societies. Portfolio managers, trustees, investment managers/advisors and asset management companies (AMCs) are also eligible to be registered as FIIs.

Hedge funds, also called *fund of funds*, are short-term funds and they rarely buy and hold any stock for long periods. Quantum of investments required in hedge funds is extremely huge. Accordingly, most of the hedge funds are owned by mutual fund companies that pool resources together to allocate and provide for huge amounts required in hedge funds.

There are umpteen regulations that one has to adhere to, in order to be registered with the SEBI to invest in the Indian securities. Plus, one is under constant scrutiny of the regulators. *Participatory Notes*, also called P-Notes or PNs, act as an easy solution from being registered with the SEBI. Using P-Notes, one need not register with the SEBI and it, thus, facilitates maintaining anonymity. P-Notes thus enable interested investors or hedge funds that are not registered with the SEBI to invest in the Indian securities.

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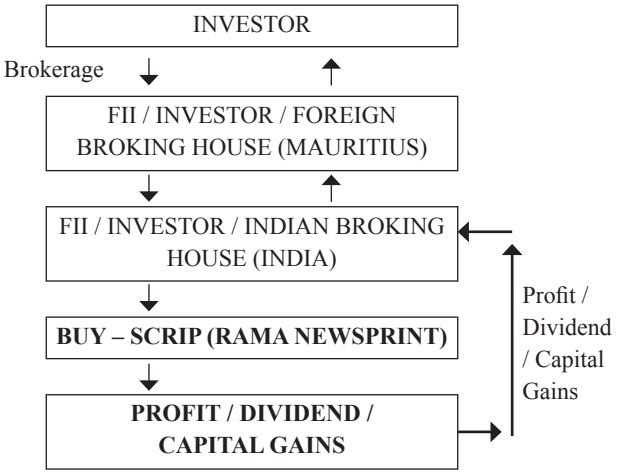
How are P-Notes issued?

P-Notes are used when one wishes to make investments in the Indian stock markets from outside the country. The investments are made in the shares listed in India. Accordingly, they are also called *offshore derivative instruments*. When investors express their intent to invest in a particular Indian stock, an investment bank/ institution with an FII status may issue a P-Note to them. The said bank/financial institution would subsequently purchase that Indian stock under its own name, and issue it to the investors in nature of a P-Note. Thus a P-Note is nothing but an opaque veil on an Indian stock. All dividends and capital gains accrued and earned on such stock go back to the investors, after reduction of the mutually agreed brokerage to the bank.

The following depicts a simplified procedure of how P-Notes are transacted:

Say an investor in Mauritius intends to invest in Rama Newsprint Limited, a scrip registered on the Indian stock market, and uses the services of a hedge fund for the same. In such a case, the said investor will be issued the said securities through the following procedure:



Who can invest in P-Notes?

SEBI has put forth the following rules for enabling entities to invest in India through the P-Notes' route:

*"**a.** Any entity incorporated in a jurisdiction that requires filing of constitutional and/or other documents with a registrar of companies or comparable regulatory agency or body under the applicable companies legislation in that jurisdiction;*

***b.** Any entity that is regulated, authorised or supervised by a central bank, such as the Bank of England, the Federal Reserve, the Hong Kong Monetary Authority, the Monetary Authority of Singapore or any other similar body provided that the entity must not only be authorised but also be regulated by the aforesaid regulatory bodies;*

***c.** Any entity that is regulated, authorised or supervised by a securities or futures commission, such as the Financial Services Authority (UK), the Securities and Exchange Commission, the Commodities Futures Trading Commission, the Securities and Futures Commission (Hong Kong or Taiwan), Australia Securities and Investments Commission (Australia) or other securities or futures authority or commission in any country, state or territory;*

***d.** Any entity that is a member of securities or futures exchanges such as the New York Stock Exchange (Sub-account), London Stock Exchange (UK), Tokyo Stock Exchange (Japan), NASD (Sub-account) or other similar self-regulatory securities or futures authority or commission within any country, state or territory provided that the aforesaid organisations which are in the nature of self regulatory organisations are ultimately accountable to the respective securities/financial market regulators.*

***e.** Any individual or entity (such as fund, trust, collective investment scheme, Investment Company or limited partnership) whose investment advisory function is managed by an entity satisfying the criteria of (a), (b), (c) or (d) above."*

Benefits Derived from P-Notes

Following are the incentives which lure a prospective investor to take the P-Notes' course:

1. *Ease of Trading:* Trading through P-Notes is a very trouble-free, easy and quick process because P-Notes are easily transferable. No regulations set by market regulators or the RBI have to be adhered to for their conveyance.
2. *Anonymity:* Anonymity is the foremost reason why an investor invests through the mode of P-Notes. P-notes enable an investor to hedge funds on the Indian stock market without disclosing their identity.
3. *Economical:* Investors often find it costly to establish broker and custodian bank relationships, deal in foreign exchange, obtain or maintain an investment identity or regulatory approval in certain markets, and more importantly, pay taxes. Such investors look for an effortless and painless solution to gain exposure in individual, or a basket of, stocks in the relevant market.
4. *Money Laundering:* P-Notes are an easy route for many who carry funds out of the country through hawala, and then get it back into India using the anonymity provided by P-Notes.

Vis-à-vis these merits, investors investing in the Indian securities through P-Notes face only one major problem which is, that the investor is a deemed captured client of the P-Note issuer, such that he must egress the position only through the broker/issuer of the participatory note.

Regulatory and Reporting Requirements for FIIs

SEBI has proposed stringent reporting requirements for FIIs; the regulations are:

"1. FIIs and sub-accounts that issue, renew, cancel, or redeem participatory notes are required to report

their activity to SEBI on a monthly basis by the seventh day of the following month.

2. FIIs and sub-accounts investing in or subscribing to participatory notes, access products, offshore derivative instruments, or any such type of instrument and security with underlying Indian market securities are required to report on a quarterly basis.

3. FIIs and sub-accounts that do not issue participatory notes but trade and hold Indian securities during a reporting quarter are required to submit "nil" undertaking on a quarterly basis.

4. FIIs and sub-accounts that do not issue participatory notes and do not have trades or holdings in Indian securities during a reporting quarter are not required to report for that reporting quarter."

A reporting quarter starts from January and runs as January–March, April–June, July–September, and October–December.

2007 Crisis

It is luring to see increasing foreign investment flowing into a country, but at the same time, it is also imperative to monitor where this foreign investment is really coming from. Not only the size, but also the sources of these funds are really important to be tracked. Though the popularity of P-Notes is on the rise, the growth of P-Notes as an investment opportunity is a matter of concern for the stock market regulators and the RBI. The apprehension and the unease is rooted in the fear that it is the laundered money that is paving its way into the Indian markets. To solve this problem, the SEBI had proposed to restrict issuance of P-Notes on 16th October, 2007.

This was taken very unwelcomingly by the investors and the following day, the Sensex crashed by about 1745 points, being 9 per cent of its value. This was the biggest intra-day fall in Indian stock markets in absolute terms and led to an automatic suspension of trade for an hour. It was then that the-then Finance Minister Mr. P. Chidambaram, was requested to manage the situation. He elucidated that the government was not being hostile to the FIIs and there was no instantaneous prohibition on P-Notes. After this announcement, the stock market opened again and a remarkable reversal was seen in the market position to welcome the Finance Minister's proclamation.

Though the situation was well handled at that point in time, this incident clearly anguished every investor citizen of the country. It clearly laid out that India was not ready to let go its foreign investments, even if that led to compromising on regulations set out by allowing anonymous investments.

Who Uses P-Notes Route?

P-Notes can essentially be used by people from four categories:

1. First is of regular investors whose only objective is to make earnings on a round the clock basis. They are interested in the growth that India showcases and truly believe that Indian returns are more attractive compared to developed markets. These regular investors' motive is not so much to make anonymous investments.
2. Second is of those who illegally mint money, and want it invested back into India. It is not a secret that a large number of politicians/bureaucrats business-persons have accumulated wealth abroad. This secretively accumulated wealth is a result of illegitimate money earned through corruption, money laundering, anonymous gifts from abroad etc.
3. Third comprises companies and high net-worth individuals who plan to take over an Indian entity by secretively investing in them.
4. Fourth comprises people who simply find this route very simple and uncomplicated to follow.

P-Notes on Derivatives

P-Notes on derivatives allow unrecognised investors to not invest in Indian equities, but also carry out hedging and speculative trading. This gives them not only the benefit to earn a wholesome when the market is showing a positive trend, but also an opportunity to make the most of the rising value of the Indian rupees. It further casts a threat on the Indian economy as these inflows are extremely short-term in nature, and may be reversed abruptly by an investor, causing immense volatility in the financial market.

Conclusion

The SEBI's FII rules provide that every FII shall unquestioningly offer all information as regards its trades carried out to SEBI/RBI, as required by them. Considering SEBI and RBI have been unsuccessful in blocking the P-Notes route, it may best be suggested that the SEBI carry out raids or go for surprise checking of the information to be supplied by FIIs, so that FIIs maintain the proper accounts as to where these funds are being maintained in compliance with the guidelines framed by SEBI. It is time that, what ever be on paper, be brought in action. ■