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P. Notes and sub accounts: The achilles heel of Indian stock market

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ABSTRACT

Participatory Notes are offshore derivative instruments (ODIs) issued, by SEBI-registered Foreign Institutional Investors (FIIs) in India, against an underlying security, which entitles the holder to a share in the income, either dividend or capital gain, from the underlying security. These are issued to foreign investors, which may be hedge funds, foreign pension and mutual funds, or other High Net worth Individuals abroad. They are issued outside of India to people outside of India. The underlying securities, shares of listed companies in India, are held in the custody of FIIs on behalf of the P-Note holders.There are several issues associated with P.Notes. The anonymity of investors-difficulty in fulfilling KYC (Know Your Client) and FTAF (Financial Action Task Force) norms for P-Notes, the Anti-Money Laundering issues and difficulty in tracing the identity of the funds, Lack of transparency and anonymity worries the government authorities. There are fears that P-Notes are ideal money-laundering vehicles. Some reports suggest that some FIIs created their own separate and parallel offshore market for Indian securities in derivative form-which will develop and this will take volumes and revenues from our markets. About 50% of the portfolio inflows into India come in the form of P-Note There are some apprehensions, and some evidence, that the P-Note route was being used for “round-tripping” resident Indians’ money-going out by questionable means and coming back through the P-Note route. It is in light of these features the paper analysis the various issues related with P. Notes.

Introduction

In the recent past, a lot of coverage has been given to participatory notes and they have become a matter of concern for regulatory bodies in India. They have always generated lot of debate and controversy in the financial markets circle. The participatory notes were responsible for largest fall witnessed ever in Indian Stock markets. Participatory notes have been in news for all the wrong reasons and now and then Indian regulators i.e. SEBI and RBI are seen issuing notices or warnings to all the parties associated with these instruments. In fact the capital regulators dislike for them is so much that they have proposed a ban on participatory notes in India to protect the Indian capital markets from the market manipulators and for ensuring greater transparency of the capital markets. For all these reasons, participatory notes are sometimes referred to as Problematic notes.

Concept of Participatory Notes

FII may issue, deal in or hold offshore derivative instruments which derive their values from underlying Indian securities which are listed or proposed to be listed on any stock exchange in India. PNs are like contract notes and are issued by FIIs, registered in the country, to their overseas clients who may not be eligible to invest in the Indian stock markets. PNs are used as an alternative to sub-accounts by ultimate investors generally based on considerations related to transactions costs and recordkeeping overheads. The special features about the participatory notes are that they are largely unregulated instruments and regulatory bodies in India do not exercise any regulatory jurisdiction over them and so they are not required to adhere to disclosure and other norms which are generally applicable to other market players. Another special feature of Participatory Notes is that the beneficial ownership or the identity of the owner is not known unlike in the case of FII since these are freely transferable and trading of these instruments makes it all the more difficult to know the identity of the owner of these instruments and this the most important reason for high popularity of the Participatory Notes. Their anonymity and secrecy enables large hedge funds to carry out their operations without disclosing their identity. Then, some of the entity route their investment through participatory notes to take advantage of the tax laws of certain preferred countries.

Since 1992, when the FIIs were allowed to invest in Indian equity markets after the balance of payments crisis, an offshore market for PNs developed as a primary conduit for foreign investors to invest in India.

Origin of the Problem: “The Bilateral Tax Treaty between India and Mauritius

The bilateral tax treaty between India and Mauritius has helped in attracting FIIs to the Indian equity markets especially from 1992, when FIIs were allowed to invest after the balance of payment crisis. Entities based in Mauritius are exempted from capital gains tax arising from their investments in India. This resulted in several offshore funds registering in Mauritius to invest in India. Registering a company in Mauritius was (and is) expensive and cumbersome but it did avoid the capital gains tax that has been as high as 40 percent in the past. Mauritius has exploited their tax advantage and has raised costs to a point where some doubt it is worth bothering with that jurisdiction. There is still some tax arbitrage as derivatives are taxed at 33 percent onshore but tax-free offshore. This has given rise to sizable positions recently via PN issue on derivatives. Hedge funds in recent years have found value in Indian equities. These

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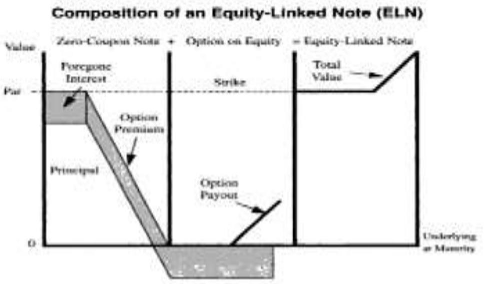
investors usually do not have along-term interest to register as an FII. Thus, they resort to Mauritius based entities that issue participatory notes (PNs) through which such investors can invest in India. Market sources and regulators have stated that the origins of such flows remain questionable. However, SEBI, the local regulator, classifies such PN inflows that are not registered in India under the 'FII inflows' category"The modus operandi is that the FIIs buy stocks and securities on behalf of the overseas investors in the domestic capital markets: the unregistered investors place their order with the FIIs and registered FIIs execute that order and uses its internal account to settle the trade. In the entire process, registered FIIs act like an exchange and they keep the investors name anonymous. Though this is balance of convenience between them but ultimately the nature of money, source of money and the identity of the owner remains in the dark. All FIIs are required to be registered with SEBI but the holder or owner of Participatory notes are not required to register with SEBI. That is the reason why capital market regulators dislike participatory notes. The other such offshore derivative instrument includes equity linked notes, capped return notes and investment notes. These offshore derivative instruments may be better understood with the help of the diagrams(Fig:1) and further discussion.

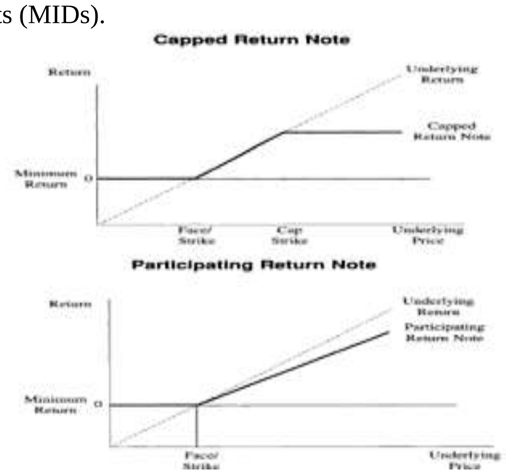
Influence of P-Notes on Indian Market

The participatory notes have a very strong influence in Indian markets and Governments and regulators cannot take the risk of taking them lightly. Their strong presence in the Indian markets has cautioned the government to address the issue of participatory notes very carefully because otherwise they may adversely affect the FIIs inflow into India: the prime reason being is that those FIIs that don't wish to register with SEBI or fails to get registration or are ineligible to get registration make entries in the Indian capital markets through the participatory notes and the other reason being is that FIIs earns huge rent while facilitating investment of participatory notes holders like unregistered FIIs, hedge fund, university endowments, etc in the Indian Capital markets. The influence of Participatory Notes in Indian Capital markets can be gauged from the simple fact that, there were 34 FIIs/sub-accounts issuing ODIs. The notional value of PNs outstanding grew to Rs. 3,53,484 crore by August, 2008, constituting 51.6 per cent of Assets Under Custody (of all FIIs/sub-accounts).

Figure 1: Composition of Equity-Linked Note, Capped Return Note and Participating Return Note



Equity-Linked Note (ELN): A security that combines the characteristics of a zero or low-coupon bond or note with a return component based on the performance of a single equity security, a basket of equity securities, or an equity index. In the latter case, the security is typically called an equity index-linked note. Equity-linked notes come in a variety of styles. The minimum return may be zero with all of what would normally be an interest payment going to pay for upside equity participation. Alternatively, a low interest rate may be combined with a lower rate of equity participation. The participation rate in the underlying equity instrument may be more or less than dollar for dollar over any specific range of prices. The participation may be open ended (the holder of the note participates proportionately in the upside of the underlying security or index, no matter how high it goes), or the equity return component may be capped. Other things equal, a capped return is associated with a higher rate of participation up to the cap price. Various versions of this Instrument are known as Capital Guarantee Note, Equity-Linked Debt Placement, Equity-Linked Certificate of Deposit (ELCD or ECD), Equity Participation Notes (EPNs), Indexed Notes, Index-Linked Bonds or Notes, Equity Index Participation Notes, Equity Index-Linked Note, Equity Participation-Indexed Certificates (EPICs), Index Principal Return Note, All Ordinaries Share Price Risk less Index Notes (ASPRINs), Geared Equity Capital Units (GECUs), Performance Index Paper (PIP), Customized Upside Basket Security (CUBS), Structured Upside Participating Equity Receipt (SUPER), Portfolio Income Note (PIN), Market Index Deposits (MIDs).



Source: "The dictionary of financial risk management" by Gary L. Gastineau, Mark P. Kritzman,

The Concerns

There are several reasons that have made the issue of participatory notes hotly debatable in India. Firstly, investors who are investing money in the market deserve access to details from FIIs on inflow of funds. This will help them find out how much a registered FII has invested or holds in the country. This will also helps investors in gauging the investment climate of the country as accurately as possible. But this is not possible in the case of participatory notes which constitute the major chunk of FIIs inflow into India.

Secondly, Another cause of concern is that many times accounted wealth of rich Indians veiled under the pretext of foreign institutional investment is used to invest in these participatory notes and it is generally alleged that such monies are tainted and linked with illegal activities such as smuggling and drug-trafficking and most dangerously the terrorist organizations also invest monies in the Indian capital markets through the participatory notes since the identity of the holders is not disclosed. This matter becomes all the more important that India is one of the prominent country suffering from militancy and terrorism for the last few years and all the more importantly India's financial capital is infected by mafias and underworld dons for whom it is very lucrative to invest money in Indian capital markets which are used not only to fund terrorist organizations and make them financially stronger but are also used in promoting drugs-trafficking, smuggling and all other kind of illicit and anti- national activities. Even experts are of the view that money laundering is taking place through large extent in the Indian capital markets through the use of participatory notes. Moreover, such participatory notes are the best instruments available for corrupt politicians and businessmen to convert their black money into white money by routing the money through foreign institutional investors. Hence, participatory notes are associated with all kinds of benami transactions which are not allowed in Indian capital markets and market regulator SEBI applies strict and comprehensive disclosure norms for protecting investor's interest. The sensitivity of the matter can be gauged from the fact that recently National Security Advisor M K Narayanan had cited instances of terrorist outfits manipulating stock markets to raise funds for their operations. The stock exchange in Mumbai has reported fictitious or notional companies engaged in trading only confirm the Narayanas worst fears.

Thirdly,, the intelligence agencies have, time and again, pointed towards the financing of the terrorist outfits and organizations through the stock markets. The reason for showing interest towards the Indian financial markets is obvious. Indian markets being one of the energetic and promising economies of the world is an attractive target of investment, the investors from different part of the world want to enter this market and want to depart with both hands filled with huge profits. There is no denying in the fact that monies earned through the stock markets will be used to fund and finance the terrorist activities which is a great threat to the stability of our country as well as the stability of the whole world and hard earned income of the retails investors are being used for terrorist activities. Apart from this, another cause of concern is that Indian financial markets can be manipulated by few unidentified corporations or persons through the use of participatory notes and they can make the market more volatile by their conducts and manipulate it as per their wishes. These participatory notes are like capital flights and these notes could be quite volatile in nature and may adversely affect the stability of the Indian capital markets.

Not only the SEBI but RBI is also not happy with the participatory notes and it has time and again expressed concern over the secrecy about its ownership and source of fund. SEBI is of the view that non-residents Indians may be using participatory notes route and round tripping investment into India. In view of the above apprehensions, there was a major clampdown of the participatory notes in October, 2007. There is general apprehension among the regulatory bodies that the participatory notes have become convenient route for foreign investors to take up exposure to Indian securities without taking the trouble of registering with the market regulators. There are number of investors who want to take this route of participatory notes and the reasons may be that they don't want to disclose their identity or to avail of tax benefits or they are not eligible to invest in Indian capital markets and regulator may not grant registration. For example, hedge funds are not granted registration as they are not regulated in their own country. In such cases, the registered FII act as an exchange since it executes trade and uses its internal account to settle this.

Fourthly, another Contentious issue regarding the participatory notes is tax issues. The income tax department has proposed to tax participatory notes holders. The FII invests in Indian securities and issue participatory notes to its beneficial owners. On redemption/maturity, the FII passes on the gains to the investors. Since FII holds securities, it may be asked to pay tax in India on any gain derived from such transactions. However, if FII registered in a tax favourable jurisdiction, then FII discloses the gains in its return of income and validly claims the exemption, the contention of the FII is that such gains should be considered as reported to the tax authorities in India and hence should not be considered again in the hands of the overseas investors (participatory notes holders). However, in some of the merger and acquisition deals, the tax authorities have taken the view that even if transaction has taken place outside India between the two overseas investors, tax is payable in India as it amounts to transfer of controlling interest of an underlying asset situated in India. Apparently, applying the same analogy, tax authorities have started to examine whether participatory notes can be taxable in India and whether FII should withhold tax while passing on the gains to participatory notes holders. The tax authorities are aware of the fact that tax implications of gains made on participatory notes trades would have to be carefully considered in the light of Indian domestic law and tax treaty which India has with the country of residence of participatory notes holders. The implication could vary significantly depending upon the exact structure and cash flow of each participatory note transaction and one really cannot apply one general principles of taxation to all the participatory notes transactions. For example a funded transaction would stand on a different footing as compared to a non-funded one. Similarly, participatory notes may be an uncovered one i.e. the issuer may not always hold underlying Indian securities. Such cases would have to be viewed differently as compared to the covered participatory notes. Also, where an issuer FII actually sold the underlying securities is very different from where it does not sell its securities in order to pay the participatory notes holder. Since, the approach adopted by the tax authorities would have a long-term impact on India's ability to attract foreign capital, the tax authorities should go slow on this issue.

Lastly, Another concern among some experts is that the investment made through participatory Notes creates a mirage that the market is booming, but the reality is that they are destructive for the market. The market always has the fear in the mind that as and when FIIs will go back the market will again be at odds. The Government is also under the pressure that FIIs will take their money back and cannot take any policy decisions comfortably, as every time there is an apprehension in the mind that whether or not a particular policy will be appreciated by the FIIs and adverse consequences that may flow there from.

The Other Side

Some of the experts are of the opinion that regulating and restricting participatory notes in the name of increasing transparency may be counter productive. They are of the view that when the flow of foreign capital into India is caused by a global rather than a local phenomenon, can the solution lies in blocking a few channels? India now has a gigantic capital account: if all else fails, over invoicing and under invoicing can be used to move capital across the border on a gigantic scale. They are of the opinion that if the entry conditions in Indian markets were made easier, instead of money coming through Participatory notes; it would come through registered bodies. Vast pools of foreign money are in action in the New York Stock Exchanges, or the London Stock Exchanges, etc. But this foreign money does not flow through participatory notes in those countries, because the market is easily accessible to the foreign investors. This has neither weakened regulation nor led to market manipulation, do they contend. The way to better regulation is to make the Indian market directly accessible. They argue that participatory note route has fallout in terms of high rents earned by FIIs registered in Indian markets. SEBI and RBI rules have made entry for foreign entities, including cumbersome and expensive. When investors come through those already registered in the markets they pay them. When we allow entry only to a few, by making it difficult for other to invest, we make the incumbent more powerful. The way to increasing competition, increasing liquidity in the market and making it more difficult to manipulate markets is through making those markets accessible to all, not by restricting entry. If the market is made more accessible, then instead of a handful of FIIs making decision to buy or sell, the decision will be taken by thousand of investors scattered all over the world. The government job is to save capitalism from capitalists and remove the rent earned by a few privileged FIIs.

The policy of making entry into Indian markets difficult favours the incumbents FII. It creates a new business opportunities for those already registered in the Indian markets. They argue that it is in the India's interest to have a level playing field between all the investors in the world, and not to concentrate the financial capital of global investors into a handful of FIIs. Giving so much privilege to FIIs strengthen them while hurting small investors. It reduces liquidity and makes regulation more difficult.

Regulators Reaction and Response

The issue was examined by the Ministry of Finance in consultation with RBI and SEBI. Following this consultation, it was decided that with effect from February 3, 2004, overseas derivative instruments such as PNs against underlying Indian securities can be issued only to regulated entities and further transfers, if any, of these instruments can also be to other regulated entities only. FIIs/sub accounts have been required to ensure that no further downstream issuance of such derivative instruments is made to unregulated entities. The insertion of regulation 15 A on Feb. 3, 2004 states the following:

Regulation 15 (A), inserted effective February 3, 2004 in SEBI (FII) Regulations, 1995 15(A). (1) FII or sub account may issue, deal in or hold, off-shore derivative instruments such as PNs, equity-linked notes, or any other similar instruments against underlying securities, listed or proposed to be listed on any stock exchange in India, only if favor of those entities which are regulated by any relevant authority in the countries of their incorporation or establishment, subject to compliance of 'know your client', requirement.

Provided that if any such instrument has already been issued, prior to February 3, 2004 to a person other than a regulated entity, contract for such a transaction shall expire on maturity of the instrument or within a period of five years from February 3, 2004 whichever is earlier. (2) A FII or sub account shall ensure that no further down stream issue or transfer of any instrument referred to in sub-regulations (i) is made to any person other than a regulated entity.

As per above regulation one important term seems to be regulated entities which is also clarified by the SEBI on Feb. 3, 2004 which is as under Appendix II. Regulated Entity: The Parameters Laid Out by SEBI, February 3, 2004 are:

i) 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 will be deemed as regulated entities.

ii)Entities that are regulated, authorized or supervised by a central bank, such as Bank of England, the Federal Reserve, the Hong Kong Monetary Authority, the Monetary Authority of Singapore or any other similar body would also be considered as regulated entities.

iii) Entities that are regulated, authorized or supervised by a securities or futures commission, such as Financial Services Authority (UK), the Securities and Exchange Commission (USA), the Commodities Futures Trading Commission (USA), the Securities and Futures Commission (Hong Kong and Taiwan), the Australian Securities and Investments Commission (Australia) or other securities or futures authority or commission in any country would also be considered as regulated entities.

iv) Members of securities or futures exchanges such as New York Stock Exchange (USA), London Stock Exchange (UK), Tokyo Stock Exchange (Japan), NASD (US), or any other similar self-regulatory securities or futures authority in any country, state or union territory are deemed as regulated entities.

v) 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 above parameters, is eligible to invest in domestic market.

Apart from insertion of regulation 15A the FIIs issuing such derivative instruments are required to exercise due diligence and maintain complete details of the investors, based strictly on "know your client" (KYC) principles which includes that FIIs must know all the requisite details about their clients and be able to furnish the same, as and when demanded by the regulator, to which there should be strict compliance, failing which they should suffer the wrath of the regulator. Along with this SEBI has indicated that the existing non-eligible PNs will be permitted to expire or to be wound-down on maturity, or within a period of 5 years, whichever is earlier. Besides, reporting requirement on a regular basis has been imposed on all the FIIs.

The SEBI has decided to tighten disclosure norms in the light of the Joint Parliamentary Committee (JPC) report on stock markets that surfaced in 2001. While investigating into the last stock market manipulation, SEBI had come across certain cases of participatory notes issued by FIIs. In order to increase transparency, SEBI had in October, 2001 issued circular to all FIIs and their custodians advising the FIIs to report as and when any derivative instruments with Indian underlying securities are issued/renewed/redeemed by them either on their own account or on behalf of sub-accounts registered under them. Accordingly, FIIs are sending reports from time to time whenever they are issuing participatory notes. What is required is that disclosures in the reports submitted by FIIs are to be enhanced and should be made more comprehensive. The JPC in its report suggested that failure on the part of FIIs to report about details of participatory notes should be viewed seriously and should entail stringent punitive actions. The committee has said that it should be ensured that this instrument is not misused in any way to manipulate the Indian securities markets. The JPC report observed that some of the Indian promoters had purchased shares of their own companies through participatory notes issued by sub-accounts of FIIs and this mechanism enables holders to hide their identities and enable them to practice Insider Trading which is prohibited under the Indian law. Further, in order to negative any adverse implication on the FIIs inflow into India, SEBI has decided to encourage participatory notes to register themselves as FII and for that purpose registration process would be made faster and more streamlined. SEBI has clarified that the real aim is to not to discourage the FII flow into India but to make the market more transparent for the healthy development of Indian capital markets and to curb money laundering activities and to prevent the capital markets from being acting as the financial hub for terrorist outfits.

The RBI is also deeply concerned with the matter and it shares the same view and concern of SEBI on the entire matter. RBI is of the view that foreign entities should not be allowed to enter the Indian market through the route of Participatory notes and if overseas investors are willing to take exposure into Indian markets, it must be mandatory for them to get registered themselves as FIIs so that they can comply with the regulatory requirements of the regulators. The RBI stance is valid because when UBS securities scam took place, SEBI took one long year to find out who the real beneficiaries were and in the process circumvented the whole world without any success. The Fact of the UBS securities scam will explain the disliking of regulators for Participatory notes.

On 17 May, 2004 FIIs made a sale of about Rs. 188.35 crores in the stock market. This immediately sent shivers into the market and investors especially the small investors upon seeing this sale, started panic selling their shares too. Like any self-fulfilling prophecy, the stock market plummeted. The Sensex fell by 567.74 points, NIFTY fell by 196.90 points & the Intra-day Sensex fell by 842 points. The estimated loss in the market was about Rupees One Lakh Crores. The stock market had to be closed three times that day and when it reopened the next day it again saw some fall. Upon investigations by SEBI it was found that UBS got its order to sell on its sub account by Swiss Finance Corporation Limited, which was based in Mauritius. This acted on the orders of UBS AG London, which got its orders from its clients including Caxton international, which is a hedge fund based in the British Virgin Islands. This one hedge fund alone had issued sales orders of about Rs. 99 crores. Lo and behold! SEBI further investigated only to find NRI names at the root of this long chain.

It took SEBI almost one full year to get to the bottom of the chain and that too without being able to hold any one person or entity responsible. It meanwhile had stopped UBS from market transactions since UBS was not cooperating in sharing much of the information. This case is a good pointer as how P Note channel is an open invitation to irregular investors. That is why SEBI guidelines to the FII and brokerage houses include KYC or Know Your Client. Meaning, the FII should be able to provide information on who are the ultimate investor and beneficiary of the trade to facilitate SEBI to monitor the market closely for unsettling flows but this is rarely followed in its full dimension.

It must be remembered that SEBI is a part of International Organization of Securities Commissions (IOSOC) and has signed information-sharing agreements with leading regulators but there was no support from them during the investigation of UBS scam. In UBS case, the letter of request for information sharing being sent by SEBI Chairman did not gave any desired result to the regulator. The regulator found itself helpless in such circumstances and so the only option left to them is to ban such notes. The RBI has clarified in its press note that they do not have anything against the participatory notes but their only concern is that this instrument helps in concealing the original beneficiary of the instruments and leads to multi-layering which makes it more difficult to find out the beneficiary. RBI has reiterated its stance, time and again, that issuance of Participatory notes should not be permitted. It is of the opinion that by not allowing the suspicious fund in the market, image of the market can be enhanced which will ultimately leads to healthy flows in the economy. Further, RBI is of the opinion that money coming through the route of FII is hot money which can become cold at any point of time. More than 40% of FIIs at any given instance comprise of money through Participatory notes. RBI feels that even if FIIs take 20% of the total invested money out of India, it might lead to financial crisis or destabilize the economy.

The Lahiri Committee (June 2004), which was set up to recommend measures on FII inflows, describes Participatory notes as akin to contract notes issued against an underlying security usually to investors that are not otherwise eligible to invest in India The Lahiri Committee (on Encouraging FII flows and checking the vulnerability of capital markets to speculative flows) had debated the issue of Participatory notes in detail. While taking note of the possibility of misuse of the instrument, the Lahiri panel had favoured the continuation Participatory notes with the rider that SEBI should have full powers to obtain information regarding the final holder/beneficiaries or of any holder at any point of time in case of any investigation or surveillance action. However, RBI was not happy on the recommendation given by the committee and has given a dissent note.

The RBI representative on the panel said the central bank reiterated that the issuance of Participatory notes should not be permitted. The member had pointed out that the main concern of the RBI was that the nature of the beneficial ownership or the identity of the investor will not be known, unlike in the case of FIIs registered with a financial regulator. The Lahiri Committee was expected to throw some light on Participatory Notes and the way to make them a more acceptable and a secure instrument but the report was found wanting on this issue.

The report failed to deal comprehensively with the issue of Participatory notes and failed to throw light on the entire matter from the different angles. Again, one important dimension to the entire matter is that Ministry of Finance feels that Participatory Notes are a major source of much needed foreign inflow in India and cannot be banned.

Hence, there is no unanimity between the Government and regulator on the banning of Participatory Notes. The RBI has called for one more committee to examine the whole matter comprehensively. As for today the issue of P notes still remains unsolved and loophole of Indian stock market

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