Participatory Notes in India: The Self-Destructive Route

I) Introduction:

Inception Of P-Notes: The story of the collapse of India's foreign exchange reserves in 1990-91 following a combination of withdrawal of foreign currency bank deposits by NRIs, the collapse of the Soviet Union and the oil-price rise in the wake of the (first) Iraq War and how this forced the process of economic reform is well known. After the 1991 BoP crisis, FIIs were allowed to invest in India. The process of foreign investments in India was boosted by initiation of P-Notes. It went on to entrench itself as the primary tool of FIIs in India.

Definition: P-Notes are a type of Offshore Derivative Instrument (ODI). Regulation 15A of SEBI Regulations, 1995 defines ODI as an instrument "which is issued overseas by a foreign institutional investor (FII) against securities held by it that are listed or proposed to be listed on any recognised stock exchange in India." These ODIs can also be issued against derivatives, resulting in leveraged exposure to the Indian stock market.

II) Background:

Investment can be classified as – FDI and Portfolio investment.

> Portfolio Investment (Investment in India through stock markets) includes:
1) QFI – Qualified Foreign Investor
2) Investments by NRI or Person of Indian Origin (PIO)
3) FII- Foreign Institutional Investor

Foreign Institutional Investor (FII) - An investor or investment fund that is from or registered in a country outside of the one in which it is currently investing. Institutional investors include hedge funds, insurance companies, pension funds and mutual funds. Not only do FIIs trade for themselves, but they also trade for their clients, who are known as sub-accounts. These sub-accounts do not have to be regulated to be able to register with SEBI. On the contrary, High Net Worth (over $ 50 million) Individuals can register as sub-accounts.

PNs are crucial to attract foreign investments and thereby boost the Indian growth story. PNs generate a magnetic pull to attract these investments. Additionally, costs associated with FII registration are high. Entry into the Indian equity market through the PN route lowers cost. Lastly, according to SEBI "International access to Indian capital market is limited. PN as an investment device overcomes these limitations." Thus, the aforementioned **requirements** indicate the vitality of PNs.

Benefits (Nefarious rather than Noble):

PNs ensure a plethora of advantages for its users. It allows the investors to hide behind the veil of anonymity. Furthermore, through PNs, investors can hoodwink taxes. For instance the zero capital gains tax in Mauritius. It allows investment gains made in Indian stock markets to escape tax free. Genuinely speaking, PNs permit investors to save transaction costs and record-keeping overheads. Apart from its ease of use, PNs are freely tradable which provides liquidity in the market. Thus, regulation of this liquidity by PN holders may lead to market volatility.

Working (Technical Aspects) Of PN mechanism:

If an investor would like to buy securities or derivatives, he sends his order to the FII. This FII then conveys the order to his broker in India, who actually buys the securities. In return, PNs are issued to the FII, who then passes them on to its clients. According to the '**Report of the Expert Group on Encouraging FII Flows and Checking the Vulnerability of Capital Markets to Speculative flows (Lahiri Report 2005, p.7)'** - "Participatory notes (PNs) are instruments used by foreign funds, not

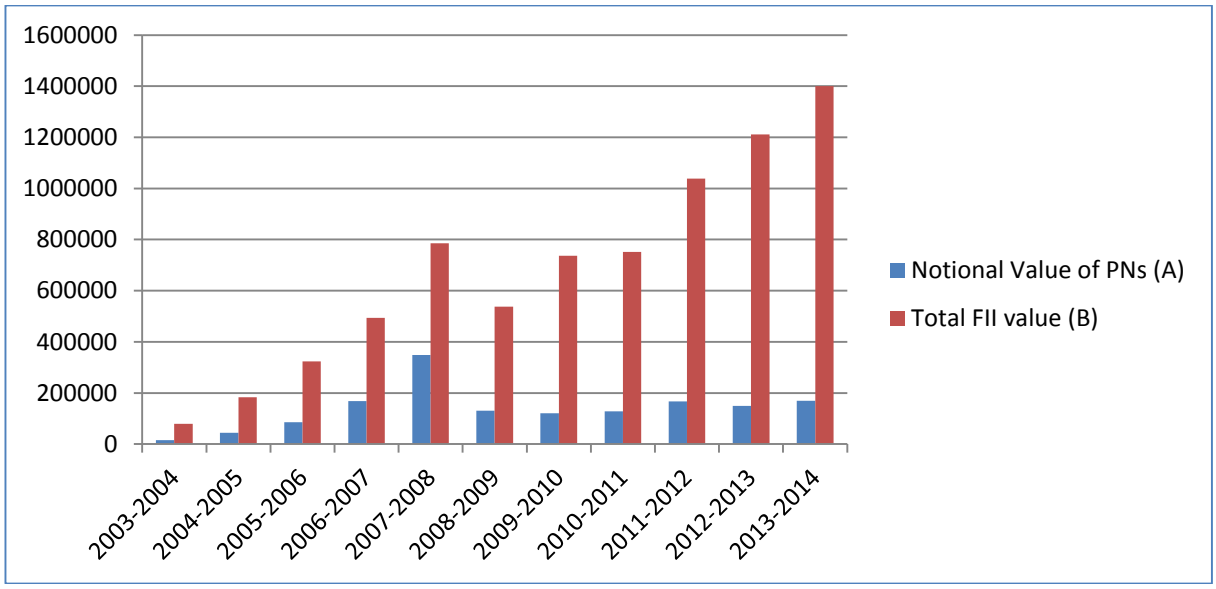
registered in the country, for trading in the domestic market. They are a derivative instrument issued against an underlying security which permits the holder to share in the capital appreciation/income from the underlying security. PNs are like contract notes and are issued by FIIs, registered in the 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."

Temporal Evolution Of P-Notes:
According to the SEBI website: "The notional value of PNs outstanding, which was at Rs 31, 875 crore (20 per cent of Assets Under Custody of all FIIs/Sub-Accounts) in March 2004, increased to Rs 3,53,484 crore (51.6 per cent of AUC) by August 2007.

"The value of outstanding ODIs, with underlying as derivatives, currently stands at Rs 1,17,071 crores, which is approximately 30 per cent of total PNs outstanding. The notional value of outstanding PNs, excluding derivatives as underlying as a percentage of AUC is 34.5 per cent at the end of August 2007*(Paper for Discussion on ODI 2007, p.2-3).*"

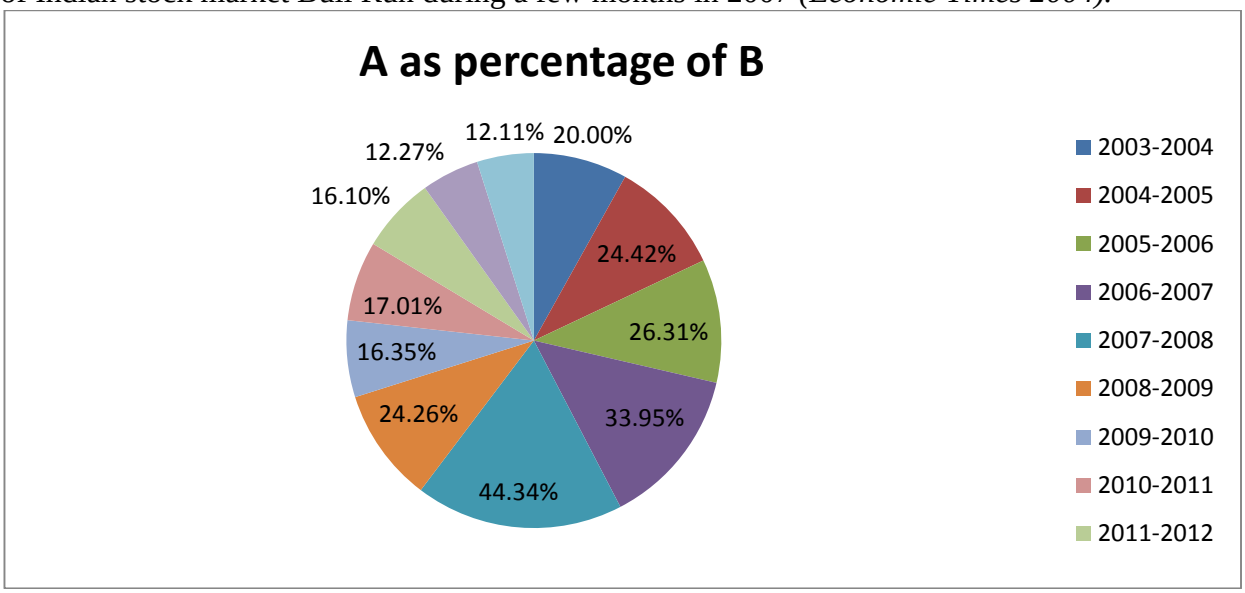
Note: Below is a table indicating the notional value of PNs including derivatives, debts and equity. It shows the contribution made by PN investments to total value of FIIs. The financial year runs from 1st April to 31st March.

Financial Year	Notional Value of PNs (A) (in crores)	Total FII value (B) (in crores)	A as percentage of B
2003-2004	15726.75	78618.25	20.00%
2004-2005	44641.5	182784	24.42%
2005-2006	85187.9	323668	26.31%
2006-2007	167703.9	493858.4	33.95%
2007-2008	348375.5	785554.8	44.34%
2008-2009	130387.8	537449.6	24.26%
2009-2010	120480.9	736459.8	16.35%
2010-2011	127816.6	751121.8	17.01%
2011-2012	167301.1	1038749	16.10%
2012-2013	148754.3	1211753	12.27%
2013-2014	169651.5	1400645	12.11%



P-Notes used to account about 50 per cent of the total FII investments, but their share has fallen after SEBI tightened the disclosure norms and other regulations for such investments. P-Notes have been accounting for mostly 10-20 per cent of the total FII holdings in India since 2009, while it used to be

much higher, in the range of 20-40 per cent, in 2008. It was as high as about 50 per cent at the peak of Indian stock market Bull Run during a few months in 2007 *(Economic Times 2004).*



III) Objectives/ Hypotheses:

(I) The main objective of the paper is to point out the redundancy of using P-Notes as an economic instrument for boosting **healthy investments**.
(II) The concept of P-Notes induces round-tripping, influences market volatility, endangers national security and enhances the probability of 'capital flight.'
(III) It exploits the **DTAA policy**.
Double Taxation Avoidance Agreement (DTAA) – ensures zero capital gains tax in nations with which India has signed DTAA. India signed DTAA with Mauritius in 1983. The first issue with PNs was the capital gains tax arbitrage opportunities that were created as a result of the DTAA. Onshore (Indian) investors had to pay taxes up to 40% on short-term capital gains, compared to 0% in Mauritius. PNs allow Mauritian individuals and companies as well as Indians (who indulge in round tripping) to exploit the zero capital gains tax as accorded by DTAA (Singh 2007, p.4).
The Mauritius Story (Aspects which render Mauritius into a tax haven)
Firstly, a corporate body registered under the laws of Mauritius is a resident of Mauritius and thus will be subject to taxation as a resident. Secondly, the Income Tax Act of Mauritius provides that offshore companies are liable to pay zero percent tax. Therefore by bringing an offshore company within the definition of resident, both the benefits of being an offshore company as well as that of residency allowed under DTAA are bestowed upon it. In effect the whole exercise of avoidance of double taxation turned out to be avoidance of taxation altogether. The advantages of registering a company in Mauritius ensure exemption from capital gains tax, quick incorporation, total business secrecy, and a completely convertible currency. Therefore the financial entities setting up companies in Mauritius do so without almost any establishment costs.
The treaty is depriving the Indian Exchequer of millions of dollars due to Round Tripping and tax evasion. The policy in itself has become a **catch-22 situation** for the Government as any stringent norms with regard to Mauritius might result in future FII investment being targeted away from India and benefitting the South East Asian countries or FIIs looking at alternate options.
(IV) It discourages real investments.
(V) Participatory Notes are **"Phantom Notes."**
P-Notes i.e. participatory notes can be termed as "**Phantom Notes**." Phantom, a fictional character, was considered to be a saviour. So, can we accord the Phantom status to participatory notes? Participatory Notes ease the process of investing in India. The channel of P-Notes provides for bulky cash inflows. These cash inflows push up the stock market index in India. Indian stock market gains notice and credible investors around the globe may flock to invest in India. In short, P-Notes assist the Indian growth story. The nature of investments through this channel is questionable though.

Moreover, Phantom was known as "the Ghost who walks." No doubt, due to the uncertainty related to P-Notes, it can be said that P-Notes have a ghostly presence over the Indian securities market.

(IV) Negative Revolutions triggered (by PNs) on the path of evolution:

This section unmasks the notorious facet of PNs.

1) Multi layering enables the original investor to invest in financial markets by hiding his/her identity through multiple layers of investment activity before investing in a financial market. Basically, it allows the PN holder to hide behind the veil of anonymity. Multi layering questions the credibility of the concerned financial market since most of the investments are "ghost" investments. Lastly, it discourages healthy financial flows.

A high-profile case in 2009 involved the Reliance ADAG group that was alleged to have manipulated the shares of Reliance Communication through a multi-layered transaction involving shell companies, P-Notes and prominent international investment banks.

2) Round-Tripping *(Domestic money masquerading as overseas inflows).*

Round-tripping is the process by which tax-free illicit or black money leaves India through illegal routes, and is then repatriated to the country with minimal fees. In the context of black money, it leaves the country through various channels such as inflated invoices, payments to shell companies overseas, the hawala route and so on. After cooling its heels overseas for a while, this money returns in a freshly laundered form; thus completing a round-trip. PNs provide a perfect path to bring prodigal money back into the country. PNs have been described as India's **"white paper on black money (Singh 2007)"** i.e. PN is the paint which colours illegal black money into legal white.

3) Hedge Funds. (Also refer to special note in the end)

Hedge funds usually indulge in short selling and arbitrage. Main objective of hedge funds is to earn money from fluctuating market prices. They do not have any long term interest to register as an FII. Thus, hedge funds use PNs to play the Indian stock market. These funds cause volatility in the market since they enter and exit the market swiftly. Just imagine the pandemonium that grips the stock market when hedge funds (volatile in nature) invest through PNs (anonymous route).

4) Terror Financing.

According to former NSA M.K. Narayanan "Isolated instances of terrorist outfits manipulating the stock markets to raise funds for their operations have been reported. Stock exchanges in Mumbai and Chennai (India) have, on occasions, reported that fictitious or notional companies were engaging in stock-market operations. Some of these companies were later traced to terrorist outfits." Thus, terrorists have been using the PN route to finance activities that endanger national security.

5) Volatility through outflows.

FII has been described as 'hot money (Lahiri Report 2005, p.21-22)' because of the potential of large capital outflows. In India, investments through PN comprised about 50% of total FII investments at a point in time. Even today it hovers around 10% - 25% of the total FII investments. In India money invested through PN is synonymous to 'hot money.' PNs ease the process of capital flight, a process undesired by any country.

Financial Year	Notional Value of PNs (A) (in crores)	Total FII value (B) (in crores)	A as percentage of B
2003-2004	15726.75	78618.25	20.00%
2004-2005	44641.5	182784	24.42%
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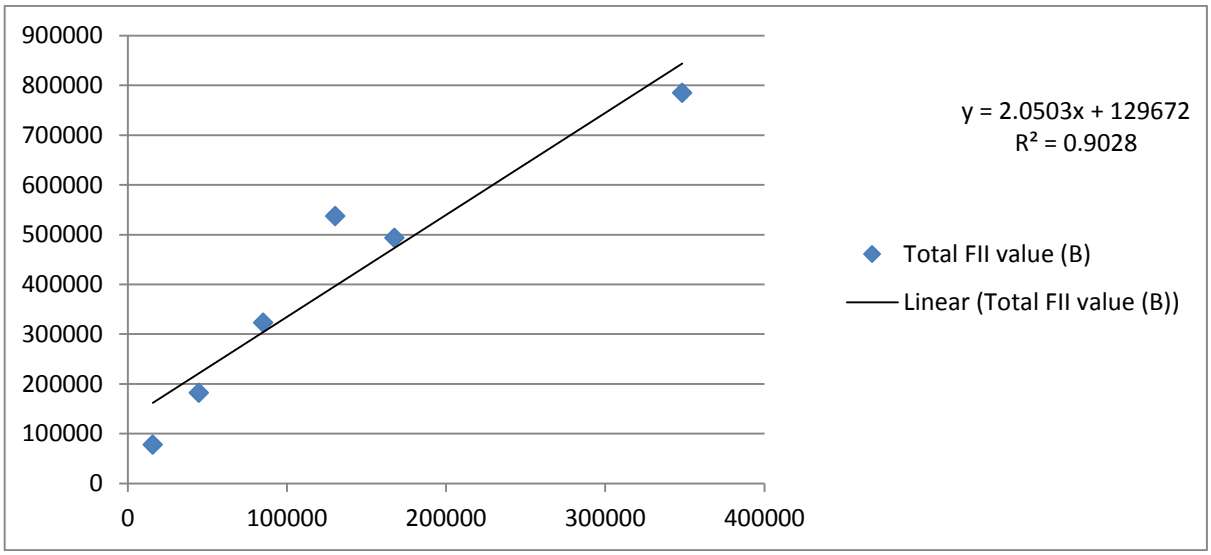
The time period 2003 to 2009 has been taken into account since it is the most eventful period for participatory notes. It is during this period that the Black Monday crash as well as P-Note Crisis took place. Additionally, during this time period, SEBI guidelines restricting the operations of PNs were implemented, though later repealed.

PN channelizes 'hot money (Lahiri Report 2005, p.21-22)' i.e. money that can be easily injected into or lifted from the security markets. This unpredictable injection or lifting of 'hot money' induces market volatility. The market index responds to this volatility, leading to an upward or a downward surge in the stock market index. PN investments comprise a considerable share in the total FII value. Thus, the alteration in notional value of PN investments is likely to affect the total FII value.

The regression model below tries to explain a cause and effect relationship between notional value of PNs and the total FII value. Notional value of PNs is taken on the X-axis as the independent variable. Whereas, total FII value (the dependent variable) is taken on the y-axis.



The R squared value of 0.9028 indicates a strong and positive relation between notional value of PNs and total FII value. Change in notional value of PNs will bring strong altercations in the total FII value. FII (hot money) is held accountable for market volatility. It can be concluded that the channel (PN route) which allows for the escape of hot money is equally responsible for market volatility.

Culmination of these negative revolutions (consequence of gradual evolution):

PN route investments are unhealthy. The past experiences of the Indian stock market corroborate that statement.

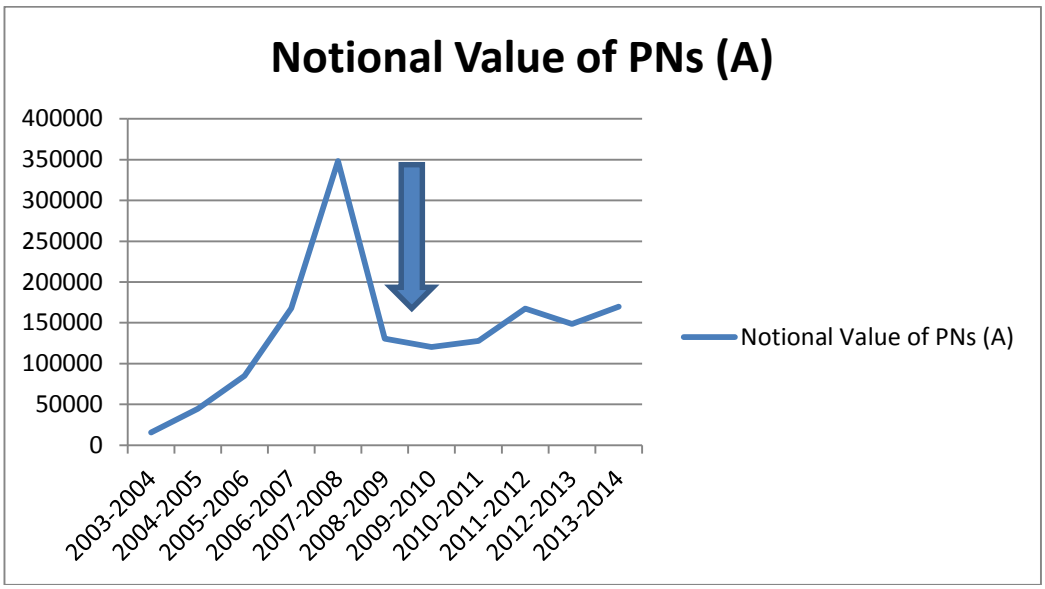
1) Ketan Parekh Scam, 2001.

The investigations into the Ketan Parekh-led stock market scam of 2001 uncovered the fact that around $2 billion had been brought in and taken out of the country through OCBs registered in Mauritius. Ketan Parekh had links with such foreign-based PN holders and he used PNs for rigging the prices of Indian shares. Shares like Visualsoft rose from Rs. 625 to Rs. 8,448 (per share) and Sonata Software from Rs. 90 to Rs. 2,150. Thus, PNs are susceptible to abuse. It was only after these revelations that SEBI barred the issuing of PNs to any unregulated entities and also enforced certain disclosures about PNs.

2) "Black Monday" crash in May, 2004.

In May, 2004 Sensex crashed by 842 points. SEBI unmasked the culprit behind this crash. It was none other than PNs. UBS, one of the largest sellers of shares, carried out large scale selling orders on behalf of unidentified clients. These clients transacted in Indian stocks through UBS, but hid behind a maze of investment deals extending all the way from India to Mauritius. What happened in 2004 was a double whammy. Not only were markets bought down through artificial selling pressure, but Indians invested in stocks via a route (the PN route) reserved only for foreign investors. It could be inferred that a large fraction of foreign institutional investment is not really foreign. It is Indian money circulating around the world and re-entering the country as foreign money all illegal.

3) P-Note Crisis, 2007.
The notorious nature of P-Notes coerced SEBI to introduce certain restrictions which curbed the freedom of PN holders. However, the guidelines of SEBI were vague and this propelled the biggest intra-day collapse in Indian stock markets – Sensex crashed by 1744 points or about 9% of its value.



The downward arrow signifies the plunge in the notional value of PNs due to constraints placed by SEBI on the PN mechanism. It propelled a Sensex crash as well as a P-Note crisis,

Finance Minister P.Chidambaram clarified that the government was not against FIIs. The SEBI chief, M.Damodaran cleared the air on the proposals to curb PNs where he announced that funds investing through PNs were most welcome to register as FIIs, whose registration process would be made faster and more streamlined. The markets welcomed the clarifications with an 879-point gain (a substantial surge), thus signalling the end of the PN crisis.

V) Economic Theory:

Investments can be classified as FDI and portfolio investment (mostly FII). FDI is real investment. It leads to the establishment of production plants, machinery etc. It incurs TFC. Real investment leads to employment generation which in turn boosts the country's economic growth. FII is financial investment. In contrast to FDI, FII engages with the secondary (stock, equity) market. FII doesn't generate productive capacities.
Capital Flight: A large-scale exodus of financial assets and capital from a nation due to events such as political or economic instability, currency devaluation or the imposition of capital controls. ***(Source: Investopedia)*** Lifting of capital from the market can be termed as capital flight. FII has been described as 'hot money.' Whenever a foreign investor smells unhealthy business sentiment he may immediately withdraw/ lift his investment/ capital from Indian markets, provided he is invested through FIIs. Investors engaged through FDI cannot do so, since they have already incurred TFC. Additionally they have baggage (of factories, machinery etc) to take care of. An emerging economy will prefer greater FDI inflows to FII inflows. Unpredictable FII outflows (thanks to capital flight) may affect the health and stability of the economy.
In India, until now, attracting FII has been easier than FDI because of the policy uncertainty and procedural delays. And as it has been expounded earlier, PNs are an integral component of FIIs. Thus, its economic relevance cannot be downplayed. For developing countries, capital flight can have cataclysmic consequences since it impedes economic growth. **P-Notes quicken the process of capital flight, thereby dumping the interests of the economy they are expected to serve.**

VI) Body:

The paper studies the PN instrument with respect to the Indian economy. It also mentions the Mauritian case with reference to the DTAA policy. Moreover, the paper has analysed the role played by guidelines issued by Securities Exchange Board of India (SEBI) to enhance the freedom of PNs or to curb the same. Suggestions provided by the Lahiri committee report on PNs, do find a place in this paper.

Prospective policies to curb the menace initiated by PNs:

(i) **Know your client (KYC) norms.**

SEBI had prescribed a "know your client" policy under which FIIs are supposed to know the ultimate beneficiary when a PN is issued. It was formulated to demystify the identity of PN users. Its effect has been minimal, since in reality, FIIs merely ensure that they know their immediate client. The ultimate beneficiary manages to conceal his identity behind long chains of investment outfits.

(ii) **GAAR – General Anti-Avoidance Rule (India):** Routing transactions through Mauritius when there is no substantial purpose to route it from there other than achieving the tax benefit will not be allowed. And earlier it has been established that PNs induce round tripping, just to avoid onshore taxes. GAAR is aimed at preventing deals that are structured only to avoid/evade taxes.

(iii) **Tobin Tax** is a proposal to impose a tax such as 0.1 per cent on all currency spot market transactions. While this was proposed many decades ago, it has not been adopted in any country till date.
According to the Lahiri report (2005, p.44) "The three difficulties with the Tobin tax are:
(a) Taxation of financial transactions drives turnover out to untaxed venues, such as the derivatives market or offshore markets,
(b) Taxation of financial transactions directly reduces the liquidity of financial markets, which is counter to the goals of financial sector policy and
(c) A modest tax rate like 0.1 per cent could considerably hurt normal users of the financial market while not being large enough to deter speculators who anticipate large profits, such as those associated with the change in a currency regime."

VIII) Conclusion:

Post 1991, India ushered into the era of economic liberalization. Participatory notes were supposed to contribute to India's growth story by attracting investments. It was entrusted with the task of easing the process of injecting money in India's stock market. It was expected to nourish the financial status of India's derivatives market. But little did we know that PNs on its path of evolution would trigger several negative revolutions. Negative revolutions that have diseased the financial flows oozing in and out of India. The notorious nature of PNs reflects the self destructive journey India has embarked upon.

To quote Manmohan Singh **– "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. We should recognise and internalise the fact that funds are in search of markets, and not the other way."**

Special Note:

What are Hedge funds?

Hedge funds, which are private investment vehicles for wealthy individuals or institutional investors, have been in existence for over half a century. They, however, have little to do with hedging or eliminating risks arising from an underlying portfolio position. Hedge funds constitute an alternative to mutual funds in terms of being a vehicle for fund management. Regulation of mutual funds, motivated by the need to protect small investors, induces significant costs of regulation. Hedge funds are prevented from accessing small investors, and are freed from this regulation. They are able to engage in a wider array of trading strategies, and contractual structures, as compared with mutual funds. They are the preserve of sophisticated investors who are able to take care of their own interests, and not rely on an intrusive regulatory framework designed at protecting small investors. If the costs of regulation of mutual funds are substantial, hedge funds would yield superior returns (Lahiri Report 2005, p.26).

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Annex I

	Notional value of PNs on Equity, Debt & Derivatives (in crores)										
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
April		35746	50650	141598	256896	258748	72314	154340	166444	130012	157578
May		31753	64589	127679	292113	234933	103470	159927	211119	128895	168263
June		29702	67187	120595	367330	181238	97885	168016	153291	129851	147498
July		30671	81333	118812	350026	176004	108345	165749	150414	129586	148118
Aug		35726	87878	136683	353484	167962	110355	163657	152288	141710	164817
Sept	22043	36993	95591	155572	407690	124981	129100	200927	175291	146600	171154
Oct	23165	44586	87690	168454	449613	82282	124575		180002	175829	183862
Nov	24881	53517	97637	192102	417936	70980	129943		179035	177170	183237
Dec	29030	67886	104179	189951	381120	71320	168632		138711	151084	167566
Jan	28754	55050	117325	202487	330704	65812	131938	174485	151956	162139	163348
Feb	28972	54941	13333	215675	322743	60948	124177	171601	183151	164271	172738
Mar	31876	59127	154863	242839	250852	69445	145037	175097	165832	147905	207639
Total	2E+05	535698	1022255	2012447	4180507	1564653	1445771	1533799	2E+06	2E+06	2035818
Avg	15727	44641.5	85187.9	167704	348375.5	130388	120481	127817	167301	148754	169652