Advances in Economics and Business Management (AEBM)
Print ISSN: 2394-1545; Online ISSN: 2394-1553; Volume 2, Number 9; April-June, 2015 pp. 914-918

http://www.krishisanskriti.org/aebm.html

# Role of Participatory Notes in the Indian Stock Market

**Kavita[1] and J.S. Pasricha[2]**

*[1,2]Department of Commerce Punjabi University-Patiala, India*
*E-mail: [1]kavitasharma930@gmail.com, [2]jspasricha1@rediffmail.com*

**Abstract—***Since the initiation of economic reforms in 1992, India has become a global player in the finance world. Inspite of its growth, India has not been successful to rid itself of the potential harmful practices in the Indian stock market. One such practice is the issuance of Participatory Notes (PN) by foreign investors, which enables them to anonymously trade in securities or derivatives listed in the Indian stock market. Participatory notes (commonly known as P-notes) are financial instruments issued by foreign institutional investors to investors and hedge funds who wish to invest in Indian stock markets. They are, in fact, offshore derivative instruments issued by foreign institutional investors and their sub-accounts against underlying Indian securities. This instrument came into public view after it accounted for approximately 50% of all foreign portfolio investments in India. Since then, the market regulator SEBI came with several reform measures to have a control over several PN holders. Such regulations helped to mitigate the volatility caused by PNs. The present study is an attempt to study the concerns and conveniences due to P-notes route of investment and also to study the impact of P-Notes on the Indian Stock Market. The analysis was made using Correlation and Percentage technique of analysis. The study made analysis of total value of Participatory notes as a percentage of FIIs. Further, Analysis of Index data was made using BSE Sensex Index. The study found that there was moderate degree of positive correlation between the values of Sensex and total values of Participatory Notes on Equity and Debt. Positive correlation was also observed between the variables while making an analysis of the Lowest values of Sensex and PNs as a percentage of FIIs. Further, there was low degree of negative correlation between the Highest values of Sensex and PNs as a percentage of FIIs. The results indicated that FIIs investment through P-Notes route play a vital role in impacting the Indian Stock market.*

**Keywords***: Foreign Institutional Investors, Participatory Notes, P-Notes, Overshore Derivative Instruments etc.*

## 1. INTRODUCTION

Participatory notes (PNs) or P-notes also known as offshore derivative instruments are issued by foreign broking firms to overseas investors who wish to have an exposure of the Indian capital market without getting registered with SEBI. Participatory notes can be issued where the securities listed on the Indian bourses are held as underlying assets. The foreign broking houses purchase the shares on the behalf of overseas investors and in return issues them P-notes, with the shares being the underlying. FIIs hold underlying securities (the shares of listed companies in India) in their custody on the behalf of the P-Note holders. In case, the investor holding the P-notes desires to sell his holdings, he gives instructions to the foreign brokerage, who then sells the shares. The foreign funds and investors who are interested in taking exposure in Indian securities but are not registered with the Securities and Exchange Board of India (Sebi) enter the stock market through the purchase of p-notes. P-Notes allow the foreign investors to enter the stock market through registered foreign institutional investors (FIIs) and exempt them from getting registered directly with Sebi. This saves time and costs for investors, but the negative aspect is that this route can also be used for bringing back the black money invested oversees. The FIIs issue PNs to companies or funds whose identity is not known to the Indian authorities. These are generally issued overseas by domestic institutional brokerages and the associates of India-based foreign brokerages.

Due to possibility of misuse of Offshore Derivative Instruments, or P-Notes, for money laundering and other such purposes, SEBI has been giving directions to foreign investors to comply with all the necessary norms before issuing p-notes. There is huge scope for misuse and tax avoidance because the ultimate beneficiary of the transactions carried out through participatory notes is not known to the tax authorities and the market regulator. Also, since the entities holding participatory notes do not attract the attention of the market regulators of the countries in which they are issued, these virtually go unregulated. These caused a lot of volatility and a subsequent crash in the markets.

In March 2015, the cumulative value of investment through P-Notes stood at Rs 2.72 lakh crore (over USD 43 billion) (Money Control). The quantum of FII investments through P-Notes were 11.3% during this period. In January and February 2015, the figures stood at Rs. 2,68,033 Crore (11.2% of FIIs investment), 2,71,752 (11.1% of FIIs investment) Crore respectively in the same year. Huge inflow of foreign funds through P-notes route has made this route quiet popular in the Indian stock market.

A significant portion of the investment through participatory notes is managed by just few entities. To put the matter in context, we could recall that the investigation of the '01 securities scam revealed that nearly $2bn was brought in or taken out of the country through overseas corporate bodies (OCBs) registered in Mauritius, whose beneficiaries were resident Indians. (Economic Times, 2004)

The stock market regulator SEBI tightens its foreign institutional investors regulations from time to time to ensure that participatory notes are not misused by overseas corporate bodies, non-resident Indians and firms controlled by Indians or by Indian promoters. These regulatory measures were meant to restrict the issue of participatory notes to only regulated entities by the foreign institutional investors. P-Notes are transferable. The Indian regulation required that FIIs ought to give monthly reports about the identity of the P-Notes holders. But the FIIs argue about the non-availability of information regarding the identity of the ultimate beneficiaries, as P-Notes are transferable instruments.

## 2. OBJECTIVES OF THE STUDY

1. To study the concept of participatory notes.
2. To study the advantages and Disadvantages of using Participatory Notes route.
3. To study the Impact of Participatory Notes on the Indian Stock Market.

## 3. REVIEW OF LITERATURE

**Chakrabarti (2001)** investigated the nature and causes of FII flows to India. Correlation, regression and granger causality test were used for the purpose of analysis. The study found that the stock market returns on the BSE index have significant relationship with the FII. US and world returns, changes in country risk ratings don't have a significant relationships with the FII investments in India. **Rai and Bhanumurthi (2004)** focused on the determinants of foreign institutional investment in India. ADF test and Unit root test was used for the purpose of analysis. The analysis revealed that FII inflows depends on inflation rates, stock market returns and ex-ante risk. In terms of magnitude, the effect of stock market returns and the ex-ante risk were found to be the major determinants of FII flows. **Bhat (2006)** focused on the concerns about the nature of access made available to foreign portfolio investors. The article highlighted that there was an increase in foreign portfolio investment in comparison to the previous years. **Singh (2007)** focused on the use of participatory notes by foreign investors as a channel of portfolio flows in the India stock market. The broadened India's foreign investor base has a bias towards unregistered foreign investor base who invest mainly via participatory notes. The study showed that the demand for participatory notes has increased during the period of time. The study observed that the ban on the issuance of participatory notes on derivatives will play a significant role on reshuffling the investor base on portfolio flows. **Vaidyanathan (2012)** studied about the possible dangerous effects of participatory notes. The researcher argued that the participatory note system is discriminatory and it favours foreign investors. A significant portion of FII flows is in the form of participatory notes. Further, bureaucrats, politicians, foreign governments, terror financiers could be the users of this route. The researchers argued that the users of p notes can use this route to the greatest danger of the Indian economy so that this should be brought under the control. **Kothari (2013)** attempted to study the impact of participatory notes on the Indian rupee exchange rate. The researcher used the vector auto regression (VAR). The researchers observed that India has not been able to rid itself from the harmful practices such as the issuance of participatory notes. Participatory notes came into public view only after it accounted for more than 50% of all foreign portfolios in India. The study found a rising trend in participatory notes. Further, the researcher observed that though the regulations helped to figure out the participatory note holder but has not helped to mitigate the volatility arising due to participatory notes.

## 4. RESEARCH METHODOLOGY

The present study is based on secondary data. The study is made for the period of 10 years from the year 2004 to 2013. The study made analysis of total value of Participatory notes as a percentage of FIIs. Further, Analysis of Index data was made using BSE Sensex Index.

For the purpose of study, analysis of Top 10 and lowest 10 values of BSE Sensex index was also done. Coefficient of correlation was applied to study the nature and extent of relationship between the highs/lows of stock market and P-notes as a percentage of FIIs. Further, analysis of 10 years monthly data was also done based on the descending values of Sensex. The analysis was also made using the Percentage technique.

The data has been collected from the Annual report of SEBI, Handbook of statistic on Indian Securities Market, NSE-ISMR.

## 5. REASONS OF FOREIGN INVESTORS USING P-NOTES ROUTE

Foreign investors prefer the P-Note route to invest in Indian securities due to the following reasons:

- Any entity who is entering the stock market using participatory notes route is not required to get registered with SEBI, whereas all FIIs have to get compulsorily registered. It enables hedge funds to undertake their operations without disclosing their identity.
- Convenience and ease involved in investing and exiting from the stock market while making investment through this route. Trading through participatory notes is quiet

easier because such notes are like contract notes which are transferable by endorsement and delivery.

- Some genuine investors who either fail to qualify so as to get registered with the SEBI as FIIs due to some technical reasons, or otherwise themselves prefer more cost effective and comparatively less cumbersome P-Note route.
- The FIIs whose registeration is pending with SEBI prefer to enter the stock market through P-Notes route.
- Tax saving: Some of the entities use this route of investment so as to take advantage of the tax laws of certain preferred countries.

## 6. CONCERNS ABOUT P-NOTES

- Difficulty is involved in fulfilling FTAF (Financial Action Task Force) and KYC (Know Your Client) norms for P-Notes, difficulty involved in tracing the identity of the funds and the Anti-Money Laundering issues.
- The FIIs issue PNs to companies or funds whose information regarding the identity is not available to the Indian authorities. These are address-less funds that could be from dubious sources. For PN investors, the system is silent, even on basic information. Procedural formalities regarding the forms and proof of residence, PAN number, are not required under this route.
- Lack of transparency regarding the identity and basic requisite information regarding the P-Note holders worries the government authorities.
- There are apprehensions that the P-Notes are ideal money-laundering vehicles.
- Portfolio inflows into India in the form of P-Note constitutes about 50% of total FIIs investments into India.
- There are evidence and apprehensions that the P-Note route was being used for "round-tripping" resident Indians' money which is going out through questionable means and coming back using P-Note route.

## 7. MAIN USERS OF P-NOTES ROUTE

- The first category includes the investors who invest their money for getting regular returns. Investors take interest in India because of the attractive returns compared to developed markets.
- A large number of bureaucrats, politicians, business-persons have accumulated wealth abroad. Unaccounted wealth has been accumulated by corruption in contracts, under-invoicing or over-invoicing, by not bringing in legitimate receipts and in the form of gifts from abroad.
- The third category includes those foreign governments and entities who desire to acquire significant control over Indian entities by way of take over.
- The fourth category includes the terror financiers who find this route quiet attractive and simple.

The first category of the investors enter and exit the market as per their calculations and they desire for maximum returns. Their main objective is to earn returns and repatriate and also to benefit out of interest rate and currency value arbitrage. The major concern is that the stock market is currently the only route for investing while several other "unlisted" sectors, such as transport, trade, restaurants and other services are suffering from shortage of funds. The steps should therefore be evolved to acquire these regular global funds so as to make investment in the needs of the large non-corporate or "unlisted" segments of the economy along with increasing the investment in the top ten shares of the stock market. Such measures can ease the volatility in the stock market.

**No more tax havens-** The second category includes those investors who are enthusiastic to bring the money back into India since the KYC (Know your Customer) norms in many "safe" territories like Switzerland are being made stringent particularly after 9/11 attacks.

**Harmful for Companies-** The third category poses dangers for the domestic companies since the unknown entity might be targeting the domestic company without its knowledge. With the use of reasonable control they can attempt to pressure the current owners so as to make them settle with them or they can even try taking them over.

**Terror Financiers** -The fourth category includes the terror financiers who try to benefit from the anonymity provided by these instruments and the liberal domestic regulations on gifting the shares.

## 8. ANALYSIS AND RESULTS

**Table 1: Table showing Correlation between highest values (Top 10) of Sensex and PNs**

| | Sensex values | PNs |
|---|---|---|
| Sensex values | 1 | |
| PNs | -0.160044717 | 1 |

Table-1 shows the highest values of Sensex and the corresponding values of P-notes as a percentage of FIIs from April 2004 to March 2013. The coefficient of correlation was found to be -0.16. It indicates that there was low degree of negative correlation between the variables. Due to the increase of P-notes instruments, corresponding increase was not there in Sensex.

**TABLE 2: Table showing Correlation between smallest (Lowest 10) values of Sensex and PNs**

| | Sensex | PNs |
|---|---|---|
| Sensex | 1 | |
| PNs | 0.48436 | 1 |

Table-2 shows the lowest values of Sensex and the corresponding values of P-notes as a percentage of FIIs from April 2004 to March 2013. The coefficient of correlation was found to be 0.48. It indicates that there was moderate degree of positive correlation between the variables. The analysis of correlation between the Highest/Lowest values of Sensex and PNs as a percentage of FIIs revealed that Sensex values were at its lowest when there was decline in investment through P-Notes route. Whereas, negative relationship was found between the variables when BSE Sensex values were at its peak.

**Table 3: Table showing Correlation between values of Sensex and PNs**

| Correlations | | | |
|---|---|---|---|
| | | **PNs** | **Sensex** |
| PNs | Pearson Correlation | 1 | .600** |
| | Sig. (2-tailed) | | .000 |
| | N | 114 | 114 |
| Sensex | Pearson Correlation | .600** | 1 |
| | Sig. (2-tailed) | .000 | |
| | N | 114 | 114 |
| **. Correlation is significant at the 0.01 level (2-tailed). | | | |

Table-3 shows the values of Sensex and the corresponding values of P-notes as a percentage of FIIs from April 2004 to March 2013. The coefficient of correlation was found to be .600. It indicates that there was moderate degree of positive correlation between the variables. Due to the increase of P-notes instruments, corresponding increase was found in S&P BSE Sensex.

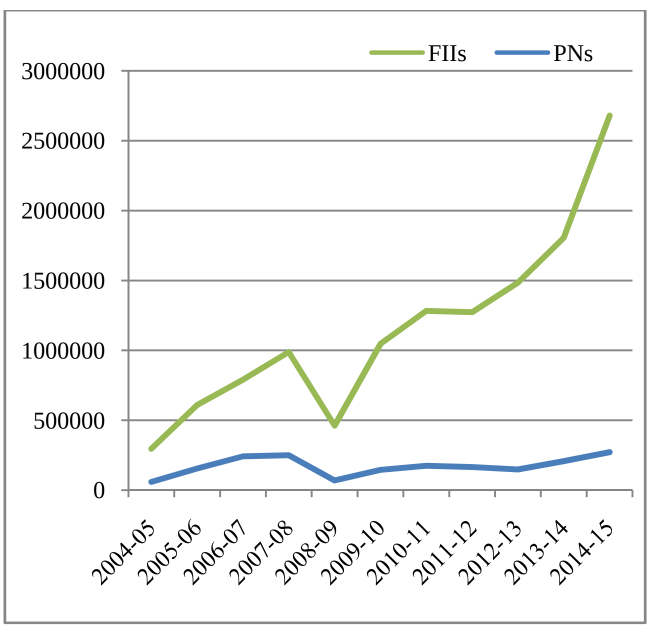


**Fig. 1**

***Source*:** Handbook of statistics on Indian Economy.

The graph shows that during the period from 2004-05 to 2013-14, FIIs showed an increasing trend till 2007-08, thereafter decreasing trend from 2007-09. After the year 2009, increasing trend was observed till the year 2014-15. It is clear from the graph that Investments via P-notes showed the similar trend as FIIs.

According to the data released by the Market regulator Securities and Exchange Board of India (Sebi), total value of investments via P-Notes route in Indian markets (equity, debt and derivatives) rose to Rs 2,36,677 crore at the end of December 2014 from Rs 2,49,210 crore in November 2014. P-Notes route, which is mostly used by the foreign institutions, hedge funds and overseas HNIs (High Networth Individuals), allow them to make investment in Indian stock markets through registered Foreign Institutional Investors (FIIs), thereby saving on time and costs associated with direct registration. According to market analysts, investments into the equity market via P-Notes had been increasing in the past few months, mainly due to government's reforms agenda and a rally in the country's equity markets. P-Note investments in Indian markets have climbed to Rs 2,65,675 crore in October from Rs 2,22,394 crore in the preceding month. The quantum of FII investments through P-Notes fell to 10.5 per cent in December 2014 from 11 per cent in November 2014. Till a few years ago, investments via P-Notes used to account for more than 50 per cent of the total FII investments, but their share has significantly fallen after SEBI tightened the disclosure norms and other regulations for such investments( economic times). P-Notes have been accounting for nearly15-20 per cent of the total FIIs holdings in India since 2009, while it used to be much higher, in the range of 25-40 per cent, in 2008.

## 9. SUMMARY AND CONCLUSION

Participatory Notes or P-Notes are offshore derivative instruments issued by foreign institutional investors and their sub-accounts against underlying Indian securities. This instrument came into public view after it accounted for approximately 50% of all foreign portfolio investments in India. Since then, the market regulator SEBI came with several reform measures to have a control over several PN holders. Till a few years ago, investments via P-Notes used to account for more than 50 per cent of the total FII investments, but their share has significantly fallen after SEBI tightened the disclosure norms and other regulations for such investments( economic times). In the present study, Relationship between Sensex and P-Notes was studied using the correlation technique of analysis. The present study showed that there was positive relationship between Sensex and P-Notes during the period 2004-13. The coefficient of correlation was found to be .600. The results indicated that FIIs investment through P-Notes route play a vital role in impacting the Indian Stock market.

## REFERENCES


[1] **Chakrabarti,R. (2001),** "FII Flows to India: Nature and Causes", ICRA Bulletin, Money and Finance, Oct- Dec 2001.

[2] **Kothari, R.(2013),** " The impact of Participatory Notes on the Indian Rupee Exchange Rate" CMC Senior Thesis Paper 654. Available online at http://scholarship.claremont.edu/cmc_theses/654

[3] **Nishith Desai Associates (2013), "**Offshore Derivative Insturments: An investigation into tax related Aspects" Available online at http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research%20Papers/Offshore_Derivative_Instruments.pdf

[4] **Singh,M (2007),** " Use of Participatory Notes in Indian equity markets and Recent regulatory changes, IMF Working Paper.

[5] **Rai and Bhanumurthi (2004),** "Determinants of Foreign Institutional Investment in India: The Role of Return, Risk, and Inflation" The Developing Economies, XLII-4 (December 2004): 479– 93.

[6] Handbook Of Statistics on Indian Economy, 2013.

[7] Indian Securities Market- A Review.


## Websites Accessed


[1] http://www.indiainfoline.com/article/news-sector-others/what-are-participatory-notes-113111501088_1.html

[2] http://articles.economictimes.indiatimes.com/2006-01-09/news/27464872_1_participatory-notes-fiis-foreign-portfolio

[3] http://articles.economictimes.indiatimes.com/2004-01-26/news/27414054_1_participatory-notes-overseas-corporate-bodies-india-based-foreign-brokerages

[4] http://articles.economictimes.indiatimes.com/2014-11-18/news/56221854_1_p-notes-p-note-investments-fii-investments

[5] http://articles.economictimes.indiatimes.com/2015-04-20/news/61339315_1_p-notes-p-notes-p-note-investments

[6] https://janamejayan.wordpress.com/2012/03/31/why-participatory-notes-are-dangerous-r-vaidyanathan/