

Participatory notes: A sensitive topic for govt, SEBI and investors

Participatory notes (or P-notes) are offshore derivative instruments used by foreign investors who are interested in betting on Indian securities but not keen on registering with the capital market regulator Sebi. P-notes are issued by foreign brokerages registered with Sebi or foreign arms of domestic brokerages to overseas investors. The broker buys Indian securities (shares, debt or derivatives) and issues P-notes to the client for a fee.

WHY ARE P-NOTES IN NEWS THESE DAYS?

A Supreme Court appointed Special Investigation Team (SIT) entrusted with the task of suggesting measures to curb black money recommended Sebi should do more to identify real owners of P-notes and restrict their transfer. Sebi already has the powers to seek information from the broker on who is it issuing. But, in some layered transactions, the end beneficiary could be different from the first P-note buyer. The committee suspects that savvy tax evaders from India are using this route to deploy their black money into Indian securities. In the past, there have been concerns over Indian promoters using P-notes to bet on their own companies.

WHY IS P-NOTE A SENSITIVE TOPIC FOR THE GOVT, SEBI AND THE INVESTOR COMMUNITY?

The positions held through P-notes are worth Rs. 2,75,436 crore or 11.5% of the assets under custody of foreign portfolio investors, which is Rs. 23,86,457 crore. Though nowhere close to their high of Rs. 4,49,613 crore during the peak of the previous bull run in October 2007, the government and Sebi worry that remarks on restrictions on P-notes can spook investors. Clamp down on transfer of P-notes could result in a fall in foreign portfolio inflows.

HOW HAS THE MARKET REACTED TO PROPOSALS ON P-NOTE BAN IN THE PAST?

On October 16, 2007, Sebi put out a discussion paper that proposed curbs on P-notes based on derivatives, and prohibiting sub-accounts of FIIs from issuing P-notes. The stock market crashed over the next three days with the Sensex diving almost 9% on October 17 leading to trades being halted for an hour. The finance ministry rushed to clarify, which led to a rebound that day. But, the market fell again on October 18 and 19. Markets had a big reason to worry then because P-note holdings had risen to almost 50% of FIIs' assets under custody. Subsequently, Sebi chairman M Damodaran held a conference with FIIs and issued clarifications.

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