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PARTICIPATORY NOTES (PNS): ISSUES AND CHALLENGES FOR INDIAN CAPITAL MARKETS

C.A. (Dr.) Pramod Kumar Pandey

Associate Professor, National Institute of Financial Management

Sector-48, Pali Road, Faridabad, Haryana, Pin: 201002

ABSTRACT

For the past few years Indian capital market was suffering from excessive speculation through investment in Participatory notes (PNs). These investments were mostly in derivative segment. The identity of P notes holders were not known and thus it was leading to high inflow of unaccounted money in the Indian economy. After restriction imposed by SEBI in 26th April, 2017, the proportion of PNs Debt has increased over PNs Equity. This paper has studied the flow of PNs from year 2012 to 2017 and further has evaluated the changes in its pattern after restrictions imposed by SEBI in 2017. Key findings included that flow of P notes were chronologically increasing for the last five years however after action by the SEBI, this proportion has sharply came down.

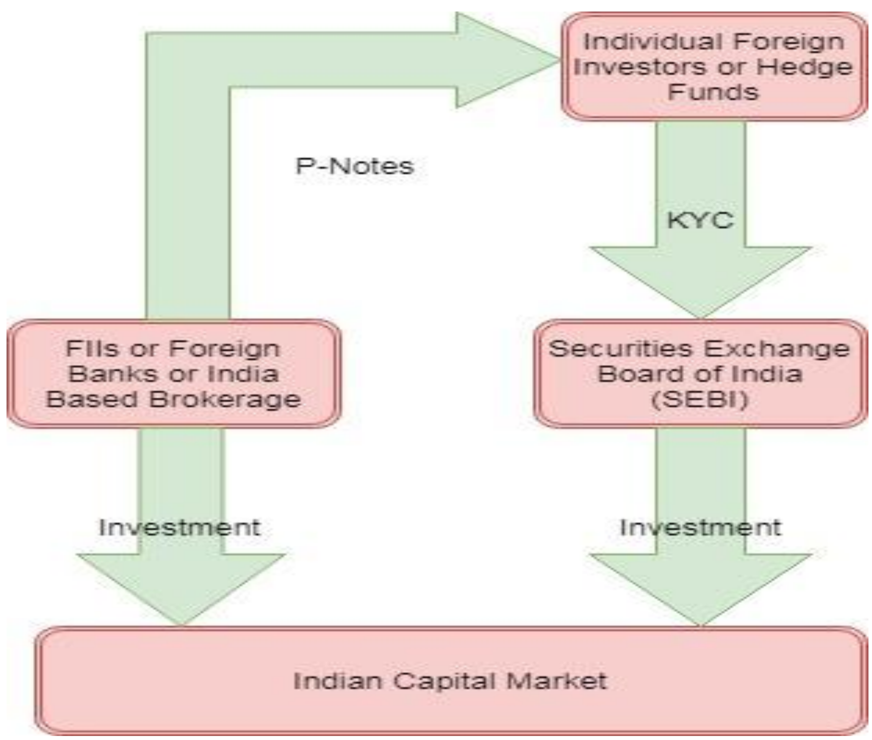
Key words: Debt, Equity P/E Ratio, Participatory note

Introduction

This paper studies the flow of PNs and its behaviour in Indian stock market and further also focuses on the changes in its pattern after restrictions imposed by SEBI. Period of study has been taken for the last five years, i.e. from year 2012 to 2017.

For making any legal investment into India, it is Participatory note (PNs) is one of the popular means of indirectly entering into Indian capital market without disclosing identity to SEBI. Participatory note (PNs) is nothing but offshore derivative instruments (ODIs) which are issued by registered FIIs/FPIs, Foreign Banks and India based brokerage houses to individual foreign investors or hedge funds. In case of P-notes, the underlying assets are derivativesnecessary for overseas investors to register itself with the Securities Exchange Board of India (SEBI) after fulfilling the required KYC norm. At times it has been found that many foreign investors including NRIs are entering into Indian capital market without routing through SEBI. This backdoor entry is not only creating disequilibrium into Indian capital market but also resulting in flow of unaccounted money into Indian economy **(Chart-A.1)**. There is a cyclical trend in P notes investments in India, Dr. Deepak Bhavya N. et al. (2016)

Chart-A.1: Mechanism of flow of P notes in India



Indian capital market is largely impacted by foreign investments. Further FIIs have very positive effect on Nifty and Sensex, Hemant Kulshreshtha (2014). FIIs/FPIs are major sources of flowing foreign capital into India. SEBI not being very positive on this side was working on P-notes for the last few years through special investigation team (SIT). FII's investments are more visible to Government than FDI, Mohammed Iftikhar Khan and Amit Banergee, et al. (2015). In response to frequently asked questions (FAQs), it had replied that P-notes were being used by some foreign banks for unduly affecting particular stock prices in collaboration with the company promoters.

Literature Review

Manmohan Singh (2007) studied the possible reasons of use of P notes by foreign investors. The research stressed that though it is hard to extricate the impact but tax, liquidity etc. may be the preferences for offshore issues. **S. Sahul Hameed and M. Fowzia Sultana (2015)** conducted a very extensive study on P notes covering the period from 2009-2014. It has been concluded under the study that more than 50% of the funds are flowing through via P-notes and therefore an exhaustive reorganization is needed. The study also revealed that highest flow of P notes were in the year 2010 and 2014. **Dr. Deepak R and Bhavya N (2016)** conducted a research on seasonality in P notes from 2003 to 2015. The study came with the conclusion that there exists a cyclical trend in investment pattern in P notes on non random basis in India. **Gaurav Barick Anshuman Bhakri and Ramneek Singh (2016)** have focused on the impact of P notes on the Sensex covering a period of 2003-2017. The study came with the conclusion that effect of any drop through P notes will reflected on Sensex in the long run. **Dr. Vinod K. Bhatnagar (2011)** analyzed the trend of FII investment in India. The paper concluded that there has been substantial growth in FIIs investment in India during the year 2004 to 2009. This paper stressed that flow of foreign capital is very necessary for a developing country like India and added that stock indices on the higher side and high P/E ratio attracts more the foreign investors. **Hemkant Kulshrestha (2014)** has evaluated the possibility of relationship between FII investment and Indian capital market. The study came out with the conclusion that FIIs have positive impact over Nifty and Sensex and it further added that FIIs investment indicates increasing global investor's confidence in particular economy and capital market. **Mohammad Iftekhar Khan and Amit Banerji (2015)** conducted study with a view to find the link between FDI and FII/FPI. This paper has identified that FPIs attract more attention of the Government than FDI because of visibility of capital market indices. The paper added that focus of planners should be to render private sector more competitive.

Current scenario in India regarding P-notes:

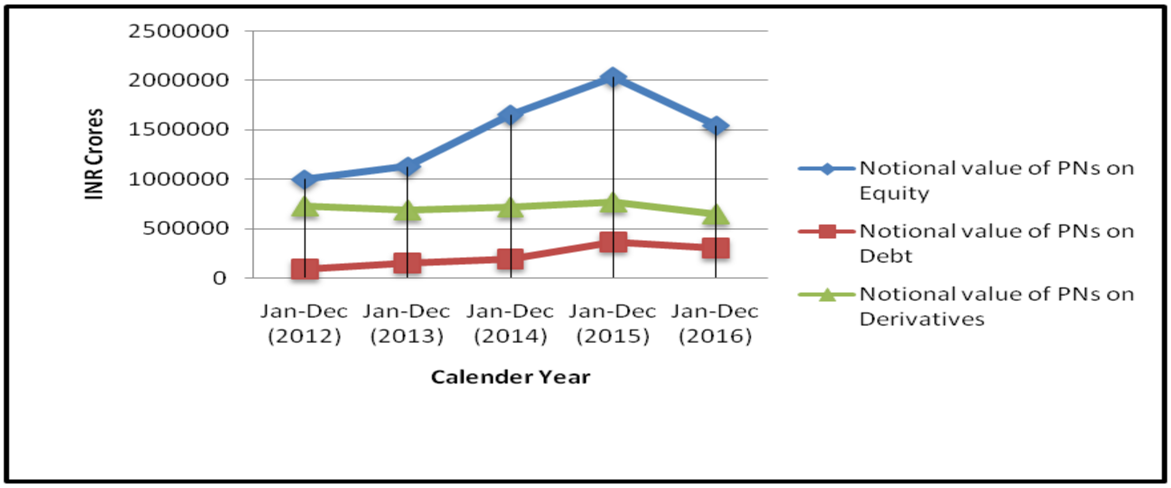
SEBI through its consultation paper on "Streamlining the process of monitoring of offshore derivative instruments (ODIs)/Participatory notes (PNs) , dated 29th May, 2017, has clarified that issue of P-notes will not be allowed unless they are strictly for hedging purposes and not for speculative purposes. The ODIs subscribers shall strictly adhere to KYC norms. The FPIs are required to ensure that all issues of ODIs strictly adhere to regulations. They are required to identify and verify the beneficial owner. It has further been provided that it is necessary to reconfirm ODI positions by ODI issuers on semi-annual basis. In cases of past issues of ODIs which were not complying the requisite norms may be held up to a maximum period of its maturity or 31st December, 2020 whichever is earlier. Now resident Indians and NRIs who are beneficial owners of ODIs will be prevented from subscribing the offshore derivative funds. At the same time, SEBI is continuously monitoring and making regulatory changes to ensure that ODI route may not be misused in any circumstances. Due to above regulations of SEBI, it will be a difficult exercise to hold beneficially the ODI positions any more.

Analysis of ODIs/ PNs investment in India

After the announcement of SEBI to shut the ways for undisclosed ODIs/PNs on 26th April, 2017, the share of P notes in overall FPI came down to 6% to 7% which earlier was lying in between 10-11 %.

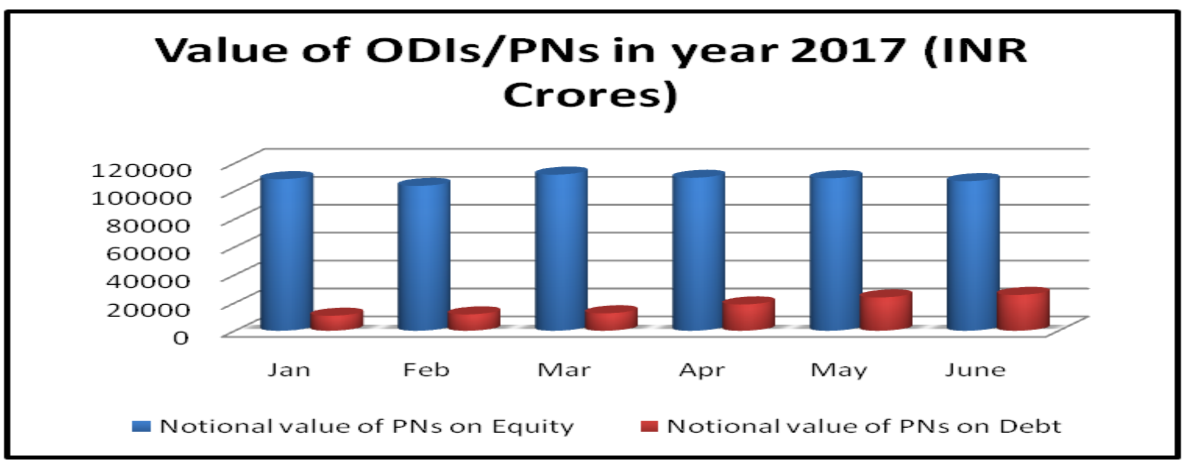
From year 2012 to year 2013, the growth rate in PNs debt was 74% as compared to PNs Equity which was only 12.98%. However, in year 2014 as compared to year 2013, increase in the growth rate of the PNs Equity was three times while the PNs Debt remained just one third. Further, in year 2015 as compared to year 2014, increase in the growth rate of the PNs Equity decreased to 23 % while the PNs Debt increased to 90%. Very interestingly the correlation between growth rate of PNs Debt and PNs Equity from year 2012 to 2015 happened to be -0.85, i.e. more or less perfect negative correlation existed. From year 2015 to year 2016, the growth rate of both PNs Equity and PNs Debt became negative after the statement of SEBI Chairman Shri U. K. Sinha who said that a strong safety net has been put to check any routing of black money through P notes **(Chart- A.2)**

Chart- A.2: Value of offshore derivative instrument (ODIs)/Participatory Notes (PNs) (INR Crores)



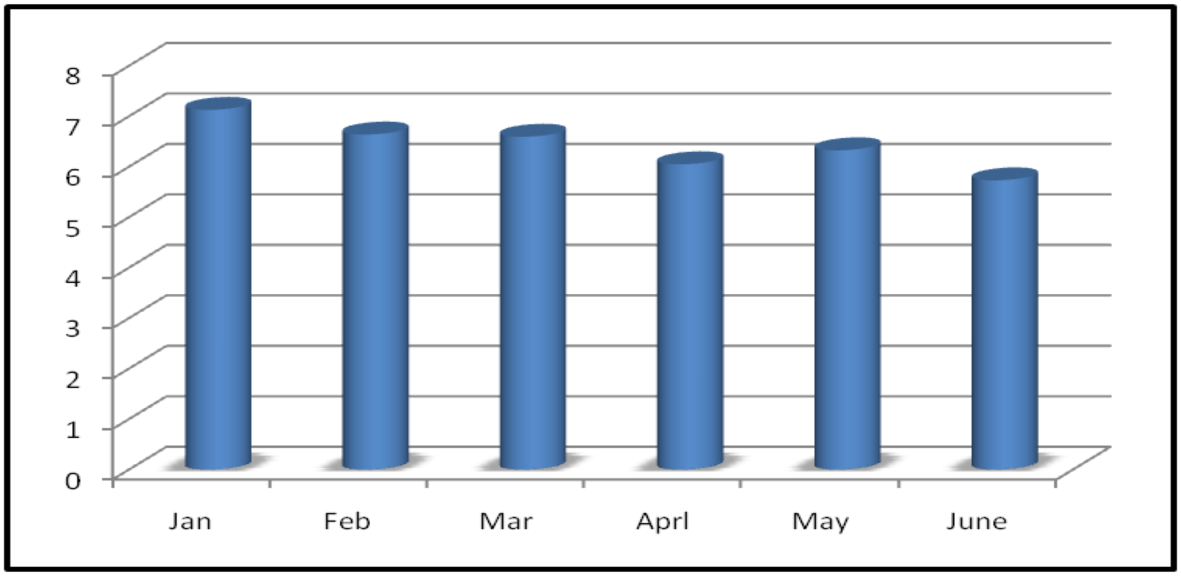
As far as year 2017 is concerned, the growth rate in PNs Equity is more or less stagnant while PNs debt has depicted positive growth rate. Probably this is happening after the restriction that PNs/ODIs to be issued strictly for hedging the equity shares held only and not otherwise **(Chart-A.3)**

Chart- A.3: Value of ODIs/PNs month wise in year 2017 (INR Crores)



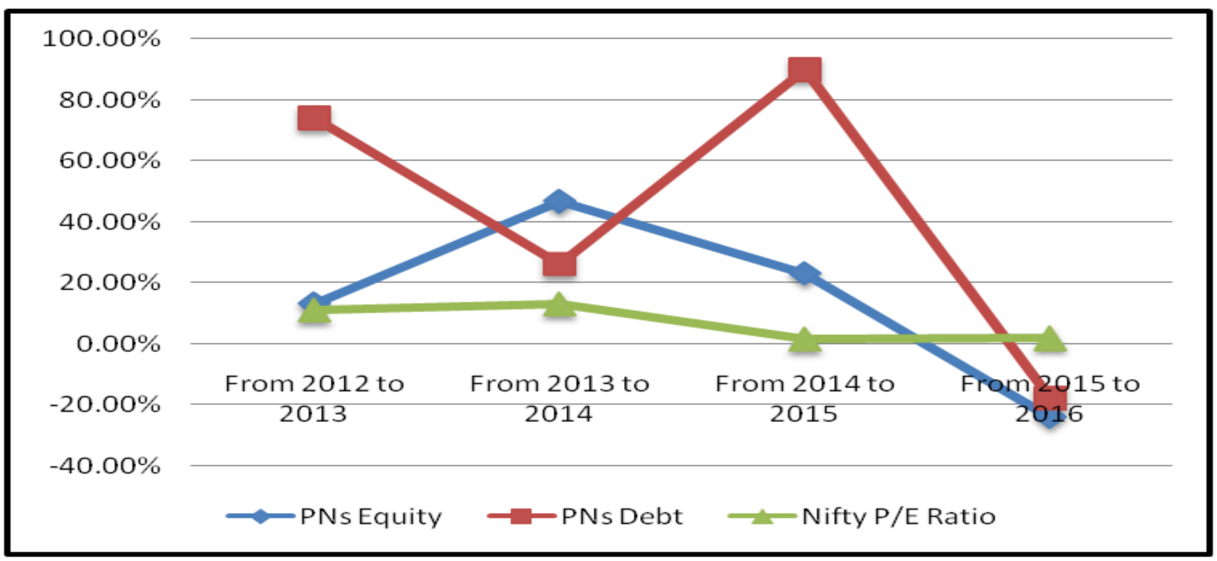
The proportion of PNs equity and debt including derivatives have sharply coming down in year 2017 (Chart-A.4) due to cleaning exercises adopted by SEBI. It not only restricted PNs/ODIs only for hedging purposes but also banned trading in 331 suspected shell companies. Further SEBI has given clear indication that in future it may impose restrictions on excessive derivatives in equity segment to curb speculation.

Chart- A.4: Notional value of PNs on Equity and Debt including derivatives to AUC of FPIs in 2017



From year 2012 and up to year 2014, growth rate in PNs Equity was higher than PNs Debt as the growth rate in the Nifty P/E ratio was increasing. However from year 2014 to year 2015, the PNs Debt has shown drastic increase over PNs Equity when the growth rate in Nifty P/E ratio was declining. Thus, it can be argued that investment in PNs Equity is having more direct relation with Nifty P/E ratio, while PNs Debt has more inverse relationship with Nifty P/E ratio **(Chart-A.5).**

Chart-A.5: Growth rate of PNs Equity, PNs Debt and Nifty P/E Ratio



Conclusion

Indian capital market is significantly dominated by FIIs/FPIs. For the past few years, entry of unaccounted money in the form of ODIs/PNs has created disequilibrium in the Indian capital market. Mostly the sources of PNs/ODIs have been Singapore and Mauritius among other countries. These ODIs/ PNs have mostly been used for speculative purposes and thus innocent investors have lost a lot of money for these gimmicks. Further, this is also adopted as a medium for evading capital gain taxes due to tax treaties of India with certain nations. Imposing restrictions on them is one of the remarkable steps of Government of India for creating a healthy capital market. In year 2017, there is only growth in PNs Debt which clearly shows the bad intentions on the speculative side. Now the PNs Equity is allowed only for hedging purposes on one to one basis for the equity shares actually held by FIIs/FPIs. Hope we will enter into a new capital market regime

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