Corpsec Hotline

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P NOTES BOUNCE BACK

With as much as 45% (estimated at around Rs 40,000 crore) of portfolio investments made in India being by the way of Participatory Notes ("**PNs**") issued by SEBI registered Foreign Institutional Investors ("**FIIs**"), the Government of India through the Ministry of Finance has decided to reject the recommendations of the Tarapore Committee report with respect to the ban on the issuance of fresh PNs by SEBI registered FIIs.

PNs, are instruments like contract notes issued by SEBI registered FIIs, they are in the nature of derivative instruments with the underlying security being Indian stocks. Generally foreign portfolio investors may prefer PNs due to the following;

1. Regulatory delays in getting an FII registration from SEBI.
2. The costs and delays of FII registration and ensuing administrative costs may not be justified for a foreign portfolio investor targeting a narrow portfolio as against those aiming at a larger diversified portfolio, such as, for instance a portfolio of 30 to 40 stocks.
3. Some foreign portfolio investors may not be eligible to invest in India through the FII route (for instance they may be fledgling entities, without the requisite track record for a SEBI FII registration).
4. The PN route is a flexible route of investment.

The Tarapore Committee report, had taken the majority view that fresh issue of PNs should be disallowed and existing PNs be phased out in one year. PNs have been a great cause of discomfort for the central banker (i.e. Reserve Bank of India), as it argues that under the PN route the identity of the investor is often unknown, which does not lend itself to the creation of appropriate audit trails and thus raises doubts as to frauds, hot money flows (leading to volatility in forex reserves), multi-layering and round tripping.

The Ministry of Finance has stood by the earlier Ashok K Lahiri Committee Report which had recommended the continuation of PNs. Thus, as of now, the current investment regime for foreign portfolio investors who want to buy into Indian stocks through the PNs route may not be disrupted.

The Government of India and SEBI have indicated that they are now working to put in place regulations which will provide a broader and more transparent investment regime for PNs. However to avail benefit of the broader PNs regime stricter KYC norms and disclosures as to ultimate beneficiaries and investors would be required. It has also been suggested that the Government of India and SEBI may seek to register the PNs holding/issuing entities.

We believe that the Government of India has a taken a step in the right direction, instead of adopting a knee-jerk reaction which would have choked substantial foreign investment flows into India and sent out a negative market sentiment. The Government of India and SEBI, it appears, have taken up the challenge to build the PNs route into a better regulated and a healthier route for foreign investments.

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You can direct your queries or comments to the authors

Source:

- *The Economic Times, September 4, 2006*
- *The Financial Express August 12, 2006*

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