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Use of Participatory Notes in Indian Equity Markets and Recent Regulatory Changes

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Abstract

This Working Paper should not be reported as representing the views of the IMF. The views expressed in this Working Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Working Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.

This paper focuses on the use of participatory notes (PNs) by foreign investors, as a conduit for portfolio flows into Indian equity markets for more than a decade. The broadening of India's foreign investor base, in recent years, has a bias towards hedge funds/unregistered foreign investors who invest primarily via PNs. While tax arbitrage via capital gains tax has almost disappeared since July 2004, it is intriguing to note that since then the demand for PNs has actually increased. The paper suggests some reasons for the continuation of a buoyant market in PNs, and explains the possible impact from the recent regulatory changes.

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I. INTRODUCTION

Foreign institutional investors (FIIs) have taken a keen interest in the Indian equity market and have been overweight the MSCI index since 2003.² While market capitalization of the large Indian stock exchanges is presently about 100 percent of GDP (around \$1.3 trillion), FIIs hold about 25 percent of the market if cumulative dividends that are rolled over are included. However, market sources suggest that around 50 percent of FII flows have been via participatory notes (PNs). PNs, which are an offshore instrument against underlying Indian securities, can be issued as derivatives or cash. They allow investors, including hedge funds, high net worth individuals, and Indian-based firms abroad to enter and exit the India market while avoiding registration, settlement and other issues. On the other hand, NRIs (non resident Indians) are not permitted to use PNs.

Since 1992, when FIIs were allowed to invest in Indian equity markets after the balance of payments crisis, an offshore market for PNs developed as a primary conduit for foreign investors to invest in India. The origins of such flows stems from the bilateral tax treaty that India has had with Mauritius. The main provision of the 1983 treaty was that no resident of Mauritius would be taxed in India on capital gains arising from the sale of securities in India. The treaty therefore gave capital gains exemption for investments routed via Mauritius. Despite the uniform reduction in capital gains tax arbitrage that existed from the early 1990s through July 2004, it is interesting to note that there has been a rapid growth in the market for PNs in the last three to four years.³

Section II provides some background on how the market for PNs has evolved over time. Section III elucidates why this market continues to remain buoyant and suggests how the recent regulatory proposals on the PNs could impact capital flows in the near term.

II. USE OF PARTICIPATORY NOTES BY FOREIGN INVESTORS IN INDIAN EQUITY MARKET

The skirting of short-term capital gains tax by investing via PNs registered primarily in Mauritius has been going on for well over a decade.⁴ The Double Tax Avoidance Agreement (henceforth, the Mauritius Treaty) has allowed ‘certified residents’ of Mauritius to pay corporate taxes in Mauritius that are effectively zero.

² Portfolio investment is primarily in the India equity market. Due to caps on holdings on the local debt market, foreign investors have little interest in this asset class that is primarily held by the large public banks and the largest government sponsored insurance and pension funds. FIIs hold less than 1 percent of this market.

³ See a prelude to Participatory Notes flows in the IMF’s Global Markets Monitor feature on *Capital flows to India* dated April 2, 2004.

⁴ Double taxation avoidance agreements now also exist with Singapore and a few other countries.

Estimates of cumulative losses to the Ministry of Finance from investments routed via Mauritius since early 1990s may be significant.⁵ For the past decade, onshore transactions have been subject to a short-term capital gains tax as high as 40 percent and long-term capital gains tax between 10–20 percent. However, these have been drastically reduced since July 2004 and presently there is no long-term capital gains tax and only a 10 percent short-term tax.

The (recent) broadening of India's foreign investor base has a bias towards hedge funds/unregistered FIIs; these investors are often not regulated in a foreign jurisdiction that is recognized by Indian regulators. Thus, technically they are not regulated by India. However, these investors primarily use PNs to invest in India equity markets. The regulator, Securities and Exchange Board of India (SEBI), does not differentiate between FIIs that are actually registered and those that are conduits for PN holders. PN positions, both on derivatives and on underlying securities (or cash), are reported via its FII conduit. Thus, it has been difficult for regulators to know the investors who use PNs and this has led them to question the source of such funds. The Reserve Bank of India has consistently asked for a ban on PNs since December 2003 when the total FII capital was around \$20 billion.

Box 1. The Bilateral Tax Treaty between India and Mauritius

The bilateral tax treaty between India and Mauritius has helped in attracting FIIs to the Indian equity markets especially from 1992, when FIIs were allowed to invest after the balance of payment crisis. Entities based in Mauritius are exempted from capital gains tax arising from their investments in India. This resulted in several offshore funds registering in Mauritius to invest in India. Registering a company in Mauritius was (and is) expensive and cumbersome but it did avoid the capital gains tax that has been as high as 40 percent in the past. Mauritius has exploited their tax advantage and has raised costs to a point where some doubt it is worth bothering with that jurisdiction. There is still some tax arbitrage as derivatives are taxed at 33 percent onshore but tax-free offshore. This has given rise to sizable positions recently via PN issue on derivatives.

Hedge funds in recent years have found value in Indian equities. These investors usually do not have a long-term interest to register as an FII. Thus, they resort to Mauritius based entities that issue participatory notes (PNs) through which such investors can invest in India. Market sources and regulators have stated that the origins of such flows remain questionable. However, SEBI, the local regulator, classifies such PN inflows that are not registered in India under the 'FII inflows' category.

With capital gains tax arbitrage having *almost* disappeared and with expensive registration costs in Mauritius, it is intriguing why FIIs are not coming onshore. From a macro stability point of view, a sizable part of capital flows since 2003 have been portfolio related, and not FDI related. Market sources and Indian regulators investigating PN flows suggest that the

⁵ Obscene profits at the FII ranch, Surjit S Bhalla, *Business Standard*, August 4, 2007. Estimates suggest *cumulative* tax losses by not having FIIs invest from onshore may have been about \$10 bn.

May 2004 and May/June 2006 sell-off by FIIs may have been triggered primarily by sell-off by PN investors and this resulted in sharp declines in the SENSEX/NSE index. Since equity flows and the rupee have had a high positive correlation since 2003, many PN holders were also long on the rupee. India remains unique among major emerging markets in that it has had a sizable build-up in reserves while continuing to have a (modest) current account deficit. Thus, monitoring equity inflows (and outflows) remains crucial to India's capital account stability.

The PNs on derivatives are reportedly used primarily by hedge funds.⁶ Typically, a hedge fund strategy is to hedge their exposure in a single security by taking a short position in the futures or options markets (e.g., Nifty). Offshore investors do not pay taxes, so these hedges yield higher net returns when the market rises. Thus, hedging strategies are seen to favor *offshore* investors.⁷ As an example, the profit (whenever the position is closed) from being *long* in a blue chip and *short* the Nifty index, would be the mark-to market value of the long cash position in the blue chip less the cost of purchase of the blue chip holding, *minus* the amount lost on the index hedge (the increase in the index times the size of the position). Therefore, assuming PNs on derivative positions are about \$30 billion this year, the loss from being short in Nifty is around \$12 billion (or the 40 percent increase in Nifty this year *times* \$30 billion). In this example, gains from offshore short-term tax arbitrage amounts to the 10 percent on being long in a blue chip. It is important to note that Nifty losses have to be paid via the 'margin' accounts as the losses accrue, even if the above trading strategy is not closed or unwound. However, if the trade was long Nifty/short blue chip, gains from offshore derivative tax arbitrage would be 33 percent.

⁶ Hedge funds also create portfolios comprising cash positions in mid caps stocks, either because futures markets do not exist or when transaction costs in single stock futures are relatively high; these portfolios are typically held via cash PNs, and are not hedged. Those that hedge prefer to short the Nifty, a very liquid market and this has been the most common hedge against blue chips. Due to the tax arbitrage, PNs on derivatives have been primarily used for such hedges.

⁷ These strategies have thrived, as the structures often allow some hedge funds to take larger exposure on a security than allowed onshore. Market sources indicate that although PN derivative positions are reported gross by FIIs, these are often after netting the short and long positions of various clients/sub-accounts. Thus, typically a hedge fund could take 10 percent long derivative position in a scrip (i.e., above the 5 percent cap allowed in that sector for the scrip, if the investment was made onshore), and another that takes a 6 percent short derivative position on this scrip (again, above the regulatory cap of 5 percent). This would be reported, via their conduit FII, to the regulator as a 4 percent holding on this scrip, within the permissible cap.

III. INDIAN REGULATORS PROPOSAL ON PARTICIPATORY NOTES AND IMPACT ON PORTFOLIO FLOWS

The SEBI's recent discussion paper on PNs states the notional value of PN issued is around \$90 billion. These include: (i) PNs on derivatives (around \$30 billion); and (ii) PNs on underlying securities/cash (around \$60 billion).

Regulators and market sources argue that PNs on derivatives are used to circumvent external commercial borrowing (ECB) rules, avoid taxes, and allow 'round-tripping' of copious monies. A common structure allowing large Indian corporates with overseas affiliates to get around the ECB caps involves the corporate pledging its shares with an Indian bank's offshore subsidiary. In turn, the Indian bank offshore provides a loan to the Indian corporate offshore. The offshore Indian corporate buys equity warrants, issued by its parent onshore via PNs on derivatives. Market sources suggest that the large size of the present PNs on derivatives may in part be stemming from such structures.

These types of structures also result in some capital inflows from hedges on PN derivatives positions. Market sources in Hong Kong, Singapore and London suggest that margins (i.e., down payments on futures positions) are roughly about 25–30 percent. Although counterintuitive, \$7.5–\$9 billion (i.e., 25–30 percent of \$30 billion PN derivatives) has come into India from such margin accounts due to losses on futures positions, without the initial transaction being closed yet. These inflows, along with the regular capital inflows via cash PNs, and the flows from many investors' taking long foreign exchange positions have placed an additional upward pressure on the rupee, over and above the pressures from onshore FII flows.⁸

Regulatory response

SEBI's proposed measures that were adopted recently will discontinue new issuance of PNs on derivatives by FIIs (and their sub-accounts) with immediate effect; existing positions will be required to wind up within 18 months. Furthermore, FIIs that have issued PNs on cash will need to bring the notional value outstanding to no more than 40 percent of their assets under custody in India, as such positions expire/close out. FIIs with current positions below 40 percent of their AUC, can issue only at the incremental rate of 5 percent of their AUC.

⁸ There was a rupee trade that some investors took that required using PN on derivatives. They would go long cash on security A and go short/hedge at the same time via derivative PNs on security A. This is effectively a long position on the Indian rupee (going long cash means rupee paid up front; short PN derivative means receiving in U.S. dollar at the time of closing this trade; since both positions are on security A there is no equity exposure). Also see Appendix 1.

The demand for PNs on underlying securities/cash are from investors who would like to come onshore, but either they are waiting to receive a license, or cannot come onshore since they are not regulated in a SEBI recognized jurisdiction. These investors also include hedge funds which have used PNs since they found the registration as an FII to be an onerous process.⁹ The 40 percent cap on AUC (assets under custody) on foreign flows may impact inflows for two reasons.¹⁰ First, there still remains some ambiguity regarding certain terms (i.e., ‘registered entity’, ‘regulated entity’). If SEBI requires that only regulated entities can be registered, some hedge funds will not be able to come onshore (see Appendix 2 on ‘Regulated Entity’). Secondly, FIIs who have hedged with one leg of the transaction in PN derivatives and the other via cash may unwind their positions as the PN derivative leg is no longer available. Thus, for these two reasons, the 40 percent regulatory cap could also impact the inflows.

Possible impact from the regulatory changes

SEBI’s ban on the issuance of PNs on derivatives will reshuffle the investor base on portfolio inflows.¹¹ Its proposal may increase the inflows *onshore* by the apparent interest from real money accounts to register onshore (including pension, endowments, charitable trusts etc); however, inflows from margin accounts (i.e., from investors who use PNs on derivatives) are likely to disappear along with some investors from the PN cash market. Inflows from PNs on derivatives will not be replaced since this route allowed transactions that cannot be mimicked onshore. The near-term impact depends on how staggered the unwinding is likely to be.¹² Once the reshuffling of the investor base in favor of the real money account takes place over the next 18 months, capital flows are likely to be more stable.

⁹ SEBI reported positions of total or cumulative PNs outstanding are after adding (not netting) the reported positions by all FIIs and their sub-accounts. It is very likely possible that some FIIs may hold offsetting positions on certain securities. Market participants have a range of numbers for such offsetting positions but in the absence of such details, the \$30 billion and \$60 billion split is the best to assume.

¹⁰ Market sources also suggest that a sizable number of PN users were from unregulated jurisdictions.

¹¹ Also, the ban on PN on derivatives will not impact liquidity of both the SENSEX and the associated hedges on the Nifty; these markets are very liquid.

¹² The 18 month window for unwinding the PN on derivatives is large in light of the fact that most positions are short term (less than one year). Market sources suggest that the 18 month window from September 30, 2007 implies March-end 2009. The regulators had stated on February 3, 2004 (under Sec 15 A of FII regulation) that they would phase out PNs issued to entities that are not regulated overseas in 5 years (or by February, 2009). Thus the 18 months is not a coincidence as it suggests consistency on the part of the regulators, and allows sufficient time for PN users to unwind their positions in line with the regulations (see Box 2).

Box 2. Regulation 15 (A), inserted effective February 3, 2004 in SEBI (FII) Regulations, 1995

15(A). (1) FII or sub account may issue, deal in or hold, off-shore derivative instruments such as PNs, equity-linked notes, or any other similar instruments against underlying securities, listed or proposed to be listed on any stock exchange in India, only if favor of those entities which are regulated by any relevant authority in the countries of their incorporation or establishment, subject to compliance of 'know your client', requirement.

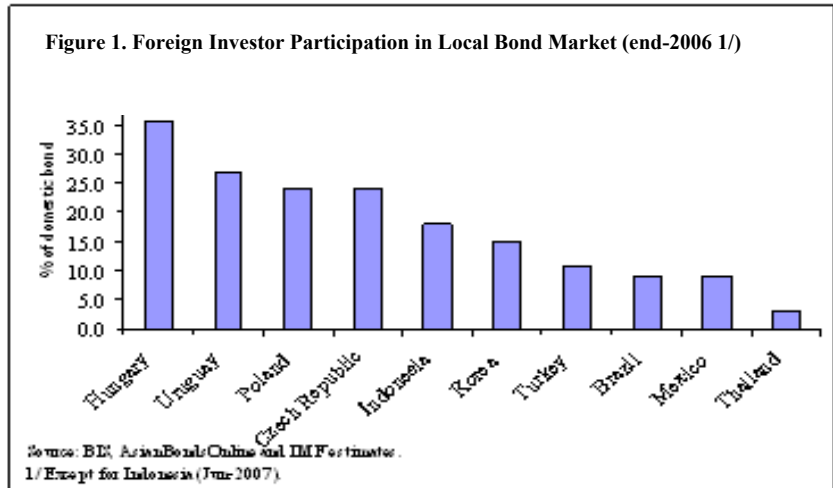
Provided that if any such instrument has already been issued, prior to February 3, 2004 to a person other than a regulated entity, contract for such a transaction shall expire on maturity of the instrument or within a period of five years from February 3, 2004 whichever is earlier.

(2) A FII or sub account shall ensure that no further down stream issue or transfer of any instrument referred to in sub-regulations (i) is made to any person other than a regulated entity.

Appendix I. Offshore Demand for Rupee-Linked Securities

The appendix provides some information on the offshore demand for rupee-linked securities that has been met by recent issuance from International Financial Institutions (all AAA rated). The demand is primarily from real money accounts that cannot take exposure via derivative markets and provides some idea to the extent of repricing that may ensue if the Indian Government relaxes the caps on the local debt holdings by foreign investors in conjunction with an earnest desire to develop this market.

Only around 1 percent or less of the Government of India debt securities (Gsec) market is with foreigners, one of the lowest among emerging markets (see Figure).¹³ Regulators have been wary of inviting large scale foreign investment in debt (unlike in equities) amid concerns that this would encourage large speculative flows that could pose a systemic risk. The local debt market could benefit from further deepening and liquidity that is in evidence from recent offshore rupee issues.



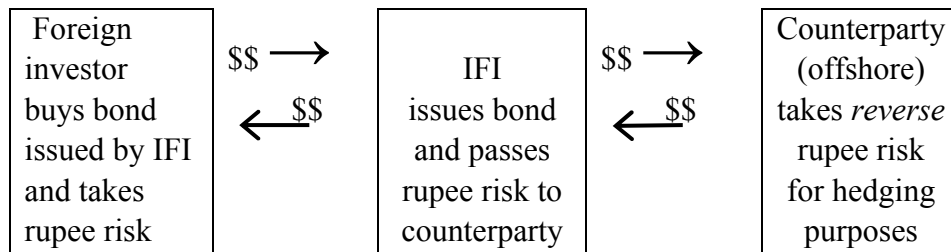
There is growing demand for offshore rupee-linked paper from real money accounts (who are not allowed to hold derivatives), given the caps on foreign investor flows to the Indian local currency debt market. Inter-American Development Bank issued the first offshore rupee bond for in February this year for Rupees 1 billion with a 3-year tenor. In May, the IADB issued another offshore rupee bond (Rupees 1.5 billion, 8.25 percent, 10 years). Since then, another supranational, the World Bank, has placed a similar issue in June (Rupees 1.25 billion, 7.25 percent coupon, 3 year), and the EBRD went further on the tenor in July (Rupees 1 billion, 7 percent coupon, 5 year).

The size of these issues may not be large in U.S. dollars, but this information is only from issuance by AAA credits. Market sources indicate sizable demand for offshore-rupee exposure by real money accounts that are not allowed to take a derivative position via the rupee NDF market or, do not want to take Gsec exposure due to liquidity, credit or other

¹³ Increasingly flows from foreign investors to emerging markets are via derivatives; see IMF Working Paper No. 06/249, Box 1.

reason. Many other institutions, especially investment banks and structured product boutiques that are below AAA also issue such securities for private placements. Thus the AAA issuance provides a snapshot of the offshore demand for rupee exposure.

A typical offshore-rupee transaction involves an IFI that acts as an intermediary between foreign investors who want rupee exposure and a counterparty that (for hedging or other reasons) is willing to take a reverse position on the rupee than that of the foreign investor.¹⁴ Market sources indicate that the AAA rating of the IFIs allows such investors to take the currency risk but eliminate any credit risk. There is no rupee changing hands. The dollars received from foreign investors (and the rupee risk) is passed by the IFI to a counterparty offshore. The coupons and principal are paid by the counterparty, in dollars to the IFI and passed on to the investors.¹⁵ All coupon and principal payments are in dollars at the prevailing rupee/dollar exchange rate on the day such payments are due.



Such issues incorporate information of comparable issues from the onshore Gsec curve and also the rupee NDF swap market.¹⁶ These issues are not just for short maturities; the EBRD issue is for a 5-year tenor and the second IADB issue is for a 10-year tenor. The fact that the first IADB came “inside” the 3 year comparable Gsec was due, in part, to the opportunity for international investors to participate in the Indian rupee bond market without having to meet the local restrictions. All other supranational issues coupons have also come inside (i.e., on average about 50–60 basis points lower) than comparable Gsec issues. Since foreign investors were primarily concerned about credit risk (and thus chose a AAA IFI), such ‘loss in their coupon’ is a proxy for the credit enhancement. It is difficult to disentangle the impact from other factors, such as tax, liquidity etc, that may be associated with the preference for offshore issues.

¹⁴ The IFI takes a swap against the bond issue and hedges the fx risk by passing it to the swap counterparty that takes the rupee risk. If counterparty misses payment, the IFI is liable to the investors.

¹⁵ If the counterparty was onshore (i.e., in India), then the counterparty would need a domestic license; in this case this debt cum swap transaction would come under the local derivatives and debt regulations.

¹⁶ Market sources indicate that the regulators do not explicitly recognize the almost \$1 billion daily volume in the NDF market (50 percent Singapore; 25 percent HK and rest New York and others).

If the rupee hovers around 40/U.S. dollar, market sources envisage a longer tenor and a larger bond issue soon. Presently, with no clear direction for the rupee since April the larger Indian corporates such as Infosys, TCS, Satyam have doubled (and some have tripled) their foreign exchange hedges; however, due to the domestic regulations, these are unlikely to be candidates as the offshore counterparty via their offshore affiliates.

The IFI rupee-linked issuance, so far, has already developed a shadow GSec offshore curve up to 10 years.¹⁷ It is widely acknowledged that the Indian domestic institutional investor base of insurance companies and provident funds, and banks, is a captive audience for the Indian GSecs at almost all points of the curve. Thus, the demand from offshore real money investors is a useful barometer for pricing the GSec curve and may be a useful signal as the regulators contemplate opening this moribund market for foreigners, especially to finance infrastructure projects. For clarification, the overnight-interest swap curve (OIS) is an *onshore* derivative play.¹⁸

¹⁷ It is not clear why one supranational (IADB) was requested not to issue such rupee-linkers and then others are allowed to (India is a member of the WB, but not of the EBRD or IADB).

¹⁸ Foreign investors take a position on the policy rate via the short end of the OIS curve that is liquid and can be rolled to almost 3 years.

Appendix II. Regulated Entity: The Parameters Laid Out by SEBI, February 3, 2004

Any entity which fulfils any one of the below mentioned requirement will be deemed to be a regulated entity:

1. Any entity incorporated in a jurisdiction that requires filing of constitutional and, or other documents with a registrar of companies or comparable regulatory agency or body, under the applicable companies legislation in that jurisdiction will be deemed as regulated entities.
2. Entities that are regulated, authorized or supervised by a central bank, such as Bank of England, the Federal Reserve, the Hong Kong Monetary Authority, the Monetary Authority of Singapore or any other similar body would also be considered as regulated entities.
3. Entities that are regulated, authorized or supervised by a securities or futures commission, such as Financial Services Authority (UK), the Securities and Exchange Commission (USA), the Commodities Futures Trading Commission (USA), the Securities and Futures Commission (Hong Kong and Taiwan), the Australian Securities and Investments Commission (Australia) or other securities or futures authority or commission in any country would also be considered as regulated entities.
4. Members of securities or futures exchanges such as New York Stock Exchange (USA), London Stock Exchange (UK), Tokyo Stock Exchange (Japan), NASD (US), or any other similar self-regulatory securities or futures authority in any country, state or union territory are deemed as regulated entities.
5. Any individual or entity (such as fund, trust, collective investment scheme, investment company or limited partnership), whose investment advisory function is managed by an entity satisfying the above parameters, is eligible to invest in domestic market through PNs.

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