Black Notes in the Stock Market*

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On 27 July, 2015 the BSE Sensex dropped by 551 points relative to its previous closing value. The index fell by a further 102 points the subsequent day. Such single-day declines need not be a cause for concern. The stock market has experienced similar volatility in the past, only to find the decline reversed. However, what was special about the late July episode was that it came after the Special Investigation Team (SIT) on black money set up by the Supreme Court and tasked with recommending measures that will help identify black money hoards, bring them into the open and prosecute those guilty of generating such stashes, submitted its third report. Among the recommendations made in that report was a call to the government and the Securities and Exchange Board of India (SEBI) to identify the 'beneficial ownership' or ultimate owner of instruments titled Participatory Notes (P-Notes or PNs). The SIT stressed that the names of the individuals owning the PNs should be identified and not just of any company through which those individuals were making their investments. It also recommended that the right to trade and transfer those notes should be revisited, because that makes the task of tracking the "beneficial owners" of such notes near impossible.

According to most market observers, while other factors such as the China stocks meltdown may have played a role, the principal reason for the end-July declines in the Sensex was the fear that the SIT's recommendation would force the government and the SEBI to scrutinise more carefully the ownership of and trade in P-Notes, and, if unable to do so, to consider banning issues of P-Notes. The government too seems to attribute the Sensex decline to this fear, since the Finance Minister has been quick to respond to the market decline by saying that there would be no "knee-jerk action" taken against P-Notes and their holders following the SIT report.

These consequences of the SIT report once again draw attention to the role that P-Notes play in the Indian stock market. That role was to a certain extent clear in the early phases of financial liberalization, during the first half of the 1990s. When India opened its doors to the inflow of portfolio capital through the stock market in the early 1990s, investments by non-residents were permitted only as foreign institutional investments. This required non-resident investors to first register with the SEBI as Foreign Institutional Investors (FIIs). The understanding was that not all applicants would be given registration, with the most important qualifying requirements set being that the concerned FII should be an entity that is scrutinised by an acceptable regulatory authority in its home country and has a reasonable track record. This meant that unregulated entities like hedge funds and private equity firms could not trade in the market. The reasoning was that highly speculative investors, not subject to any checks and balances at home, should not be allowed to speculate in the Indian market, because that would increase the vulnerability of the country to "boom-bust" cycles driven by speculative inflows and outflows of capital.

It was in that context that instruments like P-Notes or Equity Linked Notes (broadly termed Offshore Derivative Instruments or ODIs since their value is derived from the underlying equity or debt asset) gained relevance. By allowing mechanisms like "sub-accounts" of which the FII was the investment manager and ODIs, the 1992 guidelines allowed registered FIIs to invest on behalf of clients who themselves are not registered (and possibly could not register) in the country. Moreover, since ODIs could be traded in global markets, once issued it was difficult for the FII, and therefore SEBI, to keep track of the beneficial owner of the instrument. It is only when a holder of the PN decides to cash in the PN by requesting sale of the underlying equity that the FII would once again have knowledge as to who is the beneficial owner. In sum, consciously or otherwise, the government and the SEBI when formulating guidelines on foreign investment in India's financial markets, allowed for the backdoor entry of entities that could not directly register themselves as investors based on those guidelines.

What transpired was that it was this backdoor that proved to be the preferred point of entry for capital coming into India's stock and debt markets. According to one estimate, by the end of August 1995, the value of equity and debt instruments underlying participatory notes that had been issued by FIIs amounted to Rs. 78,390 crore or 47 per cent of cumulative net FII investment. The perception then was that this reflected unusual interest in Indian investments on the part of firms like hedge funds, with The Economist quoting a figure in 2003 that suggested that between a quarter and a third of foreign equity investments were being held by hedge funds.

This was not unlikely, because when a country becomes the target for a surge in investment flows, not only do stock market prices and returns rise, but the currency looks strong and even appreciates. This provides enhanced returns to investors and bolsters confidence in the currency, encouraging others to enter the market. But that makes the country concerned prone to a bust as a result of capital exit if for any reason (internal or external) such confidence is undermined.

Early concern about the 'safety' of PNs had more to do with the possibility that they provided a route to bypass measures to keep out highly speculative investors from the market. They helped conceal the true identity of the "beneficial owner" and, therefore, the motivation of the investor concerned. This increased the probability of disruptive speculative and footloose portfolio capital inflows into the country. There was also concern that the availability of this route to investors was resulting in excess capital inflows. The Reserve Bank of India, under pressure to prevent rupee appreciation, had to purchase foreign exchange and accumulate reserves, and feared that in the process it would lose control over the monetary lever.

This was flagged by the dissent note of the RBI representative on the Expert Group set up by the UPA government in 2004, to examine how it can implement its commitment to encourage FII investments while guarding against an increase in the vulnerability of the financial system due to inflows of speculative capital. That note of dissent inter alia opposed the recommendation of that Group that P-Note issues should continue, with the requirement that FIIs should report their clients' holdings of such positions. How the FIIs could do that when the instrument can be freely traded was not, however, made clear. Among the reasons advanced for the opposition to P-Notes were the implications of volatile capital flows for macroeconomic management and concerns over the origin and source of investment funds flowing into the country.

It was in that background that the SEBI issued a discussion paper in October 2007 that suggested that further issue of ODIs must be stopped and the pre-existing stock should be tapered out in 18 months. Immediately after the paper was released the Sensex recorded a dramatic fall, forcing the Finance Minister to clarify that there was no proposal to completely ban PNs being considered by the government. He also encouraged PN holders to register themselves as FIIs. To facilitate this, the SEBI diluted its norms and began registering all kinds of financial investors from abroad, including hedge funds, as FIIs.

One consequence of this has been that the share of investments flowing through the PN route has fallen. As compared with close to half of outstanding FII investments being in the form of participatory notes in the mid 1990s and 37 per cent at the end of 2007, the figure is down to around 11 per cent. This was because investors who had been using that route only because they could not register themselves as FIIs, then preferred to register themselves, unless their interest in the Indian market was short term.

However, 11 per cent too is not a low figure, given the large volume of outstanding FII investments in India. Even allowing for a part of this use of the PN route to be on account of mere short-term interest in the Indian market, there must be some other reason why investors accounting for substantial investments are still choosing this route. As noted earlier, there are two other important characteristics of P-Notes. One is that they can be traded. The other is that, being eligible for sale and transfer, the beneficial owners of the PNs and underlying assets can be kept concealed for considerable periods of time. Both these features give the instrument attributes that make it a medium that can be used to convert illegitimate money or wealth into that which can be declared and brought into the open. Transactions of that kind in India's stock markets are not unknown. Only recently, the SEBI announced that it had clamped down on some 900 entities which were manipulating the market to convert black money into legitimate funds using the stock market platform. If that is possible, the PN route may be a way in which holders of black money abroad can engage in such alchemy.

This could possibly explain why P-Notes are still so important. So perhaps the SIT has strong grounds for its recommendation that PNs should be phased out if they cannot be made more transparent. But the government's first response suggests that, fearing investor exit, it would ignore even this argument in favour of a P-Note ban.

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