Participatory Notes and Stock Market Resurrection: An Appraisal

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INTRODUCTION

The market capitalization of the Indian stock market is about 100 percent of the GDP ($1.3 trillion) and foreign institutional investor (FIIs) hold about 25 percent of the market if cumulative dividends that are rolled over are included[1]. In pursuance of economic liberalization policy of 1991-92, FIIs were allowed to participate in the Indian Stock Market (ISM) to accelerate the pace of market depth and liquidity[2]. Since then, an offshore market for Participatory Notes (PNs) was developed as a primary conduit for FIIs investment in India. The market data revealed that about 50 percent of FIIs inflows constitute PNs and holders of these instruments are mainly anonymous that causes discomfort to the market regulator, Security Exchange Board of India (SEBI). The present market doldrums in the context of global market meltdown rooted from the subprime fiasco[3] and subsequent failure of giant investment banks, the Lehman Brothers, Merrill Lynch, the insurance giant-American International Group (AIG) etc. coupled with uninterrupted south bound movement of the premier indices eating the country's once burgeoning forex reserve, an apprehension has erupted regarding the behavior of FIIs who have turned net sellers throughout the major part of 2008. The market regulator, SEBI announced host of regulatory measures in October 2007 that prohibited FIIs from issuing or renewing PNs with underlying as derivatives and directed them to unwind their position by June 2009. The RBI representatives on panel also dissented and 'reiterated that the issuance of PNs by FIIs should not be permitted'. The Lahiri committee[4] favoured the continuation of the PNs with the rider that 'SEBI should have full power to obtain information regarding the final holder / beneficiaries or of any holder at any point of time in case of any investigation or surveillance action'.

Under this backdrop, the paper examines the suitability of PNs along with effect of FIIs activities on market volatility, real exchange rate and market capitalization of ISM.

WHAT ARE PNs?

Participatory Notes or P Notes or simply PNs are offshore derivative Instruments (ODIs)[5] issued against the underlying securities; mainly shares, stock/stock index derivatives by the FIIs and their sub-accounts[6] registered with SEBI to the overseas investors; foreign funds or hedge funds who wish to invest in the ISM without registering themselves with the market regulator, SEBI. These are special type of financial instruments issued only to foreign entities other than Indian nationals, persons of Indian origin or restricted entities, subject to compliance with 'know your clients (KYC)' requirements issued by the SEBI implying that ultimate beneficiaries of PNs should be disclosed as demanded by the SEBI. FIIs find it an attractive route as it can be traded in international markets.

MODUS-OPERANDI OF PNs

FIIs and their sub-accounts issue PNs to overseas investors disseminating details of scrips that can be bought with expected return over a specified period. The clients make deposit of fund with overseas branch of the FIIs. The Indian arm of FIIs buys scrips from the ISM and settles it on its own accounts and repatriates dividend, capital

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1 Manmohan Singh. Use of Participatory Notes in Indian Equity Markets and recent Regulatory changes. Working Paper – WSP/07/291. IMF.

2 Ashok Desai. The Economics and Politics of Transition to an open market Economy- India.OECD, Development Centre, Working Paper No 155, October 1999.

3 Sub-prime issue roiling the financial sector in the USA. Bank after Bank have been forced to write off billions of dollars of loans gone sour in the housing loan markets and flaky derivatives that were layered on the top of these assets. The Lehman Brother went for bankruptcy, Investment Bank-Merrill Lynch is to be acquired by Bank of America, and Insurance Giant AIG is following a massive capital restructuring. Bear and Stearns somehow managed the buyers.

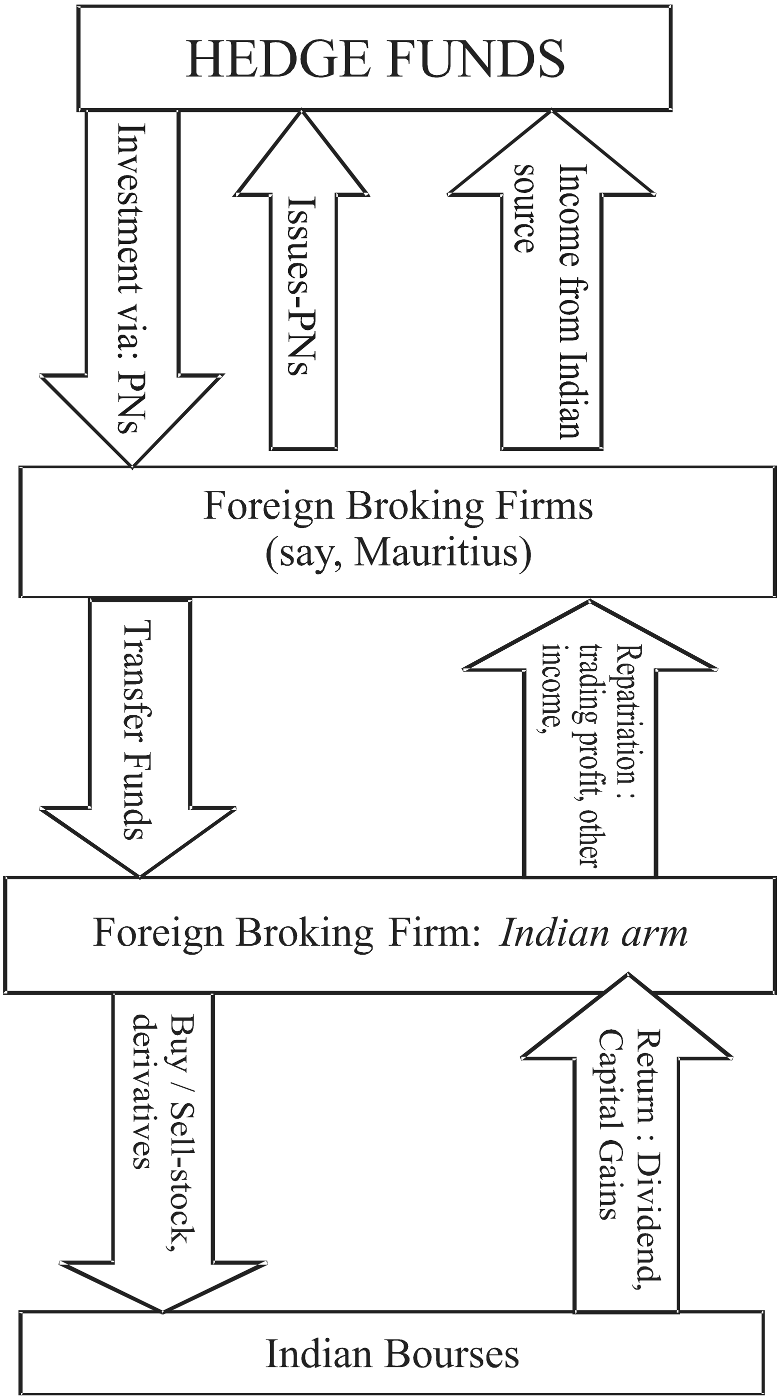
4 Dr. Ashok K. Lahiri, U.K. Sinha, Umesh Kumar. Report of the committee on Liberalisation of Foreign Institutional Investors. Government of India, Ministry of Finance, Dept of Economic affairs. June 2004.

5 ODIs include PNs, Equity linked notes, capped return notes, participating return note and similar other instruments issued by the FIIs/ sub-accounts outside India against their underlying investment in India.

6 The sub account is generally is the underlying fund on whose behalf FIIs invest. The following entities are eligible to be registered as sub accounts viz; partnership firms, private companies, pension funds, investment trusts and individuals.

gains, from such underlying securities to the PNs anonymity of foreign investors. Thus, the PN holders, without owning shares directly, are able to get dividends or capital gains that accrue from the underlying assets.

The flow chart exhibits the modus-operandi of PNs in the ISM. However, PNs are major irritant for market regulator because they are opaque instruments belonging to faceless investors, besides; they amplify the risks associated with volatility in financial markets due to their multiplicity in use. Moreover, the identity of actual investors to such derivatives is seldom exposed leaving the scope for flouting entire rules of the game[7].



[7] For instance, the UBS securities Asia Ltd (UBS), registered FII carried out sales order for Rs 188.35 crore in May 17, 2002 on behalf of its sub-account, Swiss Finance Corporation (Mauritius) Ltd (SFCML). The SFCML acted on behalf of its affiliate USB-AG London who received the order from *Caxton International,* a hedge fund, based in British Virgin Islands, managed by Delaware (US) based *Caxton Associates*. UBS failed to comply with SEBI's disclosure norms, KYC status, i.e. actual investors of *Caxton International.* Later on, a name of Indian investor was exposed highlighting how Indian money was rooted from India to Mauritius , London, British Virgin Islands-US, and finally returned to India in the form of foreign currency as PNs.

PRESENT STATUS OF PNs

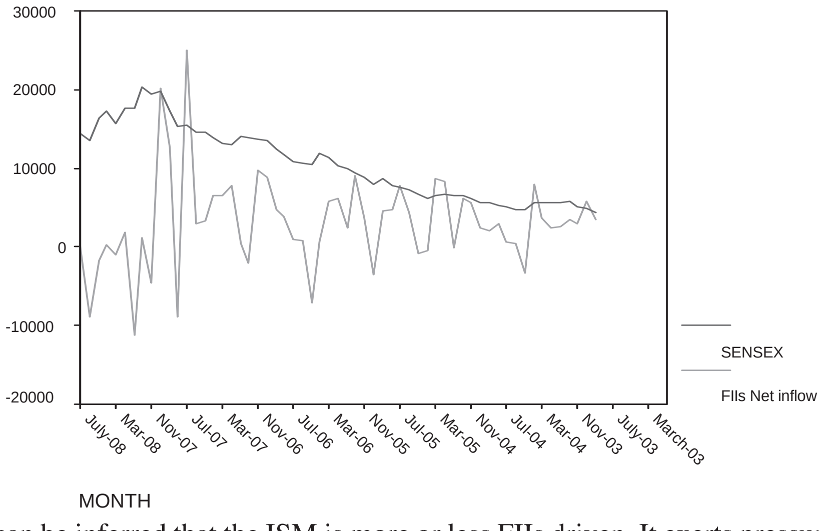
The number of FIIs registered with SEBI significantly increased from 638 in December 2004 to 1065 in July 2007 further to 1443 in July 2008. Out of these registered FIIs, a few are both stock brokers and institutional investors who issue PNs. Merrill Lynch, Morgan Stanley, Credit Lyonnais, Citigroup and Goldman Sachs are among the prime issuers of PNs. According to SEBI, the notional value of PNs outstanding has shot up ten times between March 2004 and August 2007 – from Rs.31,875 crore (20 percent of AUCs- *asset under custody* of all FIIs/ sub accounts) to Rs.3,53,484 crore (51.6 percent of AUCs).The value of outstanding ODIs as derivatives stands at Rs 117071 crore which is approximately 30 percent of total PNs outstanding and the notional value of outstanding PNs as a percentage of AUCs, excluding derivatives as underlying, is 34.55 percent at the end of August, 2007.

FIIs TRANSACTION

FIIs are the driving force in the determination of market sentiments and its price trends. This is so because, they do only on delivery based trades and they are perceived to be infallible in their assessment of the market[8]. The strong risk adjusted returns of the ISM have led to FIIs to make more allocation to India. During the current year (up to July, 2008) FIIs turned to be net seller except in February 2008 (net inflow was Rs 1780.80 cr). Net FIIs inflows remained positive during 2007 except in the month of August and November. Moreover, during 2006 and 2005, barring few in all months, FIIs purchases superseded sales enabling benchmark indices ticking.

During the pre-subprime debacle, India was concerned about streamlining huge inflow of FIIs in an orderly manner. In October 2007, the market regulator SEBI announced a ban on issue of Participatory Notes (PNs) and also announced temporary restriction on ECB. The net flows of FIIs did turn negative only in November 2007 but remained buoyant during December 2007, despite en masse apprehension of their exit. Since then, FIIs turned out to be net sellers because of liquidity crisis in their own country due to global financial storm. Indian companies as a result are catapulted into rough to raise capital in the international debt and equity market indicating clearly the need for government's intervention in dispensing those restrictions. It is moreover viewed that government should raise the cap on FII investment in the debt substantially and in general ease, the inward flow of foreign capital. That would stabilize the currency and make it eventually easier to raise overseas finance for expansion of capacity of the companies as well as creation of fixed infrastructure. The following graph reveals 'converging and co-movement' behavior of the two variables.

Converging and co-movement: Sensex and Net FIIs inflows



From the graph it can be inferred that the ISM is more or less FIIs driven. It exerts pressure on the market leading to its volatility and also triggers the 'real economy' fuelling 'consumption glut' due to capital gain and their subsequent investment. Another pertinent point is that during 58 months, the linear growth rate[9] for Sensex was 4 percent in comparison to growth of FIIs purchases (3pc) and Sales (9pc). Thus it can be said that the net inflows of FIIs definitely added much volatility to the market and its net inflows *inter-alia* affect sensex trajectory.

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8 Indian Stock Market Review, Annual Report-2004, NSE, p-125

9 Growth rate =b=dy/dt in y=a+bt (t= time) y= $[\ln(R_t/R_{t-1})]*100$; R_t =value at t period, R_{t-1} =value at previous to R_t

To assess the effect of FIIs flows both inbound and out bound on the market movement and other variables like market capitalization, effective exchange rate (as rupee depreciates with outflow of dollar) and market volatility (sensex price earnings ratio), we have calculated correlation coefficient among the variables to test the hypothesis that H_0: r=0, H_1: r ≠ 0. We used two tailed test.

The following correlation matrix delineates interrelation among the variables:

Pearson Correlation

	Growth of sensex	Growth of FIIs Purchase	Growth of FIIs Sales	Growth of net inflow of FIIs	Growth of Market Capitalis ation	Growth of EER	Growth of market volatilit y
Growth of sensex	1.000					**	**
Growth of FIIs Purchase	.010	1.000	**				
Growth of FIIs Sales	-.253	.561**	1.000				
Growth of net inflow of FIIs	.061	.027	.136	1.000			
Growth of Market Capitalisation	.087	-.011	-.071	.004	1.000		
Growth of EER	-.394**	-.061	.054	-.096	.193	1.000	**
Growth of market volatility	.623**	.206	.123	.116	.100	-.382**	1.000

* 58 month time period considered , August 2003 to July 2008, Return/Growth=[ln(Rt/Rt-1)]*100

**. correlation is significant at the 0.01 level (2 tailed)

The aforesaid econometric analysis exhibits that Net inflow of FIIs into the economy boosts the upward movement in benchmark indices i.e., Sensex and influences significantly market volatility measured in terms of Sensex PE Ratio and Effective Rate of Return.

In the present fiscal, there is a massive depreciation of Rupee against the 'green back' about 16 percent. The reasons of rupee fall may be attributed to 'imported inflation'; subdued capital inflow since January 2008, and fast rising commodity prices (Oil- in May'08). This apart, the market is moving in an orderly manner on pure macro and micro fundamentals which makes the task of managing exchange rate risk very difficult for the market participants who run on multi currency balance sheet. Rupee against Dollar depreciated by inflation adjusted inflation rate differential. This has further been fuelled by trade gap and net inflows through the capital account (debt & equity) in the form of FII/FDI/ECB/FCCB etc.

It is seen that market volatility represented by Sensex PE is directly associated (correlation coefficient is positive) with FIIs inflows, EER, and Growth of Market Capitalisation. We fitted linear regression model amongst these variables taking sensex movement (growth of sensex) as a dependent variable. The accompanying table exhibits the model summary.

Coefficients [a]

Model		Unstandardized Coefficients B	Unstandardized Coefficients Std. Error	Standardized Coefficients Beta	t	Sig.
1	(Constant)	2.115	.728		2.904	.005
	Growth of FIIs Purchase	7.975E-03	.017	.055	.459	.648
	Growth of FIIs Sales	-7.43E-02	.026	-.350	-2.905	.005
	Growth of net inflow of FIIs	2.369E-02	.096	.024	.246	.806
	Growth of Market Capitalisation	2.870E-03	.009	.033	.324	.747
	Growth of EER	-72.310	53.245	-.150	-1.358	.180
	Growth of market volatility	.616	.114	.591	5.379	.000

F= 9.179 (df=6,51) p<.05, R-squared=.519

a. Dependent Variable: Growth of sensex

It is observed that F-statistic is statistically significant ($p<.05$) indicating that independent variables are reasonably explaining the variation in the dependent variable i.e. market volatility. This is also confirmed by R squared statistic which became 0.519, implying that about 52 percent of variation in the Sensex is explaining the intervening variables. Further, growth of FIIs' purchases triggers the sensex movement. The statistically not significant coefficient

(β=.055, p>.05) clearly indicates that among host of factors affecting the sensex, inflow FIIs (purchase) is one of the factors in accelerating rally in the ISM. However, off loading of FIIs position (sale of FIIs) significantly affect market movement and pushed the market into further volatile region.

The rupee is weakening continuously. The biggest that is weighing on the rupee is dollar outflow as FIIs are selling stocks and taking the money out of the country. The FIIs have sold over $11 billion till date. The worry is that they do not plan to halt the stock sales. At the same time , exporters are not bringing their earnings immediately into the country. They are are holding their dollars abroad in anticipation that the rupee will weaken. There is a huge demand for dollars from the importers who fear that the US greenback can appreciate further. All these factors have led to a huge gap between the demand and supply of dollars, skewing the exchange rate further. The situation may further aggravate to deleveraging of attempt which would result in more domestic pressures. Besides, Hedge funds are likely to net sellers in the local markets. A depreciating rupee has a varied impact on the economy. Exporters will benefit as they will get more rupees for their dollar earnings but importer will become expensive. Moreover, the oil imports will get more expensive by sparing the country the risk of importing inflation. Currently inflation – which is ruling over 11pc would have been much lower if the rupee had not fallen so quickly.

In this respect, the market regulators have indentified that in the course of outflow of funds, the Hedge funds react sharply and bring chaos in the market. They generally use *Equity Swap*[10] route to gain exposure to India's futures and options market. Thus, FIIs have deep rooted influence in the ISM. In the context of present global market turmoil due to sub-prime issues and tumbling of Wall Street banks, Indian corporates will not get opportunity to access to foreign borrowing as they did earlier. A lot of hedge funds' participation in ISM will also slow down. The crisis has been big and its effects will endure long after financial market heals.

REGULATION RESPONSE ON PNs

a) The Reserve Bank of India categorized the PNs as opaque instruments that pose a serious threat to the integrity of the entire economic system. The seriousness of the situation was felt in the context of using PNs by Indian companies to bring in funds parked overseas to fund the creeping acquisition of the company's stock to guard against takeovers. Janakiraman Committee (1994)[11] especially identified the mechanism through which funds borrowed from abroad by public enterprises were diverted by the banks through brokers into the stock market that led to collapse of stock market in 1992. RBI, as a result, opposed the PNs. It even send a note of dissent to the expert group of the Ministry of Finance to check the vulnerability of the capital market to speculative flows. The Tarapore Committee, in July 2006, also recommended that FIIs be prohibited from investing fresh money through PNs. The committee was in opinion that PNs be phased out in a year after providing its holders an exit route. The market regulator SEBI announced a ban since October 2007 on PNs, prohibiting FIIs and their sub-accounts from issuing or renewing PNs with underlying as derivatives and directing them to unwinding their positions within 18 months, June 2009. However, in the present context of financial catastrophe across the globe, SEBI has allowed FIIs to issue PNs subject to fulfillment of KYC status. Further it has disapproved *stock lending and borrowing activities* by FIIs to the entities outside country as KYC norm is not applicable. SEBI viewed that overseas lending and borrowing of stocks through PNs route had precipitated short sales[12] on domestic bourses and therefore announced stringent measures including banning of FIIs.

b) **Margin trade**: SEBI instructed all FIIs to shell out margins for their trade in the cash market. This would bring double barrel effect; locking up of certain portion of fund in the system otherwise it will be used in short term transactions. Margining would ensure genuine trade reining on market volatility. It is, in this context, worth mentioning that, all non- institutional investors- retail, high net worth investors and corporate have to pay upfront up to 50 percent margin on cash market. No other market in Asia has this system. Korea and Taiwan have margining in respect of only high '*beta*' stocks.

c) **International connections**: SEBI's connection with International Organisation for securities commission (IOSCO)[13] enables it to control faceless foreign investors as the guide lines suggest that entities registered in non

[10] It is an arrangement where a series of future cash flows are made by the two counterparties to each other. The pre-determined set of payments which is based on a notional principal amount may be determined by returns on stocks or indices or a fixed or floating rate.

[11] JanakiRaman Committee (1994), Final Report of the committee to enquire into the securities transactions of the Banks and Financial Institutions, The Reserve Bank of India.

[12] Short sales is an activity wherein traders / investors sell shares of a company without owning them. It is done in anticipation that price of the stock will fall in future. The short sellers will buy these shares at a cheaper rate from the market to cover their short position and thus make profit.

IOSCO compliant jurisdiction may not able to register as FIIs in India. IOSCO has a finite test of non cooperative jurisdictions and as per the international obligations. SEBI is empowered to disallow any foreign investor belonging to that jurisdiction.

d) Further SEBI's recent registration criteria for foreign investors are broad based. It has modified to include entities having at least 20 investors holding not more than 49 percent, against 10 percent at present.

e) In partial amendment to SEBI circular reference no IMD/CUST/15/2004 dated April 02, 2004, the undertaking required to be provided by the Foreign Institutional Investors (FIIs) and their sub-accounts with respect to the monthly offshore derivative instruments (ODIs) from May, 2008 particularly in respect of that they have not issued/ subscribed/ purchased any of the offshore derivative instruments directly to/ from Non Resident Indians/ Indian Residents.

CONCLUSION

In the context of global financial turmoil and stock market meltdown, the US government bailout does not ensure the blowing over of financial storm. The Wall Street mayhem is likely to spill over to the other sector of the economy. The high commodity prices and food supply are not keeping up with demand in several parts of the world. Thus, India has to fire on all the cylinders economically, politically and socially. The growing economic importance of services and the increasing share of knowledge based services within this fold are accelerating the structural and geographical realignment of the global economy. The centre of gravity of economic and strategic power is now shifting to Asia. The global financial turmoil, on the other hand, has triggered a panic reaction among the investors pushing their confidence level at the bottom, resulting in the high volatility in the Indian stock market. In this respect, it is required to strengthen the market with introduction of more transparent measures in the stock market operation where participants - both domestic and foreign should strictly adhere to the time tested principles.

India is the fastest growing economy in the world and needs FIIs to sustain the pace of growth. Currently the country is running with a current account deficit (CAD) which is likely to increase to 2.6 percent of GDP in 2009 from 1.5 percent in 2008, due to uncertainty in international price of oil, food commodities. Moreover, CAD presently is financed by *net foreign exchange flows* including FDI ($11bn), Portfolios flows ($41bn), ECB and borrowing by Indian corporate ($33bn) and banking capital ($7.5bn)[14]. Financial market crisis would widen the pace of CAD further. Besides, global financial turmoil and fluctuation in oil prices seem to continue for some time; may be for a year or two. The liquidity crisis in their home would pressurize FIIs for further withdraw from ISM. An intriguing fact of the aftermath of October 2007 circular (SEBI announced Ban on issue of PNs), the net flows of FIIs did turn negative only in November 2007 and remained buoyant during December 2007, despite en masse apprehension of their exit. Since then, they became net sellers because liquidity crisis erupted in their own country.

The table manifests that individual investors, Financial Institutions and promoters have offloaded their holdings in the rising market to prop up their bottom lines. Interestingly, FIIs' stakes of more than 25 percent in the Indian companies has significantly increased from 2 to 14pc in June 2008 over June 2003. On average, their holdings have increased in 92 of the 100 sample companies during the period under consideration.

Thus, alternative strategies to rescue the market's vertiginous fall are lying with correction of structural deficiencies to insulate the market from its future mayhem. The following steps seem to be appropriate: a) More institutional players, particularly pension funds are to be encouraged by allowing tax benefits, to balance out investment horizons and to provide markets with adequate depth. Presently, MFs, Insurance companies and also individual investors are jittery about buying stocks inspite of sitting on a cash pile. b) Robust securities lending and short selling infrastructure to be established to bring heterogeneity in the market operation. c) Market liquidity to be emphasized and in that respect, the pipelines that facilitate movement of cash is to be addressed to. d) Reining of present unbridled inflation is *sin-qua-non* of reviving market sentiments. The Mutual Funds and Insurance Companies would emerge as major investors in the stocks as they did earlier in the inflation contained financial environment. The FIIs also no longer seem enamoured by the India story, rising inflation, oil price, burgeoning CAD and so on. e) Market transparency is needed to ensure that beneficial interest is known so that suspected or tainted money does not enter into the stock market. f) The

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[13] International Organisation for securities commission (IOSCO), with HQ at Spain is a standard setting body for securities markets. It is mandatory for all IOSCO members to sign a Memorandum of understanding(MoU) and follow the principles endorsed by the body and facilitate exchange of information among the international community of security regulators. Market regulators in some countries that are also popular tax havens responsible for substantial quantum of foreign fund flow into the country have MoU with IOSCO. Mauritius, Cyprus and British Virgin Islands all have signed MoU with IOSCO.

[14] RBI. Hand Book of Statistics on Indian Economy. RBI

cap on FIIs investment in debt substantially to be increased and that would, in general, ease the inward low of foreign capital. It will enable the currency to strengthen and make it eventually easier to raise overseas finance for ongoing expansion in creation of fixed assets in manufacturing and infrastructure. g) Surveillance mechanism needs to be reoriented in connection with checking inflow of tainted money into the economy, issuance of PNs to unregulated entities, strict adherence to KYC norms, and disciplinary regime for foreign investors and so on.

However, FIIs are not to be blamed for the present market volatility as evidenced from the following empirical analysis:

PERCENTAGE OF SHARE HOLDING IN SAMPLE COMPANIES during June 2003-June 2008: A Breadth Analysis. (Total Sample 100 companies).

Category of shareholding	Increase in No of companies	Decrease in No of companies	Breadth (*Advances less Declines*) (+/-)	Divested in major companies	Share holdings in companies (Nos)			
					June 2008		June 2003	
					< 25pc	>25pc	<25pc	> 25pc
Individual Holding	11	89	-78	All most all NIFTY constituents to book profit	90	10	76	24
Promoters Holding	34	66	-32	All fundamentally weak companies (selective basis) to book profit.	4	96	5	95
FIIs Holding	92	08	+84	Hindal Co (.34pc), Infosys (6.43), Ranbaxy Lab(7.02), Pantaloon Retail (3.45) Arvind (3.75), etc.	86	14	98	2
FI& Insurance Holding	31	69	-38	Selective basis to book profit	1	99	95	5

Source: *CMIE (prowess database) & BSE website: published in The Economic Times: FIIs raise stake in India Inc as individual investors cash out, September 22, 2008.*

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