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mint ANALYNSIS - TWIN OBJECTIVES - Why Sebi decided to act against PNs

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T he discussion paper issued by stock market regulator Securities and Exchange Board of India (Sebi) on 16 October which proposed measures to cap investments through Participatory Notes (PNs) was largely motivated by two objectives: slowing down capital inflows and limiting the extent of unidentifiable money in Indian stock markets.

"The decision of Sebi is to moderate capital inflows into India," finance minister P.

Chidambaram told reporters.

"We have simply placed a cap on the proportion of money coming through PNs vis-a-vis the total assets under management and the total derivative position," he added.

The ambiguity surrounding the source of PN investments was also responsible for the measures proposed in the discussion paper, said a government official who did not wish to be named.

Sebi is able to identify only the first three legs of transactions in PNs, and the eventual owners of PNs remain unknown to Indian authorities, the official added.

PNs allow foreign investors who are not registered with Sebi as an Foreign Institutional Investor (FII)to invest in an indirect way. An FII buys shares in the Indian market on behalf of such investors and issues them PNs for such purchases.

"There have been instances in the past when the regulator has been unable to find out the ultimate beneficiary of PNs.

The product structure is such that even the FII may not genuinely know about the ultimate beneficiary and hence not able to provide the information to Sebi as needed" said Siddharth Shah, head of funds practice, Nishith Desai Associates, a Mumbai-based law firm. A case in point is Sebi's May 2005 order against foreign broking house UBS Securities banning it from dealing in PNs for a period of one year.

The regulator had imposed this ban in connection with its investigations over a sharp fall in Indian stocks in May 2004 and it argued that the brokerage house did not share full details about the beneficiary of the participatory notes.

While the securities and appellate tribunal set Sebi's order aside, the issue did bring to the forefront questions over know your customer (KYC) guidelines related to the issue of PNs.

Once issued by an FII, PNs can be further traded by a third party who could be an investor sitting in any part of the world.

The SS Tarapore Committee report on Full Capital Account Convertibility (CAC) which came out in July 2006 suggested that PNs should be phased over a period of time.

For months, senior officials in the finance ministry have said the government's policy on PNs is based on the recommendations made in the November 2005 ‘Report of the Expert Group on Encouraging FII Flows and Checking the Vulnerability of Capital Markets to Speculative Flows' (popularly known as Lahiri Committee report as the committee was chaired by finance ministry's chief economic advisor Ashok K. Lahiri).

The Lahiri Committee report recommended that economic policy on PNs be consistent with liberalization.

However, the Lahiri report also acknowledged the difficulty of simultaneously managing liberalization of capital flows, exchange rates and an autonomous domestic monetary policy.

"This (move towards opening up) does not mean inflexibility even in the face of extreme situations. A sovereign always has the power to evolve policies, and take suitable actions in emergency situations," said the Lahiri report.

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