

Understanding Participatory Notes

What are Participatory Notes?

Participatory Notes or P-Notes or PNs are instruments used by foreign investors or hedge funds that are not registered with SEBI, to invest in Indian securities.

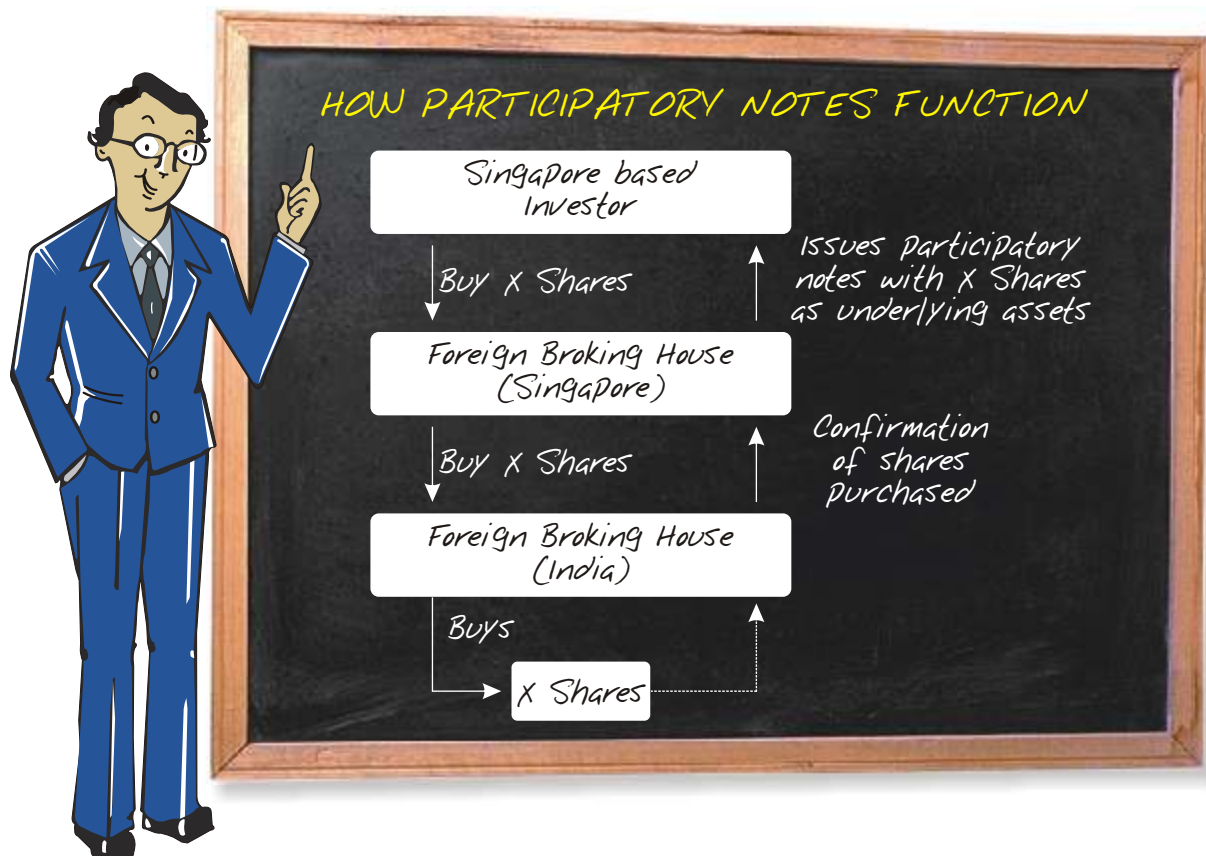
Since international access to the Indian capital market is limited to FIIs registered with SEBI, the market has found a way to circumvent this by creating a simple pass-through mechanism called participatory notes.

These are instruments issued by SEBI-registered Foreign Institutional Investors (FIIs) to overseas investors, who wish to invest in the Indian stock markets without registering themselves with the market regulator, SEBI.

PNs thus allow broader participation from foreign investors and Hedge Funds who can now participate in Indian securities markets, even if they are not registered with SEBI.

How do Participatory Notes work?

India based brokerage houses buy Indian securities on behalf of foreign investors such as Hedge Funds and issue PNs to them. This PN is basically a contract between the foreign investor and the broking entity which assumes the responsibility of trading on behalf of the foreign investor. This is illustrated below:-



As seen in the chart alongside, the Singapore based foreign investor has issued a buy order for certain X shares.

This buy order has been given to the local Singaporean broking house, which in turn has relayed the instructions for execution of buy order to its office based in India. The India-based broking house executes the buy order and confirms the same to its parent office in Singapore. The broking house in Singapore then issues Participatory Notes to the investor, with X shares as underlying assets.

Subsequently any dividends or capital gains collected from the underlying instruments flow back to the investors via the India based brokerage house.

The value of the Participatory Notes is determined on the basis of the underlying assets so purchased. In the case of participatory notes, the underlying assets are shares listed on the stock exchanges.

In the Indian context, FIIs use these instruments for facilitating the participation of their overseas clients, who

are not interested in participating directly in the Indian stock market, for reasons of anonymity.

It is not obligatory for the FIIs to disclose their client details to SEBI unless asked specifically.

Broad features of PNs

- Any entity investing in participatory notes is not required to register with SEBI, whereas all FIIs have to compulsorily get registered.
- Secondly, some of the entities route their investment through participatory notes to take advantage of the tax laws of certain preferred countries (Refer box below on Double Tax Avoidance Treaty).
- Thirdly, participatory notes are popular because they provide a high degree of anonymity, which enables large hedge funds to carry out their operations without disclosing their identity.

Double Tax Avoidance Treaty and its linkage to Participatory Notes

Double taxation is a situation in which two or more taxes need to be paid for the same asset, financial transaction and/or income and arises due to overlap between different countries' tax laws and jurisdictions. The liability is often mitigated by "tax treaties" between countries.

It is not unusual for a business or individual who is resident in one country to make a taxable gain (earnings / profits) in another. This person may find that he is obliged by domestic laws to pay tax on that gain locally and pay again in the country in which the gain was made. Since this is inequitable, many nations make bilateral double taxation agreements with each other.

E.g. A large number of FIIs who trade on the Indian stock markets through the Participatory Notes route operate from Mauritius. According to Double Taxation Avoidance Act between India and Mauritius, capital gains arising from sale of shares are taxable in the country of residence of the shareholder and not in the country of residence of the company whose shares have been sold. Therefore, a company based in Mauritius selling shares of an Indian company will not pay tax in India.

Since there is no capital gains tax in Mauritius, the gain will escape tax altogether.