Participatory Notes

Or

Offshore Derivative Instruments

What are participatory notes?

- **Participatory notes are Offshore, OTC Derivatives on Indian securities sold by registered foreign investors (FIIs) to unregistered foreign investors.**
- **First set of questions are:**
  - **Why unregistered foreign investors?**
  - **Why derivatives?**
  - **Why OTC?**
  - **Why offshore?**
- **Second set of questions:**
  - **Policy concerns**
  - **Policy responses**

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Why Register Foreign Investors?

- Rationale for registering FIIs:
  - Some investors (like pension funds) are good while others (like hedge funds) are bad.
  - Investors must be regulated in their home markets
  - Investors must be identifiable
  - Illusion of capital controls
- None of these arguments make sense.
- In particular, closing our market to foreign retail investors is a big mistake.

Why don't all investors register?

- Some investors may not be confident of meeting eligibility requirements for registration as FIIs.
- Registration involves a significant upfront and recurring compliance cost apart from the payment of fees of $10,000 ($2,000 for sub accounts). This is not worthwhile if average portfolio size over a medium term horizon is modest.

Why derivatives?

- Exposure to Indian securities without registration.
- Leverage (attractive especially to hedge funds and similar investors).
- Non linear pay-offs:
  - Capital protected products for high net worth individuals
  - Exotic structures for more sophisticated investors.

Why OTC?

- OTC products can be customized to meet the needs of the investor.
  - Long dated (for example three year) options. Exchange traded flexible options could be a good substitute.
  - Total return swaps
  - Barriers and other exotic options
- For transactions in the range of USD 10 million, OTC may provide lower bid-ask spreads for some products.

Why Offshore?

- India does not allow OTC derivatives yet and exchange traded derivatives are limited in maturity.
- Trading in onshore derivatives would also require FII registration because "securities" includes derivatives.
- India is tax unfriendly for foreign investors except for the Mauritius window which does not cover derivatives. (The US is a tax haven for foreign investors as are many other countries).

Three Policy Concerns

- PNs circumvent the FII regime and allow "bad", "unregulated", "unidentifiable" investors to come in.
- PNs constitute a major part of the portfolio capital flows into India. Some people think capital inflows are bad and portfolio inflows are worse.
- Offshore market takes liquidity, jobs and incomes away from India.

Three policy alternatives

- Allow PN market to flourish
  - Current regulatory policy (despite October 2007)
- Restrict or ban PNs
  - This may not be feasible
  - Will simply move market to exchanges in Dubai and Singapore
- Bring the PN market onshore
  - This will strengthen the domestic financial sector in India and is the best solution.

Can PNs be brought onshore?

- To the investor, participatory notes have low fixed costs and high variable costs (several hundred basis points per annum).
- Onshore market will have lower variable costs because of higher liquidity onshore.
- The market can be brought onshore if
  - We remove the fixed regulatory cost and
  - Solve the tax problem.