Why India must shun a derivatives crackdown

India's securities regulator will stifle the country's $4 billion derivatives market if it misjudges the riskiness of participatory notes and imposes unnecessary regulation. By Sandeep Parekh

Recent media reports have focussed on the absence of regulatory control over India's market in participatory notes and the risks that these equity-linked derivatives allegedly pose to the country's capital markets. But the risks are overstated.

As a growing number of investors seek more exposure to emerging markets such as India without investing directly, the use of participatory notes is becoming widespread. These derivative instruments, capped return notes, participating return notes and investment notes are issued outside the home country and are based on the value of home country securities. The final structure of the transaction is such that the issuer is fully hedged while the investor gets full exposure to the local capital markets.

India has seen a surge in issuance of these securities over the past few years. The market for participatory notes in India is nearly Rs200 billion ($4.4 billion). These investments have added to the depth of the secondary and derivatives market and improved market sentiment in the primary market.

Typically a large financial institution registered in India as a Foreign Institutional Investor (FII) issues the notes, which are the economic equivalent of owning a security or a bunch of securities. To cover its risk on the overseas part of the transaction, the issuer hedges its position either by buying securities in India or investing in the exchange traded derivatives market in its own name. Thus there is a single transaction split into two parts: an overseas, unregulated portion, and a domestic, regulated portion.

Regulatory gaps

The use of participatory notes began in 1999 with few restrictions. However, in 2001 a financial scandal thrust them into the limelight. Ketan Parekh was using participatory notes, among other products, to illegally channel moneys through tax havens to hide the tracks of his activities in the Indian capital markets.

The scam brought into disrepute the Non-Resident Indian (NRI) and Overseas Corporate Body routes of investing in India, and led to these investments being banned. Yet participatory notes remained legal. There was nothing inherently wrong with using them.

Part of the problem was that neither the Securities and Exchange Board of India (Sebi) nor the Reserve Bank of India (RBI) regulated these instruments. The overseas transaction is between two foreign entities in foreign derivative securities. No part of India's foreign exchange regulations or any securities regulation covers this transaction, therefore it does not appear on the radar of either regulator.

Despite this, Sebi has tried to stamp out any illegalities being committed under the guise of the notes. Following a circular in October 2001 an FII issuing the instruments must make certain disclosures.

Risks

Given the size and importance of the market for these notes in India, it is necessary to understand any risks they introduce and whether there is anything systemically wrong in allowing them to continue to flourish.

Specifically, participatory notes present three risks to the Indian capital markets. The first is that hedge funds are entering the markets by buying notes from FIIs. Since these funds are adept at moving in and out of countries, Sebi has always equated their presence with so-called hot money.

While it is true that many hedge funds have used this route to enter the market, they are not speculative funds. Sophisticated managers run them and look for the slightest opportunity to make money. In September 2003 a study by the regulator found that the investments resulting from these notes are spread over 200 stocks. The risk of increased volatility as a result of the concentration of trading in a handful of stocks thus may not exist.

Ultimately, hedge funds make India's markets more efficient by providing liquidity and reducing aberrations by taking advantage of arbitrage opportunities. The funds also participate in the derivatives and corporate debt markets, both of which require more liquidity.

A second risk of participatory notes is that Indians (to evade some disclosure or other norms) or Overseas Corporate Bodies (which are expressly prohibited from investing in the Indian markets) could route their money into India through the notes.

However, at the time of the Parekh scam the Joint Parliamentary Committee report spotted this risk. It seems unlikely that an FII would risk losing its local operating licence by acting as a conduit for prohibited investors and contrary to the express undertaking that they need to supply every fortnight.

In October 2003 a news report alleged that a large proportion of money coming into India from NRIs and Overseas Corporate Bodies is through participatory notes, but the regulator said these reports were at best conjectural. Nevertheless Sebi is investigating entities with Indian sounding names as a precaution.

The third risk is that the Indian regulator does not know the identity of the final beneficiary of the notes. Sebi has found that a typical note is issued to an entity but that the real owner is typically three bodies removed. This reduces market transparency, particularly if the subsidiary is cross-owned.

But a detailed look at the certificate that FIIs need to submit to Sebi shows that there is no requirement for the issuer to submit such details. Added to this, the transaction is between two foreign entities and is for derivatives securities, which do not come under the regulator's jurisdiction. The regulator thus has to rely on the FII to provide the information voluntarily. Sebi should introduce a requirement that asks for details of the final beneficiary in the chain.

Status quo

In 2001, Credit Suisse First Boston was barred for two years from broking and FII business in India for its role in market manipulation. Reports have stated that CSFB may have bought equity securities based on participatory notes. Whether buying notes – and thus Indian securities – violated the ban on dealing in securities needs to be investigated. But addressing specific issues should not be mixed with the general fact that these investments are improving India's capital markets. ■

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