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THE WALL STREET JOURNAL.

Posted: Mon, Oct 5 2009. 11:54 PM IST

FIIs shun PN route, take to sub-accounts

From 55.7% in June '07, participatory notes accounted for 15% of total assets managed by foreign funds in Aug

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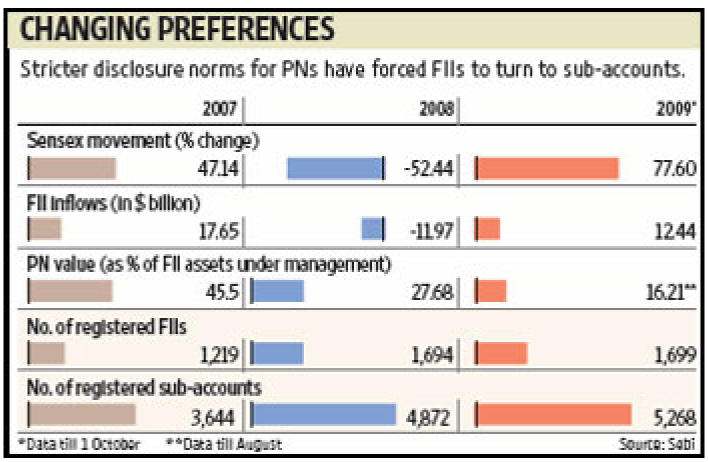
Mumbai: Foreign institutional investors (FIIs), the main force behind the doubling of India's benchmark equity index this year, are favouring so-called sub-accounts to fund stock purchases, shunning participatory notes (PNs), restrictions on which were lifted a year ago.

Capital market regulator Securities and Exchange Board of India (Sebi) had banned PNs in October 2007, amid concerns about volatile foreign exchange inflows that were fuelling the creation of an asset bubble. A year later, the credit freeze forced the regulator to lift the ban as part of the efforts to revive the equity markets.



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Overseas investors are staying away from PNs to keep on the right side of the regulator, say some legal experts.

"Foreign investors now prefer to park their funds through the sub-account route even though they are allowed to come through PNs. This is because there is an uncertainty whether Sebi will continue to allow FIIs to issue PNs or not," said Kishore Joshi of **Nishith Desai Associates**, a Mumbai-based legal and tax counselling firm.

Merrill Lynch and Co. Inc. (now Bank of America Merrill Lynch), Morgan Stanley, Credit Lyonnais SA, Citigroup Inc., Goldman Sachs and Deutsche Bank AG were the biggest issuers of PNs when the Indian market was in the midst of a bull run that began in 2004. They charged clients stiff commissions, often exceeding 85 basis points, while direct trades can be executed for 25 basis points or even less.

One basis point is one-hundredth of a percentage point.

A sub-account, an actively managed investment book, is run in the name of registered FIIs, but managed by separate fund managers.

PNs are derivatives used by foreign funds not registered in India to trade locally while the actual investors remain anonymous. The derivatives permit holders, some of whom may not be eligible to trade in the Indian stock markets, to benefit from the value of the underlying security.

While Sebi removed curbs on such derivatives after a year, it tightened know your customer norms for FIIs issuing the instruments and asked them to report details about the assets under PNs every month.

According to experts, these stringent disclosure norms have persuaded investors to adopt the sub-account route. where registration is relatively easier.

In the past two years, 1,878 entities have registered with Sebi, taking the total to an all-time high of 5,268 on 1 October, a 55% increase over last year. FII registrations have also seen a similar spike, rising from 1,219 to 1,699 between 2007 and 2009.

In contrast, from the peak of 55.7% in June 2007, PNs account for 15% of total assets managed by FIIs in August 2009. This has remained unchanged since January despite an inflow of $12.13 billion (Rs57,618 crore today). In 2007, FIIs pumped a record $17.65 billion into Indian equities.

Unlike PNs, sub-account books are non-transferable; they cannot be sold to any other FII without Sebi's nod. A precondition for opening a sub-account in India is that the fund managers are to be regulated or recognized entities in their respective countries.

Arun Jethmalani, managing director of ValueNotes Database Pvt. Ltd, a Pune-based equity and financial services research firm, supported Joshi's argument, and said: "Uncertainties over the PN route have driven FIIs towards sub-accounts. Though opening sub-accounts requires more paperwork and disclosures in the beginning, it ensures a hassle-free future for these foreign investors."

Lawyers say investors don't want to take chances as the regulator has reserved the right to ask FIIs to divulge "any information" it may require from time to time about the PN investor.

A senior Sebi official, who did not want to be identified, said it may not be appropriate to completely stop PN issuance now, but that the regulator may ask FIIs to disclose details of certain clients or their investments on a case-by-case basis to ensure transparency in market transactions.

Sub-accounts give FIIs the operational freedom of PNs along with the legitimacy conferred by greater disclosure.

According to California-based FII EM Capital Management Llc's chief executive Seth R. Freeman, the sub-account route is "far more convenient for investments" in initial public offerings (IPOs) and qualified institutional placements (QIPs). A QIP is a private placement of shares or securities convertible to equity by a listed firm with qualified institutional buyers approved by Sebi.

So far this year, domestic companies have raised Rs13,062.30 crore through 12 IPOs and about Rs27,832.40 crore through 34 QIPs, according to **Prime Database**, a Delhi-based primary market tracker.

"A growing number of investors wish to invest into India, but not as part of a fund. They want to have greater control and monitoring of their assets and in some cases to influence or participate in the stock selection," Freeman said.

Even hedge funds, normally secretive about their investors and investment strategies, seem to be preferring sub-accounts. "Earlier, many investors used to come through the PN route, but now they are coming directly either through the sub-account route or the FII route," said Joshi of Nishith Desai. Only 20% of his company's clients now invest in Indian equities through their PN accounts, sharply down from 50% in 2007.

Two key Sebi moves, according to Shuva Mandal of **AZB and Partners**, a Mumbai-based law firm, have helped hedge funds consider registering themselves. First, Sebi has started accepting the audited results of funds instead of the investment adviser. Second, the regulator has done away with the one-year track record required for the fund manager.

Still, the issue of PNs is unlikely to cease completely at least in the near future and the instruments will continue to be an alternative route for those who do not want to invest in staff and office infrastructure. “The registration of FIIs might have become easy, but the cost of operations is still a deterrent for many investors and they still prefer PNs. They are opening sub-accounts to ensure continuity in case they are not allowed to trade through PNs in future,” said Haresh Shivdasani, managing director and head of equities at HSBC Securities and Capital Markets (India) Pvt. Ltd.

Some local brokers, too, have ended their association with the derivatives. “After Sebi banned PN issuance in 2007, the margins in the PN business have fallen steeply to 10 and 15 basis points against 80-85 basis points during 2007. This is partly explained by the fall in demand for PN and migration to sub-accounts by foreign investors,” said Anup Bagchi, executive director of ICICI Securities Ltd, the research and financial services arm of ICICI Bank Ltd.

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