
THE LEGAL AND REGULATORY FRAMEWORK GOVERNING PARTICIPATORY NOTES IN INDIA: AN ANALYSIS OF SEBI'S ROLE

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I. Introduction

The liberalization of the Indian economy during the early 1990s ushered in a new era of heightened capital flow and market presence of foreign investors. Of the many financial tools instituted to support such investments, Participatory Notes (popularly called P-Notes) have been innovative but contentious. These overseas derivative instruments (ODIs), which are offered by registered Foreign Portfolio Investors (FPIs) to non-registered foreign entities, facilitate investment in Indian securities without explicit registration with the Securities and Exchange Board of India (SEBI). Whereas P-Notes have made foreign capital available through a channeled route, they have also attracted serious regulatory attention due to their lack of transparency and misuse possibilities for money laundering, round-tripping, and tax avoidance.

The appeal of P-Notes lies in their flexibility as well as their anonymity. For hedge funds and institutional investors generally, particularly those who are bearish on procedural nuances, the instruments provide a cost-effective channel to access Indian capital markets. But it is this same characteristic—failure to disclose the ultimate beneficial owner—that has led the regulators to worry about system risks and money laundering. The response of the regulators to these issues has changed considerably, with SEBI being at the forefront of strengthening the oversight mechanisms and implementing reforms to enhance transparency and investor accountability.

This paper aims to critically examine the legal and regulatory framework governing P-Notes in India, focusing specifically on SEBI's role as the primary regulator of the securities market. It assesses the effectiveness of SEBI's measures in curbing misuse while facilitating legitimate investment. The study further explores the historical development of P-Note regulation, key legislative and regulatory instruments, and enforcement challenges. In doing so, it situates

SEBI's regulatory strategies within a broader comparative and policy framework to identify areas of improvement and reform.

The analysis draws upon statutes such as the SEBI Act 1992, the Foreign Exchange Management Act 1999, and the Prevention of Money Laundering Act 2002. It also reviews SEBI circulars, parliamentary committee reports, and select judicial decisions where relevant. Through this inquiry, the paper contributes to the growing discourse on financial regulation, market integrity, and the future of offshore derivatives in India's investment landscape.

II. Historical Evolution of Participatory Notes in India

The development of Participatory Notes (P-Notes) in India is contemporaneous with the larger process of economic liberalisation and capital market reform that was initiated in the early 1990s. To attract foreign capital, India adopted mechanisms through which non-resident investors could have access to domestic securities without being required to directly register with Indian regulators. This resulted in the creation of offshore derivative instruments (ODIs), like P-Notes, issued mainly by Foreign Institutional Investors (FIIs), a category which has since been absorbed under the Foreign Portfolio Investors (FPI) regime.¹

P-Notes were not explicitly prohibited in the early years and faced scant regulation attention. The ease of their non-regulated operations, though, caught on later when investment flow through P-Notes ballooned in the first years of the 2000s. As of October 2007, reacting to apprehension about increased speculation using P-Notes as a conduit for money laundering, SEBI promulgated a circular prohibiting the issue of them. The regulatory change was prompted by suggestions from the Tarapore Committee, which had cautioned about the systemic threat emanating from less transparent investment products and demanded stricter standards on capital inflows through derivative instruments.²

A key turning point came with the 2004–07 boom in capital inflows, when P-Note investments accounted for over 50% of total FII investments in Indian equity markets. SEBI's 2007 circular required that P-Notes only be issued to regulated entities and introduced a sunset clause for unwinding existing positions. This was a significant change from permissiveness to a cautious

¹ SEBI, *Framework for Overseas Derivative Instruments (ODIs)*, Circular No. SEBI/HO/IMD/FPI&C/CIR/P/2019/124 (10 September 2019).

² Tarapore Committee, *Report of the Committee on Fuller Capital Account Convertibility* (RBI, 2006) 32–35.

approach, based on the duty of the regulator to maintain market integrity under Sections 11 and 11B of the SEBI Act, 1992.³

Later reforms were more directed towards improving disclosure and transparency. The 2014 implementation of the SEBI (Foreign Portfolio Investors) Regulations further integrated the FII and Qualified Foreign Investor (QFI) frameworks and strengthened Know Your Client (KYC) and due diligence norms on P-Note holders.⁴ In 2017, SEBI made beneficial ownership disclosures mandatory and banned issue of P-Notes where the underlying was a derivative security (other than for hedging), to check speculative activities.⁵

Most recently, the SEBI (FPI) Regulations, 2019 marked a significant policy recalibration. These regulations classified FPIs based on risk profiles and imposed specific eligibility and disclosure standards for ODI subscribers. While SEBI stopped short of banning P-Notes outright, it has progressively narrowed the scope for their use by increasing compliance burdens and disincentivising non-transparent investment.

This evolutionary trajectory reveals a gradual shift from regulatory tolerance to risk-based supervision. SEBI's role has expanded from that of a market facilitator to a systemic risk mitigator, seeking to balance investor access with capital market stability.

III. SEBI's Role and Regulatory Powers

The Securities and Exchange Board of India (SEBI), established under the SEBI Act 1992, is the primary regulator responsible for the protection of investor interests and the regulation of the securities market. SEBI's regulatory powers with respect to Participatory Notes (P-Notes) have evolved substantially, transitioning from a reactive posture to a more proactive and risk-based supervisory model. The legal basis for this authority lies primarily in Sections 11 and 11B of the SEBI Act, which empower SEBI to regulate intermediaries and take measures necessary to protect investors and the integrity of the market.⁶

³ Securities and Exchange Board of India Act 1992, S.11 and S.11B.

⁴ SEBI (Foreign Portfolio Investors) Regulations 2014, regs 4–7.

⁵ SEBI, *Enhancement of Monitoring of Offshore Derivative Instruments (ODIs)*, Circular No. SEBI/HO/IMD/FPIC/CIR/P/2017/53 (7 May 2017).

⁶ Securities and Exchange Board of India Act 1992, S.11 and S.11B.

1. Statutory Mandate and Enforcement Powers

Section 11(1) of the SEBI Act obliges the Board to "protect the interests of investors in securities and to promote the development of, and to regulate, the securities market." Section 11(2) authorizes SEBI to register and oversee intermediaries, monitor and examine books of account, and restrain insider trading and manipulation. Also, Section 11B empowers SEBI to give directions in the interests of investors or the securities market, inter alia, to foreign portfolio investors and their associates.⁷

These provisions form the bedrock for SEBI's oversight of P-Note issuances by registered FPIs. Since P-Notes are issued offshore and technically fall outside the jurisdictional boundary of Indian law, SEBI relies on its control over the issuers—i.e., FPIs registered in India—to indirectly regulate these instruments.

2. Regulatory Measures and Circulars

SEBI has issued several circulars and guidelines targeting the issuance and monitoring of P-Notes. The key features of SEBI's regulatory measures include:

- **Issuer restrictions:** Only Category I FPIs and those from FATF-compliant jurisdictions and under direct regulation by their home country regulators are permitted to issue ODIs.⁸
- **Subscriber eligibility:** P-Notes may be issued only to entities subject to KYC norms and regulatory oversight in their jurisdictions.⁹
- **Reporting requirements:** FPIs must submit monthly reports on P-Note transactions, including details of securities underlying the ODIs, end beneficiaries, and jurisdictions involved.¹⁰
- **Prohibition of certain derivatives:** In 2017, SEBI prohibited issuance of P-Notes where the underlying securities were derivatives, except when used for

⁷ *Ibid.*

⁸ SEBI (FPI) Regulations 2019, reg 22(2).

⁹ SEBI, *Circular on ODI Eligibility Conditions*, SEBI/HO/IMD/FPIC/CIR/P/2017/53 (7 May 2017).

¹⁰ SEBI, *ODI Monthly Reporting Format*, SEBI Circular CIR/IMD/FIIC/21/2014 (October 2014).

hedging.¹¹

These regulations aim to close loopholes that historically allowed for anonymous and high-risk foreign investments into Indian securities.

3. Beneficial Ownership and KYC Norms

In line with FATF suggestions, SEBI introduced stricter due diligence standards to reveal the ultimate beneficial owners (UBOs) of P-Note subscribers. The circulars issued in 2014 and 2017 obligated FPIs to report UBO information, broadly defined as per Prevention of Money Laundering (Maintenance of Records) Rules 2005.¹²

This was done to counter layering and round-tripping of funds in tax havens. Failure or misreporting of UBOs can result in suspension or cancellation of FPI registration.

4. Surveillance, Enforcement and Inter-Agency Coordination

SEBI relies on a mix of real-time monitoring, audit requirements, and data analysis to track suspicious P-Note trades involving ODIs. FPIs that offer P-Notes are audited and are required to maintain records for examination. Concurrently, SEBI works in conjunction with other financial regulatory and enforcement bodies like the Enforcement Directorate (ED), the Reserve Bank of India (RBI), and the Financial Intelligence Unit (FIU-IND) to probe suspected infractions linked to P-Note abuse.¹³ Notably, SEBI's lack of direct jurisdiction over offshore subscribers and its dependency on disclosures by FPIs remain persistent challenges. Efforts to enhance cross-border cooperation through Memoranda of Understanding (MoUs) with regulators in the US, UK, and Singapore have helped address some gaps, but enforcement hurdles remain in cases involving opaque ownership structures or shell entities.¹⁴

IV. Key Challenges and Criticisms

Despite SEBI's evolving regulatory framework for Participatory Notes (P-Notes), several challenges persist that undermine the effectiveness of the oversight regime. These challenges

¹¹ *Ibid.*

¹² Prevention of Money Laundering (Maintenance of Records) Rules 2005, R 9(3).

¹³ Standing Committee on Finance, *53rd Report on Regulation of Capital Markets*, Lok Sabha Secretariat (2007) paras 15–18.

¹⁴ SEBI, *List of MoUs with Foreign Regulators* <https://www.sebi.gov.in/legal/mous.html> accessed 1 May 2025.

fall broadly into three categories: transparency and traceability, jurisdictional and enforcement limitations, and market distortions arising from overregulation or compliance burdens.

1. Lack of Transparency and Beneficial Ownership Issues

A persistent criticism of P-Notes is the difficulty in establishing the identity of the ultimate beneficial owner (UBO) of the investment. While SEBI has mandated Know Your Customer (KYC) compliance and UBO disclosure norms for FPIs issuing P-Notes, enforcement is largely dependent on self-reporting by foreign entities.¹⁵ Regulatory arbitrage remains a concern, particularly where P-Note subscribers route funds through jurisdictions with lax disclosure norms or through complex multi-layered structures designed to obfuscate ownership.¹⁶

A significant loophole was exposed during the 2007 market turbulence, when SEBI discovered that a considerable proportion of P-Note subscribers were either unregulated or lightly regulated hedge funds. The inability to verify the actual source of funds poses risks not only to market stability but also to national security, especially in the context of round-tripping and terror financing.¹⁷

2. Jurisdictional and Enforcement Constraints

SEBI's authority is territorially limited to entities operating within Indian jurisdiction. Since P-Notes are issued offshore by FPIs to foreign clients, SEBI can only indirectly regulate them through conditions imposed on the FPI issuer. This structural limitation makes enforcement difficult when violations or suspicious transactions occur outside India's territorial reach.¹⁸

Further, the absence of an international treaty-based enforcement mechanism constrains SEBI's ability to obtain evidence or compel compliance from foreign jurisdictions. Though the Board has signed MoUs with several regulators under the aegis of IOSCO, the practical utility of these agreements is constrained by diplomatic and legal complexities.

¹⁵ SEBI, *Guidelines for Identification of Beneficial Ownership*, Circular No. CIR/IMD/FPIC/59/2016 (10 June 2016).

¹⁶ Bimal Jalan Committee, *Report on Financial Sector Governance* (RBI, 2013) para 5.3.

¹⁷ SEBI, *Consultation Paper on ODIs* (2014) https://www.sebi.gov.in/sebi_data/attachdocs/1396444973783.pdf accessed 13 April 2025.

¹⁸ A Sundararajan, *Cross-Border Financial Regulation: SEBI and Offshore Derivatives* (2018) 43(2) JILI 88.

3. Regulatory Overreach and Market Impact

On the other side of the debate, critics argue that SEBI's overregulation of P-Notes may have adverse effects on market liquidity and foreign investor confidence. After SEBI's 2017 restriction on P-Notes linked to derivatives, FPI investment via P-Notes dropped by over 80% within a year.¹⁹ While this may have improved transparency, it also reduced portfolio flexibility for foreign investors, particularly hedge funds and institutional investors seeking to hedge exposures efficiently.

Industry bodies such as the Asia Securities Industry & Financial Markets Association (ASIFMA) have voiced concerns that increasing compliance costs and uncertain regulatory environments discourage long-term capital flows and reduce the competitiveness of Indian markets vis-à-vis other emerging economies.²⁰ There is an ongoing policy dilemma between fostering a business-friendly investment environment and safeguarding against financial opacity and illicit flows.

4. Judicial and Parliamentary Critiques

Indian courts have occasionally commented on the speculative nature of offshore derivative instruments, particularly in cases involving income tax evasion or money laundering. In *UoI v. Azadi Bachao Andolan*, the Supreme Court, while upholding the legality of tax treaties, acknowledged the need for caution in dealing with instruments that can facilitate treaty abuse.²¹ More recently, parliamentary committees have expressed concern about the systemic risks posed by P-Notes and called for a stronger audit trail and real-time tracking mechanisms.

V. Comparative Regulatory Approaches: Lessons from other Jurisdictions

While India's regulatory framework for Participatory Notes (P-Notes) has been shaped by domestic concerns regarding financial stability, market integrity, and investor protection, it is beneficial to examine how other jurisdictions have approached the regulation of offshore derivatives and similar financial instruments. By comparing India's approach with those of leading financial markets, such as the United States, the United Kingdom, and Hong Kong, it

¹⁹ SEBI, *FPI Statistics Dashboard* (2018–2019) <https://www.sebi.gov.in/statistics.html> accessed 13 April 2025.

²⁰ Asia Securities Industry & Financial Markets Association (ASIFMA), *Position Paper on Offshore Derivatives and P-Notes in Asia* (2019).

²¹ *Union of India v Azadi Bachao Andolan* (2004) 10 SCC 1.

is possible to draw valuable lessons on best practices and areas for improvement in India's regulatory environment.

1. The United States: Regulatory Oversight of Derivatives

In the United States, the regulation of derivative instruments, including offshore derivatives similar to P-Notes, falls under the jurisdiction of multiple agencies, including the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). The U.S. approach focuses heavily on transparency and market surveillance. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 significantly restructured the regulatory framework for over-the-counter (OTC) derivatives, which include instruments like P-Notes. A key component of the Dodd-Frank Act was the mandatory clearing and reporting of derivatives transactions, ensuring that they are subject to stringent oversight.²²

For foreign investments in U.S. markets, the SEC requires that all foreign institutional investors (FIIs) register as Qualified Institutional Buyers (QIBs) if they wish to trade U.S. securities. This is analogous to the registration requirements under India's SEBI FPI regime. However, unlike SEBI, which has allowed the issuance of P-Notes under certain conditions, U.S. regulations discourage the use of opaque investment vehicles like P-Notes, focusing on direct market participation by foreign investors.²³ The U.S. model underscores the importance of transparency and accountability in managing offshore derivatives.

2. The United Kingdom: Financial Conduct Authority (FCA) and P-Notes

In the United Kingdom, the Financial Conduct Authority (FCA) is the primary regulator for financial markets. The UK's regulatory framework places significant emphasis on preventing market manipulation and ensuring that investors have clear visibility over their investments. While the FCA regulates P-Notes indirectly by overseeing the firms that issue them, the UK market has not experienced the same volume of P-Note issuance as India. The UK's approach tends to favour more direct investment channels, such as exchange-traded funds (ETFs) and

²² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), sec 722.

²³ U.S. Securities and Exchange Commission, *Qualified Institutional Buyer (QIB)* <https://www.sec.gov/answers/qib.htm> accessed 1 May 2025.

futures contracts, which are more transparent than P-Notes.²⁴

The UK's stringent disclosure rules and KYC norms for financial institutions offering such derivative instruments help ensure that the risks associated with offshore investments are appropriately mitigated. However, critics argue that the UK's model may inadvertently reduce foreign participation by imposing overly burdensome reporting and regulatory compliance costs on investors.²⁵ In contrast, India's more flexible approach has arguably been more successful in attracting foreign investment, albeit at the cost of regulatory challenges.

4. Lessons for India: Improving Regulatory Balance

The comparative analysis of the U.S. & U.K. regulatory frameworks reveals several lessons for India's treatment of P-Notes:

Transparency and Disclosure: The U.S. and U.K. models underscore the importance of mandatory reporting and transparency in offshore derivatives markets. India could further enhance its P-Note regulatory framework by requiring more detailed disclosures regarding the UBOs of P-Note subscribers, with stricter enforcement mechanisms.

Direct Participation vs. Derivative Instruments: While the U.S. and U.K. focus on direct investment by foreign investors, India has opted to maintain flexibility through P-Notes. However, excessive reliance on P-Notes could distort the market, and a balanced approach might involve encouraging more direct forms of investment while keeping P-Notes as a tool for certain foreign investors.

VI. Conclusion and Recommendations

The regulation of Participatory Notes (P-Notes) in India reflects the country's efforts to balance market accessibility with investor protection. While P-Notes have played a vital role in attracting foreign investment, their opaque nature and potential for misuse have led to increasing regulatory scrutiny. SEBI's regulatory measures, including transparency requirements, KYC norms, and restrictions on certain types of derivative-linked P-Notes, have significantly curbed potential risks associated with offshore investments. Still, there are

²⁴ Financial Conduct Authority, *FCA Handbook: Conduct of Business Sourcebook (COBS)* <https://www.fca.org.uk/handbook/cobs> accessed 1 May 2025.

²⁵ Susan Wright, *Regulating Financial Markets: Lessons from the UK* (Oxford University Press, 2015) 132.

challenges, especially with regard to enforcement, beneficial ownership transparency, and the jurisdictional reach of Indian law.

Comparison with other jurisdictions like the United States, the United Kingdom, will yield useful insights for India. The markets highlight the importance of transparency, direct participation of investors through foreign portfolio investments, and stringent cross-border coordination. By borrowing lessons from there, India could strengthen its regulation further by providing greater transparency to P-Note transactions and tightening the foreign investors' disclosure requirement. Increased closer international cooperation at the regulatory level would enable Indian regulators to face the problems generated by the offshore investments effectively.

Finally, India's regulatory mechanism has to balance the need for attracting foreign capital inflows and ensuring that markets are transparent and safe. With a more developed regulatory strategy and drawing lessons from global experiences, India can mitigate risks related to P-Notes more effectively and ensure that they remain a constructive force in Indian securities market development.