

An Overview of the Regulatory Environment in India with respect to Hedge Funds

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Introduction to the Securities and Exchange Board of India

The Securities and Exchange Board of India (SEBI) is a regulatory body which oversees the Indian securities markets. This includes public issuance of securities, the secondary market and registration for brokers. The purpose of SEBI is threefold:

1. Protect investors' interests.
2. Promote and develop the securities market.
3. Regulate and supervise the securities market.

There are 2 major stock markets in India, The Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE). In addition to these, there are 21 regional exchanges with electronic trading platforms.

There are over 9,600 companies listed on all the exchanges with a total market capitalization of US\$125.5 B. The turnover for in 2001-2002 for the BSE was US\$102 B and for the NSE was US\$62 B.

SEBI & Foreign Institutional Investors Regulatory Environment

For foreign investors wanting to partake in the Indian capital markets, they must register themselves with SEBI as a Foreign Institutional Investor (FII) under the FII SEBI Regulations 1995. Under FII 1995 regulations, an FII is defined as an institution established or incorporated outside India which proposes to make investment in India in securities of companies incorporated in India. Registered FIIs can also register sub-accounts which are trading accounts created by FIIs on behalf of their clients. Before SEBI accepts the request for registration, there are several criteria that must be met. The highlights of the qualifying criteria are listed below:

- An FII must be regulated at its place of incorporation or operations.
- Before making any investments in India on behalf of a sub-account, an FII shall obtain registration of the sub account.
- **NOTE:** "If in the application for registration of a sub-account the applicant indicates that it is a hedge fund, then the consideration of the application is withheld."¹

¹ M.V. Kini & Co. , Advocates and Solicitors, New Delhi, India

- There are also additional criteria including back ground and track record etc. For more details please see SEBI FII Regulations 1995.

The fees for registration are US\$5,000 for an FII account and US\$1,000 for each sub account. SEBI targets a timeline of 10 to 12 days for processing of FII applications; however it has been known to take up to 4 to 6 weeks for FII registration.

In addition to registering with SEBI, FIIs also have investment restrictions. The highlights of FII investment restrictions are listed below:

- FIIs can invest in securities in the primary and secondary markets including shares, debentures and warrants of companies, unlisted or listed or to be listed on a recognized stock exchange in India.
- FIIs can also invest in units of schemes floated by domestic mutual funds including Unit Trust of India, whether listed on a recognized stock exchange or not, dated government securities, derivatives traded on a recognized stock exchange and commercial paper.
- FII's cannot engage in short selling of securities. FIIs can only trade on a delivery basis, however short selling in derivatives is permissible.
- There are additional investment restrictions levied on FII including ownership limitations etc. For more details please see SEBI FII Regulations 1995.

Operating Environment

Since hedge funds are not regulated in their home country, they do not qualify for registration as an FII under SEBI's regulations. However, a significant portion of the global portfolio investments made in India have come in via the hedge fund route. Hedge funds and other foreign investors, due to confidentiality concerns among others, have until recently been able to bypass the FII registration route by holding positions in *Participatory Notes*.

Participatory notes (PN) are derivative instruments that are held by foreign investors not eligible to invest directly in the Indian capital markets. PN contracts are issues by registered FIIs to [unregulated] foreign investors. This allows the foreign investor to gain exposure to

Indian securities by having the registered FII trade in the underlying security. According to some sources, PNs are also traded on exchanges like Luxembourg; however this cannot be confirmed at this time.

Hedge fund managers wanting exposure to Indian securities have two ways to do so. The first is to register with SEBI as an FII, through a Mauritius based operating company (more details in "The Mauritius Angle"). This is not feasible for a hedge fund, since it has a high probability of being denied and also would not benefit from the regulatory and disclosure requirements that FIIs must comply with. Moreover, due to investment restrictions on FIIs, registering as an FII would not be in-line with investment strategies and styles that most hedge funds follow.

The most common route taken by hedge fund managers wanting exposure to Indian securities is via the PN route. For example, a North American hedge fund wanting to hold Indian securities would place an order with a large brokerage house for PNs in the underlying security. The brokerage house would have an operation in Mauritius, which in turn would be registered as an FII with SEBI. The order placements, the issuance of the PN and the final clearing of the trade would take place through internal systems of the brokerage house. The large broker in essence would act like the market itself.



Below is a cost comparison of the FII route and the PN route. This comparison was published in one of the leading business magazines of India, **Business World** on December 15, 2003.

Entry Route	FII	PN
Mauritius registration	\$10,000	\$0
Mauritius operating costs	\$15-20,000/year	\$0
India registration	\$5,000 for 5 years	\$0
Cost/transaction	Approx 0.15%	4% of traded values
Time taken to start ops	8 weeks (5 In, 3 Mau)	Instantaneous
Confidentiality	Average	High

The Mauritius Angle

Mauritius is a small (11 times the size of Washington DC) island country in the Indian Ocean with a population of just over 1.2 million. Due to a twenty year old Double Tax Avoidance Treaty (DTAC) with India it is also the largest exporter of capital to India. Most FIIs registered with SEBI, have done so via the Mauritius route, setting up operating companies in Mauritius to avoid paying taxes in India. Additionally, funds registered in Mauritius have also been able to register themselves as sub-accounts on established FIIs in order to gain exposure into the Indian capital markets.

SEBI's Outlook & New FII Regulations

In recent days SEBI has raised a lot of concern about the issuance of PNs especially to unregulated investors and hedge funds. This has led to uncertainty about the legality of PNs and the future of FII investment in India. The financial and economic media have been covering this issue extensively.

One of the main concerns that SEBI has with PNs and other synthetic instruments issued to unregulated investors is the *quality* of money that is being brought into the country. There are questions that have been raised regarding resident and non-resident Indians that may be using PNs to route money illegally held in offshore accounts.

Due to the lack of transparency in the actual beneficial ownership of PNs, there are also doubts as to whether the money flowing into the country is real FII investment or strategic short term arbitrage investment by hedge funds. SEBI's long term outlook is to open the Indian capital markets and increase the liquidity. SEBI realizes that

hedge funds provide the much needed liquidity and price convergence. However, in the wake of financial market disasters like the 1997 East Asian Crises and the 1998 collapse of Long Term Capital Management, SEBI is taking a very cautious approach towards opening up of the Indian capital markets.

There have been recent changes (February 2004) to the FII regulation that will essentially close the PN route to any new investment in India. Under the modified FII regulation PNs can only be issued to regulated entities. The amendment dated January 27th, 2004 is listed below:

"15A. (1) A Foreign Institutional Investor or sub account may issue, deal in or hold, off-shore derivative instruments such as Participatory Notes, Equity Linked Notes or any other similar instruments against underlying securities, listed or proposed to be listed on any stock exchange in India, only in favour of those entities which are regulated by any relevant regulatory authority in the countries of their incorporation or establishment, subject to compliance of "know your client" requirement:

Provided that if any such instrument has already been issued, prior to 3rd February 2004, to a person other than a regulated entity, contract for such transaction shall expire on maturity of the instrument or within a period of five years from 3rd February, 2004, whichever is earlier.

(2) A Foreign Institutional Investor or sub account shall ensure that no further down stream issue or transfer of any instrument referred to in sub-regulation (1) is made to any person other than a regulated entity."

Given these changes to the FII regulations, the only means for a foreign hedge fund to operate in India is by obtaining a sub-account under an FII registered with SEBI. With SEBI clamping down on such activities, this approach also has several caveats and restrictions.

It must be noted however, that even though SEBI has taken a step towards shutting down the PN route, the outstanding PNs issued prior to February 3rd, 2004 are valid for 5 years. Hedge funds wanting exposure to Indian securities should closely follow SEBI's regulatory changes.



With the Indian economy booming and foreign investment pouring into the country it is in SEBI's interest to facilitate the investment environment. However, true to its nature SEBI will move very cautiously.

Sources

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