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IS SEBI'S FEAR OF HEDGE FUNDS JUSTIFIED!

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Currently, the Securities and Exchange Board of India (SEBI) does not permit hedge funds to be registered as Foreign Institutional Investors (FII) under the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995, as amended from time to time (FII Regulations), to invest in India's secondary markets.

Although the term "hedge fund" is not defined in the FII Regulations or any other Indian legislation, the SEBI uses the report of the Technical Committee of the International Organization of Securities Commissions entitled, "Regulatory and Investors Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds," published in February 2003 (Report), to identify hedge funds. Therefore, any fund or fund manager that has any of the attributes mentioned in the Report is regarded as a hedge fund by the SEBI and, thus, not treated favorably. Nevertheless, as some hedge funds have managed to register as FIIs, the entire process seems to be very opaque and subjective.

The SEBI needs to reconsider its policy of denying international hedge funds permission to invest in India for various reasons.

Most hedge funds manage investment funds as investment partnerships. The investors in these investment partnerships are high net worth individuals and institutions, who are sophisticated investors. Further, contrary to popular belief, many hedge funds have a long-term investment strategy focusing primarily on "equity" securities of public companies that are traded on public stock exchanges in various countries. They conduct their own, independent research on potential investment opportunities and make select investments into companies with deep value assets that may be undervalued in the financial markets. The investment managers' investment objectives are based on a "bottoms-up" fundamental analysis of individual securities or investment opportunities, whereby an absolute value investment strategy is employed that focuses on securities that the investment managers believe to be undervalued. Moreover, many hedge funds hold investments for a minimum period of one year and do very little trading.

A number of hedge funds do not use leverage or margin borrowing in their investment activities. In addition, investors have very limited redemption rights and are only permitted to redeem their interest periodically. In many cases,

investor contributions are subject to lock-in periods before a withdrawal can be made, due to which the investors cannot be short-term players.

Although the investment manager may have some money invested in the investment partnerships, a significant portion of the investment normally comes from third party investors. Additionally, global hedge funds value their positions using the following rules: (1) publicly traded securities are valued at the last sale price as reflected on the primary stock exchange in which the security is listed, and (2) non-publicly traded securities are valued at cost at the time of investment until the securities either become publicly traded or are otherwise able to be readily valued.

Many hedge funds are broad-based funds having atleast twenty investors with no single investor holding more than 10% of the units or shares. Over and above, a number of hedge funds and investment partnerships are registered trading / investment entities in many different Asian and European countries, and are reputable long-term investors.

Therefore, simply categorizing all hedge funds as short-term players and refusing them FII registration is anomalous. Instead, the SEBI should evolve separate regulations for hedge funds. Such regulations can seek details about a hedge fund's investment strategy, its antecedents, the background of its investors and investment manager, registration details of the hedge fund in other jurisdictions, investment track record, etc. In this manner, the applicant hedge fund will have to open all its cards before the SEBI, and the SEBI will be able to take a rational decision as to whether to permit a hedge fund to be registered with it. This will bring about significant transparency in the system and will weed out those hedge funds that do not meet the SEBI's defined criteria. Further, in borderline cases, the SEBI can seek commitments from hedge funds that they will not short sell securities in India. Although many hedge funds are not audited in the US and elsewhere, the SEBI could require them to have a mandatory audit of their Indian entity's books of accounts. This will result in a level playing field for hedge funds.

The resurgence of the stock markets after the crash of June 2006 goes to show that Indian stocks have inherent value and are continuing to attract FIIs and other investors alike. Therefore, the SEBI would do well to be a facilitator of investments, as opposed to an impediment.

In the same vein, the income-tax authorities in India should consider a separate tax on registered FIIs and hedge funds instead of seeking to deny double tax avoidance agreement benefits to such investors. Almost all FIIs operating in India have routed their investments through Mauritius to take advantage of the zero capital gains tax regime. Over the years, the Indian tax authorities have unsuccessfully sought to bring to tax in India such exempt income in various ways. Instead of playing a cat and mouse game, ushering in transparency through a fixed tax regime will result in transparency and significantly higher investment inflows into India.

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