

Corpsec Hotline

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WOULD HEDGE FUNDS BE ULTIMATELY ALLOWED UNDER THE FII ROUTE?

The Securities and Exchange Board of India ("SEBI") is proposing to permit hedge funds to register with it as a foreign institutional investor ("FII") and directly participate in the Indian capital market. SEBI chairman, Mr. M. Damodaran, has made this announcement at a meeting in Singapore recently.

Background

Hedge funds are a class of investors investing on a global basis. While the term 'Hedge Fund' has not been defined under the Indian securities laws, SEBI in its report on hedge funds referred to them as unregistered private investment partnerships, funds or pools that may invest and trade in many different markets, strategies and instruments (including securities, non-securities and derivatives) and are not subject to regulatory requirement in their home country.

At present hedge funds are not permitted to invest in Indian portfolios. They are mainly investing in India through offshore derivative instruments, including participatory notes ("PNs"). PNs are instruments issued by FIIs against underlying Indian securities. Through this route, hedge funds can derive the economic benefit of investing in Indian securities without registering as FIIs or their sub-accounts and without being supervised by the SEBI.

Regulatory aspects

Even though there is no express prohibition in the SEBI (Foreign Institutional Investors Regulations, 1995 ("FII Regulations")) on hedge funds from registering as an FII with SEBI, their unregulated nature prevents hedge funds from registering as an FII. Under the present FII Regulations, hedge funds cannot approach SEBI for registration as an FII since the norms explicitly provide that only entities regulated by a foreign regulatory authority can be registered as FIIs.

Further, there are no provisions in the FII Regulations preventing hedge funds from investing in India as an FII sponsored registered sub-account. While most hedge funds can meet the requirements of the sub-accounts of registered FII, SEBI currently withholds consideration of applications where it is found that the sub-account is a hedge fund.

Implications

Providing hedge funds a direct entry in the Indian capital market would bring them under the direct supervision / jurisdiction of SEBI. This would enable SEBI, whenever required to seek information about the ultimate beneficiaries investing through such hedge funds. This may also remove apprehensions that any India regulatory authority may have that some of the hedge funds are involved in money laundering.

It is, however, to be seen as to when and to what extent SEBI would open up the FII route for hedge funds, as this proposal has to be blessed by the Ministry of Finance ("MoF") as well; especially in view of SEBI's similar proposals in the past, which were not approved by the MoF.

Source: *Business Standard*, March 19, 2007.

- Kishore Joshi & Shiju P.V.

You can direct your queries or comments to the authors

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