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Dear Sirs

Finance Bill 2012

1. Our members have asked us to write to you to express their concern over two provisions that are proposed to be introduced by the Finance Bill, 2012. The first provision relates to the introduction of the General Anti-Avoidance Rule ("**GAAR**"), while the second provision relates to the power to retroactively tax the indirect transfer of assets.

2. Since 1985, the International Swaps and Derivatives Association, Inc. ("**ISDA**") has worked to make the OTC derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 825 member institutions from 57 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, central counterparties and other service providers. Information about ISDA and its activities is available on ISDA's website: www.isda.org.

3. At the risk of repeating the obvious, the benefits of allowing foreign investors to invest in the domestic securities market include the following:

(a) enhances access of local corporates to funding for investment without increasing the foreign debt burden of the country;
(b) leads to development and growth of the domestic capital markets;
(c) encourages reforms to improve the market design of the domestic securities market (including increased reliability in trade execution and settlement, reduced transaction costs and better price discovery); and
(d) encourages the implementation of international standards by listed corporates in terms of accounting standards, transparency and information disclosure, corporate governance, and investor protection.

4. A critical route through which India allows foreign investments into the domestic securities market is via the Foreign Institutional Investor ("**FII**") scheme. As noted in the Annual Report 2010-11 of the Securities and Exchange Board of India: "*Foreign Institutional Investors play an important role in Indian securities markets. Since 1992-93, when FIIs were allowed entry into Indian financial markets, foreign institutional investment has increased over the years except in 2008-09. In tandem with the boom in stock markets and a better global scenario, investments by FIIs into India were quite high in last few years, particularly since 2003-04. FIIs made a record investment in the Indian equity market in 2010-11, surpassing the 2009-10 inflows.*" Cumulative net investment by FIIs has grown from US$4 billion in 1992-93 to US$121.561 billion in 2010-11.

5. Unfortunately, the broad language of the two provisions referred to in paragraph 1 above has caused a great deal of concern among FII participants. Specifically, FII participants are concerned about (i) the application of the GAAR provisions to their investment activities and (ii) the application of the indirect transfer tax provision to investors in offshore derivative instruments or participatory notes issued by the FII, particularly as the indirect transfer tax provision can be applied retroactively to transfers that took place as long ago as 1962.

6. While our members note with some relief the clarifications made by the Finance Minister and Finance Ministry officials on March 27 and 30 that the provisions are not targeted at participatory notes and that a distinction will be drawn between portfolio investments and foreign direct investments, our members are greatly concerned with the statement on March 30 that the tax authorities will examine the tax liabilities of FIIs.

7. As there is an investment limit of 10% of the paid-up capital, an FII cannot acquire a substantial (let alone a controlling) stake in an Indian company. Further, the aggregate shareholding of all FIIs in an Indian company cannot exceed 24% (subject to an increase to the sectoral cap/statutory limit if so resolved upon by the board of directors of that company and by special resolution of its members). Thus, FIIs acquire their interests in Indian companies purely as portfolio investments for financial purposes and not for the purpose of managing or running the company.

8. While there has been an easing of norms to encourage direct portfolio investment in both debt and equity instruments by foreign investors, participatory notes still continue to play a key role. Investors want to gain exposure through participatory notes even when direct portfolio investment is available for myriad reasons. For example, participatory notes will be the preferred means of access for certain types of investors (or certain types of investments) based on various considerations such as lower transaction costs and compliance and recordkeeping overheads. An investor that invests directly will need to implement processes and dedicate resources to setting up and maintaining the requisite accounts with the local

intermediaries and to ensure on-going compliance with the applicable rules and regulations – for the once-off or occasional investor, the costs and effort required to do this will typically not make economic sense and it is better served by accessing the market indirectly via a participatory note and relying on the FII's infrastructure. Participatory notes may also be used because the issuer of the participatory notes provides access to markets in different countries and the investor prefers the convenience of dealing with one party across multiple markets.

9. One other significant aspect of participatory notes as compared to direct investment is that the holder of a participatory note is exposed to the credit risk of the issuer of the participatory note in addition to the risks of the underlying referenced security. This added risk is only justifiable if there are real commercial reasons for accessing the market through participatory notes, such as ability to execute directly, country risk, regulatory risk and the fixed cost savings alluded to in the paragraphs above. Conversely, the issuer of the participatory note may be exposed to the credit or other risks of the participatory note investor. These risks have to be managed using initial and variation margining techniques that are generally employed in the business of financial intermediation. There is also the cost of capital required to support this business by the issuer.

10. The participatory note structure broadens the investor base in Indian securities. This results in cost savings to Indian corporates seeking funds. Broadening the investor base increases liquidity and improves price discovery, which are essential for efficient pricing.

11. In deciding whether or not to invest on their own account as well as for the purpose of issuing participatory notes, FIIs make certain assumptions about their tax position. The continued growth in investments by FIIs into the Indian securities market may well be threatened if the tax position were to become more onerous. Worst still, if the tax position remains unclear and uncertain, FIIs may exit the market as they will not be able to "price in" the tax liability. Thus, our members strongly urge that the provisions be clarified quickly and that in the course of drafting the relevant rules or the provisions relating to GAAR and indirect transfer tax, the commercial intent of investment by FIIs be taken into consideration and appropriate carve-outs be provided.

We would be most pleased to assist in any way. Please contact Jacqueline Low (jlow@isda.org, +65 6538 3879) or Keith Noyes (knoyes@isda.org, +852 2200 5909) or our Indian counsel, H Jayesh (h_jayesh@jclex.com, +91 22 4057 5586) at your convenience.

Yours faithfully,
For the International Swaps and Derivatives Association, Inc.

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