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Dear Sirs

WORKING GROUP ON FOREIGN INVESTMENT IN INDIA

Introduction and Background

1. On behalf of our members, we would like to make this submission, particularly in regard to investments by foreign institutional investors in Indian listed securities.

2. By way of background, ISDA, which represents participants in the privately negotiated derivatives industry, is amongst the world's largest global financial trade associations, as measured by number of member firms. ISDA was chartered in 1985, and today has over 810 member institutions from 57 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end-users that rely on over-the-counter (OTC) derivatives to manage efficiently the financial market risks inherent in their core economic activities.

3. Our members applaud the establishment of this Working Group by the Ministry of Finance ("**MOF Working Group**") and are optimistic that the Report of this MOF Working Group will have as far-reaching an impact as the banking and financial sector reforms that were initiated as a result of the first Narasimham Committee Report (1991). Our members note, in particular, that the Narasimham Committee Report (1991) had led to India's liberalization of the capital account by, *inter alia*, allowing Foreign Institutional Investors ("**FIIs**") to invest in securities and to repatriate capital and earnings in 1992.

4. 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);
(d) encourages the implementation of international standards by listed corporates in terms of accounting standards, transparency and information disclosure, corporate governance, and investor protection.

5. We note the following concerns that have been raised about allowing foreign investment into the domestic securities market and also, about the issuance of participatory notes or offshore derivative instruments ("**ODIs**"):

(a) 'hot money' or speculative inflows and outflows has a destabilizing effect;
(b) macroeconomic management (in particular, maintaining the stability of the Rupee exchange rate, prices and interest rates) becomes more difficult;
(c) ODIs provide anonymity to ODI investors (i.e., the credentials and source of funds of ODI investors may be disguised).

6. Various studies and reports have been done on the pros and cons of foreign institutional investment into emerging markets (including of course, the November 2005 Report of the Expert Group on Encouraging FII Flows and Checking the Vulnerability of Capital Markets to Speculative flows commissioned by the Ministry of Finance (the "**Expert Group Report**"). Whilst the intent of our letter is not to enter into the debate on such pros and cons (as members of this MOF Working Group are much better informed than our members on this), our members wish to highlight their concerns and to propose, for the MOF Working Group's consideration, the changes that they, as financial institutions with registered FIIs within their group, would like to see.

<u>Submissions</u>

7. Above all else, the FII regime should be clear, certain, reasonable in its scope and not subject to frequent amendments. Key provisions of the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995 (as amended from time to time, the "**FII Regulations**") remain unclear despite representations seeking clarification and guidance from SEBI on various aspects. Illustratively, there is lack of clarity in relation to some critical issues within the FII regime, such as (i) the eligibility requirements for an FII or sub-account holder; (ii) the exact nature of instruments that would qualify as an ODI in terms of its definition within the FII Regulations; (iii) the nature and extent of due diligence required to determine if a person is a permitted ODI investor, and (iv) the extent of an FII's obligations in relation to onward issuances and 'back to back' ODIs. Additionally, it has been observed that amendments to, or introduction of new, material requirements under the FII Regulations have been made too frequently[1]. Our members would request that any material changes or developments in the FII regime should be preceded by a period of consultation so that all concerned participants will have a clear understanding of the purpose, scope and impact of the proposed changes or developments. Each time a material change or development occurs, FIIs need to spend considerable time and incur significant expenses to assess the impact, review and recalibrate their systems and processes accordingly, and in case of changes impacting ODIs, decide on what amendments are needed to their contractual documents with ODI investors and persuade their ODI investors to accept these amendments. Persuading ODI investors is particularly difficult where the intent and scope of the changes are unclear as different FIIs and ODI

[1] In October 2001, February 2004, April 2004, October 2007, May 2008 and October 2008.

investors will then have different opinions on what amendments are needed in order to implement the changes to the FII regime.

8. Consistent with the size and the level of maturity of the Indian securities market, our members are of the view that the Indian securities market should be accessible by all portfolio/institutional foreign investors (without discriminating as to the type of investor), and (if some form of registration is thought to be warranted) subject to a formal registration with SEBI that follows a simplified approach. In any case, the current regime where the FIIs are effectively being required to 'police' their sub-account holders and assume liability for their actions is unduly complex and unreasonable (in terms of fair regulatory risk allocation). Our members recognize that one objection to opening up access to all classes of portfolio/institutional investors is that such access may effectively expand capital account convertibility beyond what the Indian government thinks is quantitatively optimal given the size and depth of the Indian securities market. Whilst our members appreciate this concern, they submit that imposing qualitative restrictions (i.e. restricting the types of investors) is not the optimal solution and unduly skews the allocation of the regulatory risk burden against the FIIs without necessarily achieving the policy objective.

9. Based on the practice and experience of our members in other markets, investors want to gain exposure through ODIs even when direct portfolio investment is available for valid reasons and not for the purpose of anonymity. ODIs 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 recordkeeping overheads, or because the ODI issuer provides access to markets in different countries and the investor prefers the convenience of dealing with one party across multiple markets, or because they allow leveraging by the ODI investor (particularly on a global portfolio basis). Our members therefore submit that:

(a) ODI issuance should continue to be allowed.

(b) No restrictions should be imposed on how ODI issuers hedge and risk manage their ODI exposure and hence, on their dealings with the securities that form their overall hedging inventory. This is critically important given that different ODI issuers employ different strategies and techniques to hedge and risk manage their ODI exposure.

(c) There should be no limit on the amount of ODIs that can be issued as the amount of ODIs does not equate with the amount of inflows into and outflows from the Indian securities market (a point that has been accepted by SEBI)[2]. Apart from the reasons cited by SEBI, there is little correlation between the amount of ODIs and the inflows into and outflows from the Indian securities market for the simple reason that hedging and risk management tools have advanced well beyond simple delta one products.

[2] SEBI's Annual Report 2008-09.

i) The PN positions reported represented an inflated figure because of the following reasons:

- The FIIs were reporting PNs when it was merely referenced to Indian securities, or even when it was referenced to a product with Indian weightage, e.g., MSCI Index.
- In the case of ODI, it was not possible to establish any correlation between inflows and ODIs as some of the FIIs were reporting their ODI positions based on notional positions while others on the premium/ margin paid towards the ODI contracts.

ii) Further clamping down on the ODI issuance capabilities of the PN issuers on the derivatives had led to the unintended effect of exporting markets abroad.

(d) Given that the FII registration process implemented by SEBI pursuant to the FII Regulations ensures that only duly regulated offshore entities are registered as FIIs, ODI issuers have been reputable banks and financial institutions. Even when (as submitted in paragraph 8 above), FII registration is made available to all portfolio/institutional foreign investors, ODI issuers will still tend to be reputable banks and financial institutions as the ODI investors (being mindful of issuer credit risk) will want to deal with ODI issuers that are reputable banks and financial institutions. Banks and financial institutions will have in place processes to comply with 'know your client ("**KYC**")' and Financial Action Task Force ("**FATF**") requirements, which will ensure that the credentials and source of funds of ODI investors are verified by ODI issuers in accordance with international norms. Thus, the imposition of additional KYC/FATF requirements on ODI issuers has not only led to duplication and extra costs without any commensurate benefits, but has caused real difficulties in reconciling our members' global KYC/FATF processes with the Indian requirements.

10. Our members note that the Reserve Bank of India does not favour ODIs[3]. Our members, however, submit that instead of banning ODIs, more should be done to increase the attractiveness of direct portfolio investment as an alternative to using ODIs. Such measures would strengthen the Indian capital markets and may include:

(a) simplifying the FII registration process and on-going reporting and compliance requirements so as to reduce transaction costs and recordkeeping overheads of direct portfolio investment;
(b) allowing FIIs to pledge their onshore portfolio investments in favour of their local or global prime broker/custodian; and
(c) allowing a broader scope of Rupee currency hedging onshore by FIIs (including allowing FIIs to trade currency futures).

[3] Expert Group Report, Annex IV on page 61.

11. Cumulative net investment by FIIs has grown from USD4 billion in 1992-93 to USD59.1 billion as at the end of March 2009[4]. Contrary to popular perceptions, net annual outflows were recorded only in two years – in 1998-99 and 2008-09, when there were net outflows of USD386 million and USD9.8 billion respectively[5]. FII investments thus play a significant role in the market.

12. Our members support the stand of the Expert Group Report that "*there can not be a turnaround from the avowed policy of gradual liberalization*, including the capital account. All modern market economies have evolved policies to reconcile prudent monetary management with the benefits of a liberal capital account. There is no scope for any diffidence in India also moving in the same direction."[6] Our members also believe that "attempts to maintain [capital controls] over longer periods may slow needed reforms, stimulate development of mechanisms to avoid the controls, and create a constituency, in the bureaucracy and the private sector, to maintain the controls beyond the time when they are justified by national interests"[7] Therefore, our members submit that a balance be maintained in a progressive manner, between gradual liberalization and controlled economic policies and in furtherance of this objective, the afore-mentioned submissions be deliberated upon by the MOF Working Group.

ISDA would be happy to clarify any points raised in this letter. Please do not hesitate to contact Ms Jacqueline Low (jlow@isda.org, +65 6538 3879) of ISDA.

Yours faithfully,

For the International Swaps and Derivatives Association, Inc.

Keith Noyes
Regional Director, Asia Pacific

Jacqueline Low
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[4] SEBI's Annual Report 2008-09, Table 2.48 on page 64.

[5] A major factor for the outflow in 1998-99 was due to the "worsening outlook on the emerging markets" (SEBI's Annual Report 1998-99) due to the Asian crisis that started in July 1997 and probably the Pokhran nuclear test explosion in May 1998. The outflow in 2008-09 "could be attributed to the global financial meltdown and the home bias of FIIs in the crisis" (SEBI's Annual Report 2008-09, page 63).

[6] Expert Group Report, page 40.

[7] India's Financial System: The Challenges of Reform by James A. Hanson, Senior Financial Policy Advisor, the World Bank and Sanjay Kathuria, Senior Economist, the World Bank, page 28.