Report of the Expert Group
on
Encouraging FII Flows and Checking the Vulnerability
of Capital Markets to Speculative flows

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Ashok K. Lahiri
Chairman

Executive Summary

I. The National Common Minimum Programme (NCMP) envisages policies, which continue to encourage foreign institutional investors (FIIs) but reduce the vulnerability of the financial system to the flow of speculative capital. While reviewing the implementation of NCMP, the Prime Minister desired that an Expert Group should be set up to look into these issues and provide an Action Plan for time-bound implementation. Accordingly, an Expert Group was constituted to advice on an action plan for implementation of the above mentioned commitment made in the NCMP (paras 1-2). This executive summary contains salient features of the report. A dissent note on the report by Shri Vinay Baijal (Chief General Manager, FED, RBI) is appended at Annex IV (para 4).

II. Until the 1980s, India's development strategy was focused on self-reliance and import-substitution. Current account deficits were financed largely through debt flows and official development assistance. There was a general disinclination towards foreign investment or private commercial flows (para 13). After the launch of the reforms in the early 1990s, there was a gradual shift towards capital account convertibility. From September 14, 1992, with suitable restrictions, FIIs and Overseas Corporate Bodies (OCBs) were permitted to invest in financial instruments (para 14). The evolution of FII policy in India has displayed a steady and cautious approach to liberalisation (Table 3) of a system of quantitative restrictions (QRs). The policy liberalisation has taken the form of (i) relaxation of investment limits for FIIs; (ii) relaxation of eligibility conditions; and (iii) liberalisation of investment instruments accessible for FIIs (para 25).

III. Under eligibility conditions, the definition of broad based funds was relaxed in August, 1999 and in February, 2000 and newer entities, such as foreign firms were allowed to invest as sub-accounts (para 26). Participatory notes (PNs) are instruments used by foreign funds, not registered in the country, for trading in the domestic market. They are a derivative instrument issued against an underlying security which permits the holder to share in the capital appreciation/income from the underlying security. PNs are like contract notes and are issued by FIIs, registered in the country, to their overseas clients who may not be eligible to invest in the Indian stock markets. PNs are used as an alternative to sub-accounts by ultimate investors generally based on considerations related to transactions costs and recordkeeping overheads (para 20). In recent times, the anonymity afforded by the PN route has led to concerns about the desirability of PNs (para 30). With effect from February 3, 2004, overseas derivative instruments such as PNs against underlying Indian securities can be issued only to regulated entities and further transfers, if any, of these instruments can also be to other regulated entities only. FIIs/sub accounts have been required to ensure that no further downstream issuance of such derivative instruments is made to unregulated entities (para 31).

IV. Foreign investment – both portfolio and direct varieties – can supplement domestic savings and augment domestic investment without increasing the foreign debt of the country. Capital inflows into the equity market give higher stock prices, lower cost of equity capital, and encourage investment by Indian firms (para 40). Whether higher returns lead international portfolio flows or the other way round is a matter of some controversy (para 44). Evidence from causality tests suggests that FII flows to and from the Indian market tend to be caused by

return in the domestic equity market and not the other way round (para 50). One of the worries stemming from the informational asymmetries between foreign investors and domestic investors is the problem of herding and overshooting. A positive feedback strategy leads to buys (sells) when prices are rising (falling) and can lead to prices spiraling up (down) and overshooting the equilibrium (para 45). Generally, contrary to 'herding', FIIs are seen to be involved in very large buying and selling at the same time. Gordon and Gupta (2003) find evidence against positive-feedback trading with FIIs buying after negative returns and vice versa (para 125).

V. Most commentators agree that while portfolio flows are sometimes considered volatile, in India's experience, there is no significant evidence of such volatility. However, there has been increasing complexity in monetary management with the triple objectives of maintaining orderly conditions in the exchange market, price stability and interest rates. This is related to the idea of the "impossible trinity", where liberalisation of capital flows is difficult to reconcile with orderly conditions in the exchange market and autonomy of domestic monetary policy (para 59).

VI. While there is indeed the issue of timing the policy of encouragement appropriately, to avoid the pitfalls of throwing the baby with the bath water, there can not be a turnaround from the avowed policy of gradual liberalization (para 129). Any recommendation made today should be consistent with the broad strategy of further liberalisation, and not look like or be a rollback of reforms (para 130). This does not mean inflexibility even in the face of extreme situations. A sovereign always has the power to evolve policies, and take suitable actions in emergency situations. Apart from such emergencies, the broad direction of reforms since 1991 should be preserved (para 131). However, RBI is of the view that in view of macroeconomic implications, impact on financial stability, especially on exchange rate, and fiscal vulnerability, apart from monetary management, a special group may be constituted to study measures to contain large volatility in FII flows as a priority. The recommendations of such a special group may be finalized and further actions considered together. Such a package is necessary since the present report does not address the issue of volatility comprehensively (Annex IV, para 4A). Furthermore, RBI is of the view that since most of the recommendations of the Group have significant macro economic implications and also because policy actions based on them will be irreversible, considerable thought is needed to be applied before their implementation. It suggests that the Expert Group Report as well as the Report of the Special Group indicated above, along with the Reserve Bank's comments are placed in the public domain, for wider debate and consultation, before processing the proposals further (Annex IV, para 6).

VII. Indian investors are indirectly affected by FII flows to the extent that it enhances or diminishes the security prices in the Indian market. In general, enlarging the demand side of Indian securities is beneficial not only for Indian investors but also the firms that raise money from the capital markets. The only exception is when such FII flows run the risk of adversely impacting market integrity (para 133). Regulations covering issues of market integrity are designed to obtain market efficiency thorough undistorted price discovery. There is a lurking fear that such entities, which are not registered with home country regulator (in this case

financial regulator), may be difficult to regulate. In addition, reporting requirements have been imposed on FIIs and currently PNs cannot be issued to un-regulated entities abroad (para 134).

VIII. With the policy of market regulation being the encouragement of broad-based funds to invest in the country, high net-worth individuals fall outside the category of diversified investors. In order to address the market integrity concerns arising out of allowing some entities, which do not have reputational risk or are unregulated, there is merit in prohibiting such entities from getting registered (para 135). With the prudential regulations applying to FIIs, the dimension of systemic risk appears to be limited (para 136).

Encouraging FII flows:

IX. In terms of encouraging FII flows, one aspect of difficulty lies in the treatment of FDI sectoral limits and FII sectoral limits. The Committee on Liberalisation of Foreign Institutional Investment has proposed reforms aimed at separating these two (para 138). Any potential abuse of the FII route by strategic investors of foreign direct investors should be prevented by strictly enforcing the broad-based nature of the FIIs through appropriate regulation of PNs and sub-accounts (para 139).

X. Thus, FII investment ceilings, if any, may be reckoned over and above prescribed FDI sectoral caps. The 24 per cent limit on FII investment imposed in 1992 when allowing FII inflows was exclusive of the FDI limit. The suggested measure will be in conformity with this original stipulation (para 140). As a transitional arrangement, the current policy of a composite cap, wherever it exists, for both FDI and FII investment limits, may be continued. However, attempt should be made, in consultation with the Ministries concerned, that this composite cap is at a sufficiently high level (para 141).

XI. Non-availability of good quality equities in adequate volume appears to impede FII flows. FII flows would be encouraged by greater volume of issuance of securities in the Indian market. This would be assisted by PSU disinvestment (para 142). Companies executing large projects in the infrastructure sector and telecom sector should also be encouraged to access the domestic capital markets (para 143).

Vulnerability to FII flows

Strengthening domestic institutional investors

XII. The participation of domestic pension funds in the equity market would augment the diversity of views on the market. This would also end the anomaly of the existing situation where foreign pension funds are extensive users of the Indian equity market but domestic pension funds are not (para 157).

Participatory Notes

XIII. RBI is of the view that PNs should not be permitted at all. RBI's main concerns regarding issue of PNs are that the nature of the beneficial ownership or the identity of the investor will

not be known, unlike in the case of FIIs registered with a financial regulator. Further, trading of these PNs will lead to multi-layering, which will make it difficult to identify the ultimate holder of PNs. Both conceptually and in practice, restriction on suspicious flows enhance the reputation of markets and lead to healthy flows (Annex IV, para 4C). However, the majority recommends that the current dispensation for PNs may continue. SEBI should have full powers to obtain information regarding the final holder/beneficiaries or of any holder at any point of time in case of any investigation or surveillance action. FIIs may be obliged to provide the information to SEBI (para 153).

Hedge Funds

XIV. Regulatory developments with regard to hedge funds in the US and elsewhere, including Europe, may be closely watched to formulate policy on the basis of experiences of these countries at a later date. Only those funds which are otherwise eligible to be registered as FIIs/sub-accounts under SEBI (FIIs) Regulations, 1995 may be continued to be allowed (para 156).

Ceiling on FII and sub-accounts

XV. RBI is of the view that sub-accounts should not exist as a separate class of investors. However, the majority recommends that the existing limit of 10 per cent holding in any one firm by any one FII may be extended to cover the sum of the holdings of any one FII and all such sub-accounts coming under that FII which have common beneficial ownership as the FII. The onus for establishing that a sub-account does not have a common beneficial ownership will lie with the FII. This requirement may be phased in over a five-year period, with a limit of 20 per cent by December 2005, 18 per cent by 2006, 16 per cent by 2007, 14 per cent by 2008, 12 per cent by 2009 and 10 per cent by 2010 (para 158).

Broad basing of eligible entities

XVI. With the policy of market regulation being the encouragement of broad-based funds to invest in the country, high net-worth individuals fall outside the category of diversified investors. In order to address the market integrity concerns arising out of allowing some entities, which do not have reputational risk or are unregulated, there is merit in prohibiting such entities from getting registered. Such existing entities may be given sufficient time to wind up the position (para 135).

Operational flexibility to impart stability to the market

XVII. The stability of foreign investment in India will be enhanced if FIIs are able to switch between equity and debt investments in India, depending on their view about future equity returns. Greater flexibility for FIIs to participate in the bond market will induce more "balanced" strategies, and mixing of equity and debt. Such FII investment in debt will indeed be a part of India's external debt, but with an important difference, namely that such debt will be in domestic currency. Keeping this important difference in mind, the quantitative restriction upon debt flows may be progressively amended to a cap on the annual flow from the present

ceiling on the aggregate portfolio value (para 160). RBI, however, is of the view that since the requirement for operational flexibility is narrow one, the ceiling should be on the total stock of FII investment in debt and not on an incremental basis as suggested (Annex IV, para 4F).

Negative list of tax-havens

XVIII. Consistent with the recommendations of the Financial Action Task Force (FATF), it must be ensured that only clean money through recognized banking channels is permitted in the securities market (para 148). There should be a negative list of tax havens, whereby entities registered in these jurisdictions are prevented from attaining FII status (para 149).

Knowledge activities

XIX. Department of Economic Affairs should initiate a research program on "Capital flows and India's Financial Sector: Learning from theory, international experience, and Indian evidence" (para 161).

CHAPTER 1. INTRODUCTION

1.I. Background

1. The National Common Minimum Programme (NCMP) envisages policies, which continue to encourage foreign institutional investors (FIIs) but reduce the vulnerability of the financial system to the flow of speculative capital. While reviewing the implementation of NCMP, Prime Minister desired that an Expert Group should be set up to look into these issues and provide an Action Plan for time-bound implementation.

2. *Accordingly, an Expert Group was constituted to advice on an action plan for implementation of the above mentioned commitment made in the NCMP.* The Office Order constituting the Expert Group is at Annex I. The following are the members of the Group:

i) Chief Economic Advisor	Chairman
ii) Shri U.K. Sinha, Joint Secretary (CM)	Member
iii) Shri R. Bannerji, Joint Secretary (FB)	Member
iv) Shri Pratip Kar, Executive Director, SEBI,	Member
v) Shri F.R Joseph, Chief General Manager, FED,RBI	Member

After the transfer of Shri R. Banerjee, Shri P. K. Deb, Joint Secretary (FT) and the transfer of Shri F. R. Joseph, Shri Vinay Baijal (Chief General Manager, FED, RBI) became the members.

3. The terms of reference of the Group were:
(i) to consider how FII inflows into the country can be encouraged;
(ii) to examine whether existing regulatory framework adequately addresses the concern for reducing the vulnerability of capital markets to the flow of speculative capital; and
(iii) to suggest further regulatory measures as may be considered necessary.

4. The report of the Group follows. *A dissent note on the report by Shri Vinay Baijal (Chief General Manager, FED, RBI) is appended at Annex IV.*

1.II. FII inflows into India

5. Net FII inflows into India increased steadily through the decade of the 1990s to reach an annual peak of US$10.25 billion in 2004-05 (Table 1). Cumulatively, FII investments as on October 31, 2005 have been US$ 39.27 billion.[1]

6. Every year since FIIs were allowed to participate in the Indian market, FII net inflows into India have been positive, except for 1998-99. This reflects the strong economic fundamentals of the country, as well as the confidence of the foreign investors in the growth with stability of the Indian market. The year 2003 marked a watershed in FII investment in India. FIIs started the year 2003 in a big way by investing Rs. 985 crore in January itself. Meanwhile, corporate India continued to report good operational results. This, along with good macroeconomic fundamentals, growing industrial and service sectors led FIIs to perceive great

[1] RBI data generally shows that investment by FIIs has been smaller, when compared with SEBI data. This discrepancy in the statistical system needs to be corrected. One possible explanation may involve differences in the treatment of reinvestment of profit earned.

potential for investment in the Indian economy. In April 2003, prices of commodities like steel and aluminium went up, propelling FII investment in May 2003 to Rs. 3,060 crore. Around the same time, Morgan Stanley Capital International (MSCI) in its MSCI Emerging Markets Index gave a weight of 4.3 per cent to India among the emerging markets of the world.[2] Calendar year 2004 ended with net FII inflows of US$9.2 billion, an all-time high since the liberalisation.

Table 1. FII Investments

	Securities and Exchange Board of India (SEBI) data				Reserve Bank of India (RBI) data	SEBI Data
	Gross, in Rupees crore		Net		Net, in millions of US dollars	in millions of US dollars[1]
Year	**Purchases**	**Sales**	**Rupees crore**	**Millions of US dollars[1]**	**In the year**	**Cumulative**
1992-93	17	4	13	4	1	4
1993-94	5,592	466	5,126	1,634	1,665	1,638
1994-95	7,631	2,835	4,796	1,528	1,503	3,166
1995-96	9,694	2,752	6,942	2,036	2,009	5,202
1996-97	15,554	6,979	8,575	2,432	1,926	7,634
1997-98	18,695	12,737	5,958	1,650	979	9,284
1998-99	16,115	17,699	-1,584	-386	-390	8,898
1999-00	56,855	46,734	10,121	2,339	2,135	11,237
2000-01	74,051	64,116	9,935	2,159	1,847	13,396
2001-02	49,920	41,165	8,755	1,846	1,505	15,242
2002-03	47,061	44,371	2,690	562	377	15,804
2003-04	1,44,858	99,094	45,765	9,950	10,918	25,755
2004-05	2,17,911	1,71,696	46,215	10,248	8,279	36,008
2005-06 [2]	1,65,032	1,50,886	14,146	3,262	4,228#	39,270

[1] At monthly exchange rates.

[2] Until October 31, 2005.

for April-September, 2005.

7. The buoyant inflows continued in 2004-05. This weight was further increased to 5.9 per cent in April, 2004. In 2004-05, after reversing direction briefly during the period May-June, FII inflows became robust again, leading to net inflows of US$ 10.25 billion during the year.

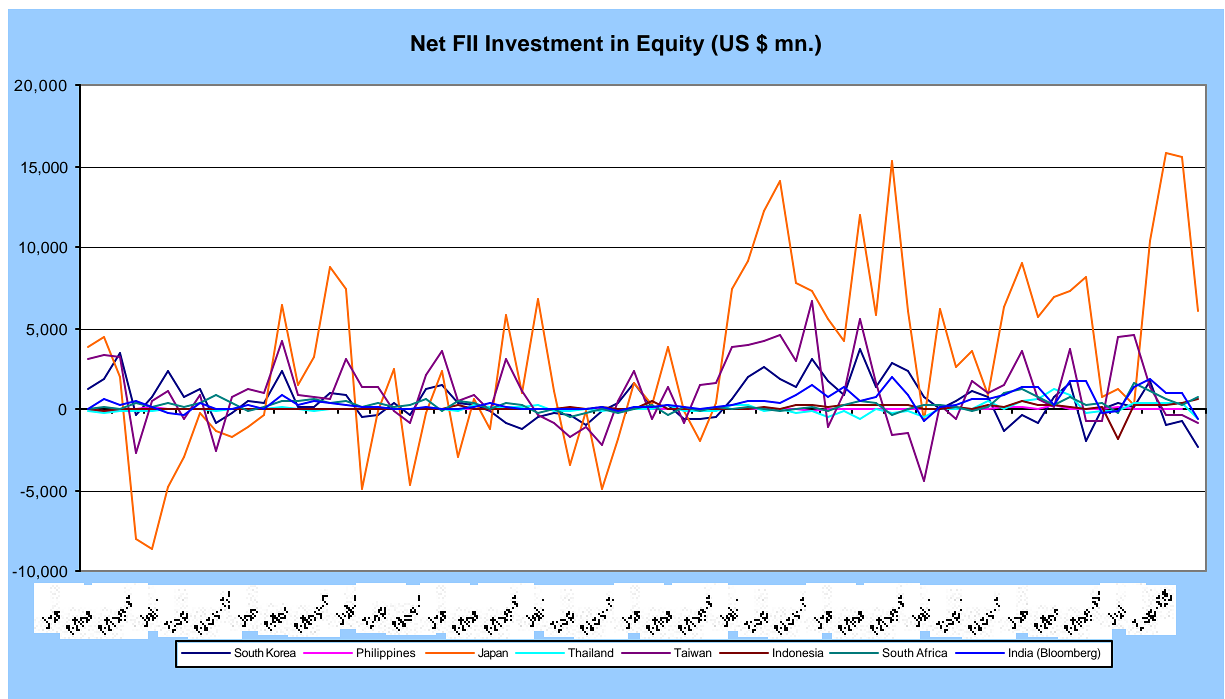
[2]MSCI Emerging Markets Index SM is a free float-adjusted market capitalisation index that is designed to measure equity market performance in the global emerging markets. As of December 2003 the MSCI Emerging Markets Index consisted of the following 26 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

The buoyancy continued in 2005-06, with net inflows aggregating to US$ 3.26 billion in the first seven months up to end-October, 2005.

8. The net FII inflows into India have been less volatile compared to other emerging markets (Chart I). This stability could be attributed to several factors:

- Strong economic fundamentals and attractive valuation of companies.
- Improved regulatory standards, high quality of disclosure and corporate governance requirement, accounting standards, shortening of settlement cycles, efficiency of clearing and settlement systems and risk management mechanisms.
- Product diversification and introduction of derivatives.
- Strengthening of the rupee dollar exchange rate and low interest rates in the US.

FIIs account for around 12 per cent of the spot or cash market volumes, and in the absence of significant domestic source of long term investment in the market through mutual funds and pension and provident funds, the FIIs have been the single dominant influence in the domestic market.



9. Apart from the cash market, the FIIs have been permitted by the SEBI and the RBI to trade also in the derivatives markets. For the purpose of risk management, the FIIs are treated as trading members in derivatives and are subjected to the same risk management measures as any other trading member. For index options and index futures, per exchange, there is a position limit for FIIs at the maximum of 15 per cent of the open interest of the respective derivative contracts on a particular underlying index or Rs. 250 crore (Annex II). In addition, they are allowed to invest more, if it is for hedging backed by securities. In case of stocks, the FII position limit is the maximum of 20 per cent of the market-wide limit (if the market-wide

position limit is less than or equal to Rs. 250 crore) or Rs 50 crore (for stocks in which the market-wide position limit is greater than Rs. 250 crore).

10. The most popular derivative product in India is single stock futures which account for almost 67 per cent of the derivative contracts, followed by index futures accounting for nearly 30 per cent, and stock options and index options accounting for the rest. The retail investors and proprietary trading account for very high proportion of trading in derivatives market. The FIIs, on an average, account for 5.1 per cent of the monthly turnover in the derivatives market. However, the FIIs account for around 25 per cent of the cumulative open positions in single stock futures. FIIs seem to have been following a hedging strategy with simultaneous investments in cash and derivatives market.

11. The diversity of FIIs has been increasing with the number of registered FIIs in India steadily rising over the years (Table 2). In 2004-05, with 145 new FIIs registering with Securities and Exchange Board of India (SEBI), as on March 31, 2005, there were 685 FIIs registered in India. The names of some prominent FIIs registered during 2004-05 are: California Public Employees' Retirement System (CalPERS), United Nations for and on behalf of the United Nations Joint Staff Pension Fund, Public School Retirement System of Missouri, Commonwealth of Massachusetts Pension Reserves Investment Trust, Treasurer of the State North Carolina Equity Investment Fund Pooled Trust, the Growth Fund of America, and AIM Funds Management Inc.

Table 2. FIIs Registered in India

Financial Year	During the year	Total registered at the end of the year
1992-93	0	0
1993-94	3	3
1994-95	153	156
1995-96	197	353
1996-97	99	439
1997-98	59	496
1998-99	59	450
1999-00	56	506
2000-01	84	528
2001-02	48	490
2002-03	51	502
2003-04	83	540
2004-05	145	685
2005-06[1]	131	803

[1] As on October 31, 2005.

12. In terms of country of origin, the USA topped the list with a share of 40 per cent of the number of FIIs registered in India, followed by UK's 17 per cent. Other countries of significance in terms of origin of FIIs investing in India are Luxemburg, Hong Kong, and Singapore. In terms of net cumulative investments by FIIs, US-based FIIs dominate with 29 per cent of the net cumulative FII investments in India, followed by UK at 17 per cent. In recent months, European and Japanese FIIs have started to evince an increasing interest in India, and of the FIIs that registered with SEBI in October 2004, a significant number belonged to Europe and Japan. These developments have helped improve the diversity of the set of FIIs operating in India.

1.III. Evolution of FII policies

13. *Until the 1980s, India's development strategy was focused on self-reliance and import-substitution. Current account deficits were financed largely through debt flows and official development assistance. There was a general disinclination towards foreign investment or private commercial flows.* Since the initiation of the reform process in the early 1990s, however, India's policy stance has changed substantially, with a focus on harnessing the growing global foreign direct investment (FDI) and portfolio flows. The broad approach to reform in the external sector after the Gulf crisis was delineated in the Report of the High Level Committee on Balance of Payments (Chairman: C. Rangarajan). It recommended, *inter alia,* a compositional shift in capital flows away from debt to non-debt creating flows; strict regulation of external commercial borrowings, especially short-term debt; discouraging volatile elements of flows from non-resident Indians (NRIs); gradual liberalisation of outflows; and dis-intermediation of Government in the flow of external assistance.

14. *After the launch of the reforms in the early 1990s, there was a gradual shift towards capital account convertibility. From September 14, 1992, with suitable restrictions, FIIs and Overseas Corporate Bodies (OCBs) were permitted to invest in financial instruments.*[3] The policy framework for permitting FII investment was provided under the Government of India guidelines vide Press Note dated September 14, 1992, which enjoined upon FIIs to obtain an initial registration with SEBI and also RBI's general permission under FERA. Both SEBI's registration and RBI's general permissions under FERA were to hold good for five years and were to be renewed after that period. RBI's general permission under FERA could enable the registered FII to buy, sell and realise capital gains on investments made through initial corpus remitted to India, to invest on all recognised stock exchanges through a designated bank branch, and to appoint domestic custodians for custody of investments held. The Government guidelines of 1992 also provided for eligibility conditions for registration, such as track record, professional competence, financial soundness and other relevant criteria, including registration with a regulatory organisation in the home country. The guidelines were suitably incorporated under the SEBI (FIIs) Regulations, 1995. These regulations continue to maintain the link with the government guidelines by inserting a clause to indicate that the investment by FIIs shall also

[3] An OCB is a company, partnership firm, society and other corporate body owned directly or indirectly to the extent of at least sixty per cent by NRIs and includes overseas trust in which not less than sixty per cent beneficial interest is held by NRIs directly or indirectly but irrevocably.

be subject to Government guidelines. This linkage has allowed the Government to indicate various investment limits including in specific sectors.

15. With coming into force of the Foreign Exchange Management Act, (FEMA), 1999 in 2000, the Foreign Exchange Management (Transfer or issue of Security by a Person Resident Outside India) Regulations, 2000 were issued to provide the foreign exchange control context where foreign exchange related transactions of FIIs were permitted by RBI. A philosophy of preference for institutional funds, and prohibition on portfolio investments by foreign natural persons has been followed, except in the case of Non-resident Indians, where direct participation by individuals takes place. Right from 1992, FIIs have been allowed to invest in all securities traded on the primary and secondary markets, including shares, debentures and warrants issued by companies which were listed or were to be listed on the Stock Exchanges in India and in schemes floated by domestic mutual funds. The holding of a single FII, and of all FIIs, NRIs and OCBs together in any company were initially subject to the limit of 5 per cent and 24 per cent of the company's total issued capital, respectively. Furthermore, to ensure a broad base and prevent such investment acting as a camouflage for individual investment in the nature of FDI and requiring Government approval, funds invested by FIIs have to have at least 50 participants (changed to 20 investors in August, 1999) with no single participant holding more than 5 per cent (revised to 10 per cent in February, 2000).

16. The Committee on Capital Account Convertibility (1997) headed by S. S. Tarapore was asked to examine the case for capital account convertibility, namely the freedom to convert domestic financial assets into foreign financial assets and vice-versa. The Committee recommended a roadmap for opening up the capital account with milestones such as sufficient foreign exchange reserves, low inflation, low non-performing assets (NPA) of banks, and low fiscal deficit,. India has been following a cautious and gradual approach to capital account liberalisation in the post-reform period. While virtually all restrictions on foreign non-debt capital inflows into India have been lifted (except for a few sectoral caps), India continues to maintain restrictions on debt inflows, particularly of short maturities, and outward investment. Recognising that the foreign flows augment the domestic capital stock and thereby higher economic growth and provide other dynamic gains from financial integration, the Committee suggested a cautious approach to liberalisation of forex flows. The Committee argued that fiscal consolidation, a mandated inflation target and strengthening of financial system should be regarded as crucial preconditions for capital account convertibility in India. As regards FIIs, the committee recommended certain procedural relaxations, such as dispensing with prior RBI approval for FIIs' private placement/primary market investment, and prior approval under exchange controls for disinvestments, and removal of restrictions on debt instrument, including maturity restrictions and on investment in treasury bills. Some of these recommendations were accepted, and the entry and exit processes of FII's investment were liberalised.

17. Currently, entities eligible to invest under FII route are as follows:

(i) As FII:
Overseas pension funds, mutual funds, investment trust, asset management company, nominee company, bank, institutional portfolio manager, university funds, endowments, foundations, charitable trusts, charitable societies, a trustee or power of attorney holder incorporated or established outside India proposing to make proprietary investments or

investments on behalf of a broad-based fund (i.e., fund having more than 20 investors with no single investor holding more than 10 per cent of the shares or units of the fund).

(ii) As Sub-accounts[4]

The sub account is generally the underlying fund on whose behalf the FII invests. The following entities are eligible to be registered as sub-accounts, viz. partnership firms, private company, public company, pension fund, investment trust, and individuals.

(iii) Domestic entity

A domestic portfolio manager or a domestic asset management company shall also be eligible to be registered as FII to manage the funds of sub-accounts.

18. FIIs registered with SEBI fall under the following categories:

(a) Regular FIIs – those who are required to invest not less than 70 per cent of their investment in equity-related instruments and up to 30 per cent in non-equity instruments.
(b) 100 per cent debt-fund FIIs – those who are permitted to invest only in debt instruments.

19. The Government guidelines for FII of 1992 allowed, inter-alia, entities such as asset management companies, nominee companies and incorporated/institutional portfolio managers or their power of attorney holders (providing discretionary and non-discretionary portfolio management services) to be registered as FIIs. While the guidelines did not have a specific provision regarding clients, in the application form the details of clients on whose behalf investments were being made were sought. While granting registration to the FII, permission was also granted for making investments in the names of such clients. Asset management companies/portfolio managers are basically in the business of managing funds and investing them on behalf of their funds/clients. Hence, the intention of the guidelines was to allow these categories of investors to invest funds in India on behalf of their 'clients'. These 'clients' later came to be known as sub-accounts. The broad strategy consisted of having a wide variety of clients, including individuals, intermediated through institutional investors, who would be registered as FIIs in India. A Working Group for Streamlining of the Procedures relating to FIIs, constituted in April, 2003, inter alia, recommended streamlining of SEBI registration procedure, and suggested that dual approval process of SEBI and RBI be changed to a single approval process of SEBI. This recommendation was implemented in December 2003.

20. *Participatory notes (PNs) are instruments used by foreign funds, not registered in the country, for trading in the domestic market. They are a derivative instrument issued against an underlying security which permits the holder to share in the capital appreciation/income from the underlying security. PNs are like contract notes and are issued by FIIs, registered in the country, to their overseas clients who may not be eligible to invest in the Indian stock markets. PNs are used as an alternative to sub-accounts by ultimate investors generally based on considerations related to transactions costs and recordkeeping overheads*.

21. FIIs invest funds on behalf of such investors, who prefer to avoid making disclosures required by various regulators. The associates of these FIIs generally issue these notes overseas.

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[4] See definition of sub-accounts below.

The investors, who buy these notes, deposit their funds in the US or European operations of the FII, which also operates in India. The FII then buys stocks in the domestic market on behalf of these investors on their proprietary account. In this case, the FII or the broker acts like an exchange: it executes the trade and uses its internal accounts to settle the trade. This helps keeping the investor's name anonymous. Other such instruments include equity-linked notes, capped return note, participatory return notes and investment notes.

22. Some genuine foreign investors often find it expensive to establish broker and custodian bank relationships, deal in foreign exchange, pay taxes and/or filing, obtain or maintain an investment identity or regulatory approval in certain markets, where their total exposure is not going to be very large. Such investors look for derivative solution to gain exposure in individual, or a basket of, stocks in the relevant market. The PN mechanism is favoured by investors on grounds of lower transactions costs and overheads. Sometimes, investors embark on investment in India in a small way using PNs, and when their positions become larger, they find it advantageous to shift over to a full-fledged FII structure.

23. Some big FIIs, including Merrill Lynch, Morgan Stanley, Credit Lyonnais, Citigroup and Goldman Sachs, who are registered in India issue PNs. Nevertheless, of the 733 entities registered as FIIs with SEBI at the end of June 2005, only 17 entities had issued PNs. The total value of underlying investments in equity represented by the PNs was Rs. 67,185 crore representing about 25.71 per cent of the cumulative net investments in equities by FIIs of Rs. 2,61,334 crore at the end of June, 2005. The details of PNs outstanding on a monthly basis are at Annex III.

Table 3. Evolution of FII policy

S.No.	Date	Contents	Remarks
1.	September 1992	FIIs allowed to invest by the Government Guidelines in all securities in both primary and secondary markets and schemes floated by mutual funds. Single FIIs to invest 5 per cent and all FIIs allowed to invest 24 per cent of a company's issued capital. Broad based funds to have 50 investors with no one holding more than 5 per cent	The objective was to have reputed foreign investors, such as, pension funds, mutual fund or investment trusts and other broad based institutional investors in the capital market.
2.	November 1996	100 per cent debt FIIs were permitted.	100 per cent debt funds were permitted to give operational flexibility to FIIs.
3.	April 1997	Aggregated limit for all FIIs increased to 30 per cent subject to special procedure and resolution.	The objective was to increase the participation by FIIs.
4.	April 1998	FIIs permitted to invest in dated Government securities subject to a ceiling.	Consistent with the Government policy to limit the short-term debt, a ceiling of USD 1 billion

			was assigned which was increased to USD 1.75 billion in 2004.
5.	June 1998	Aggregate portfolio investment limit of FIIs and NRIs/PIOs/OCBs enhanced from 5 per cent to 10 per cent and the ceilings made mutually exclusive.	Common ceilings would have negated the permission to FIIs. Therefore, separate ceilings were prescribed.
6.	June 1998	Forward cover allowed in equity. FIIs permitted to invest in equity derivatives.	The objective was to make hedging instruments available.
7.	February 2000	Foreign firms and high net-worth individuals permitted to invest as sub-accounts of FIIs. Domestic portfolio manager allowed to be registered as FIIs to manage the funds of sub-accounts.	The objective was to allow operational flexibility and also give access to domestic asset management capability.
8.	March 2001	FII ceiling under special procedure enhanced to 49 per cent.	The objective was to increase FII participation.
9.	September 2001	FII ceiling under special procedure raised to sectoral cap.	
10.	December 2003	FII dual approval process of SEBI and RBI changed to single approval process of SEBI.	The objective was to streamline the registration process and reduce the time taken for registration.
11.	November 2004	Outstanding corporate debt limit of USD 0.5 billion prescribed.	The objective was to limit short-term debt flows.

24. In order to increase transparency, SEBI issued a circular on October 31, 2001 to all FIIs and their custodians advising the FIIs to report as and when any derivative instruments with Indian underlying securities are issued/renewed/redeemed by them, either on their own account or on behalf of sub-accounts registered under them. In 2003 this circular was further revised to include disclosure of more details about terms, nature and contracting parties.

25. *The evolution of FII policy in India has displayed a steady and cautious approach to liberalisation (Table 3) of a system of quantitative restrictions (QRs). The policy liberalisation has taken the form of (i) relaxation of investment limits for FIIs; (ii) relaxation of eligibility conditions; and (iii) liberalisation of investment instruments accessible for FIIs.* In so far as investment limits are concerned, the initial limit for an individual FII was 5 per cent of the total issued capital. This was raised to 10 per cent in June 1998 and the ceiling for single FII was separated from that of a single NRI/PIO/OCB. The aggregate investment ceiling for all FIIs was 24 per cent of the issued and paid-up capital in a company. However, this was allowed to be increased subject to passing of resolution by the Board of Directors of the company followed by passing of a special resolution by the General Body of the company. The ceiling limit under special procedure was enhanced in stages as follows:

(i) to 30 per cent from April 4, 1997,
(ii) to 40 per cent from March 1, 2000,
(iii) to 49 per cent from March 8, 2001,and
(iv) to sectoral cap/statutory ceiling from September 20,2001.

26. *Under eligibility conditions, the definition of broad based funds was relaxed in August, 1999 and in February, 2000 and newer entities, such as foreign firms were allowed to invest as sub-accounts.* In order to have a level playing field in intermediation, domestic portfolio managers were allowed in February, 2000 to manage the funds of sub-accounts, so as to give end-customers a greater choice about the identity of their fund manager in India.

27. FIIs were initially allowed to only invest in listed securities of companies. Gradually, they were allowed to invest in unlisted securities, rated government securities, commercial paper and derivatives traded on a recognised stock exchange. From November 1996, any registered FII willing to make 100 per cent investment in debt securities were permitted to do so subject to specific approval from SEBI as a separate category of FIIs or sub-accounts as 100 per cent debt funds. The overall cap on investments in Government securities, both through the normal route and the 100 per cent debt fund route, was revised from US$1 billion to US$1.75 billion in November, 2004. Moreover, investments were allowed only in debt securities of companies listed or to be listed in stock exchanges. Investments were free from maturity limitations. From April 1998, FII investments were also allowed in dated Government securities. Treasury bills, being money market instruments, were originally outside the ambit of such investments, but were included subsequently from May, 1998.

28. Initially,FIIs were permitted to hedge their investments in debt instruments in India only with respect to currency risk. On June 11, 1998, forward cover to FIIs on their investment in equity was also allowed subject to the maximum of the difference in dollar terms between the market value of investment on June 11, 1998 converted at RBI reference rate and the market value of investment at the time of providing cover, or fresh inflows since June 11, 1998. Subsequently, in November, 2002, forward cover up to a maximum of 15 per cent of the outstanding position as on March 31, 1999 plus the increase in market value after March 31, 1999 was also permitted. With this 15 per cent limit liberalised to 100 per cent of portfolio value, FIIs have had unrestricted access to currency hedging from January 8, 2003 onwards. In June 1998, the proposed legal basis for trading in equity derivatives coincided with permission for FIIs to invest in equity derivatives. With the advent of trading in equity derivatives in June 2000, and permission – albeit limited in the beginning – to FIIs to participate in this market opened up further avenues for FIIs to hedge their positions in the spot market.

29. Some of the recommendations of the Committee on Liberalisation of Foreign Institutional Investment submitted in June 2004 have already been implemented. One major recommendation, namely that FII flows in to a company should be separated from FDI flows for policy purposes, has not been implemented.

1.IV. PNs and Sub-accounts: Areas of Concern

30. *In recent times, the anonymity afforded by the PN route has led to three concerns about the desirability of PNs.* First, with PNs issued to various types of entities abroad, the identity of the actual investor need not necessarily be known to the regulatory bodies. The investor could be individual or corporate investors who are not subject to Indian laws. This has given rise to concerns that some of the money coming into the market via PNs could be the unaccounted wealth of some rich Indians camouflaged under the guise of FII investment. The money might even be tainted and linked with such illegal activities as smuggling and drug-running. Second, concerns have also been raised about the potential for enhanced volatility in the Indian markets with substantial issuances/redemptions of these derivative instruments abroad. The holders of PNs may be individual entities, and as opposed to collective/pooled investment like mutual funds, may individually determine entry and exit. Third, hedge funds may be using the devices of PNs and sub-accounts of the FIIs to play in the Indian market.

31. The issue was examined by the Ministry of Finance in consultation with RBI and SEBI. Following this consultation, it was decided that *with effect from February 3, 2004, overseas derivative instruments such as PNs against underlying Indian securities can be issued only to regulated entities and further transfers, if any, of these instruments can also be to other regulated entities only. FIIs/sub accounts have been required to ensure that no further downstream issuance of such derivative instruments is made to unregulated entities.* The FIIs issuing such derivative instruments are therefore required to exercise due diligence and maintain complete details of the investors, based strictly on "know your client" (KYC) principles. SEBI has indicated that the existing non-eligible PNs will be permitted to expire or to be wound-down on maturity, or within a period of 5 years, whichever is earlier. Besides, reporting requirement on a regular basis has been imposed on all the FIIs.

32. It is pertinent to note that in Asia, Hong Kong, Singapore, Korea and Taiwan attract significant international investor attention through the medium of off-shore derivative products. In these four countries/regions, there is substantial foreign institutional investment, and there is no prohibition or restriction on off-shore derivative-activities of foreign institutional investors. In response to market manipulation concerns, in December 1999, Taiwan Securities and Futures Commission had amended its FII regulations to require periodic disclosure by FIIs of all off-shore derivative activities linked to local shares, but this requirement was subsequently removed in June 2000.

33. From the start itself, the aim of the Government of India's FII policy was to avoid "hot" (short-term and overly speculative) and "unclean" (generated from illegal businesses like drug trafficking etc.) monies coming into the country. In 1993, SEBI, in the context of registration to clients, had reiterated to the Government the need to have institutional and broad-based clients/funds. It was also mentioned that the funds coming into India should be “clean”. Towards this end, the requirement of sub-accounts being broad-based was followed from the very beginning. It was felt that broad-based sub-accounts were less likely to bring in hot or unclean monies into India. To ascertain that the sub-accounts were indeed broad-based and were institutional investors/reputed foreign investors, in the revised application form for FII Registration issued in

April 1993 in consultation with RBI, the following information was sought with respect to clients of the FIIs:

Name of Client (Sub-account)

Date and place of incorporation and constitution

Whether client is registered with regulatory agency and details thereof

Objectives and principle activities of clients

Number and types of shareholders

Volume of assets

34. The yardstick adopted for broad-basedness of a fund was a minimum 50 investors with no investor holding more than 5 per cent of the shares or units of the fund. The judgment on whether a sub-account was broad-based often required considerable correspondence between SEBI and the concerned FII. Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995 issued by SEBI as well as practices and procedures in consultation with RBI and the Ministry of Finance were clearly guided by the principle of allowing only broad based-funds enunciated in the Government guidelines.

35. Representations were received to simplify the application form, particularly in respect of details on clients/funds of the FII mentioned above. The matter was considered by SEBI (which includes members from RBI and MOF) in its meeting on June 23, 1998. It was felt that much time was being lost in correspondence to judge broad-basedness of the sub-accounts, which in turn was leading to delays in the registration process. It was decided that the system of seeking client details as above should be discontinued and instead SEBI should take an undertaking from the FII regarding the sub-accounts being broad-based. Amendment to regulations in this regard was carried out on June 30, 1998.

36. In response to requests from FIIs, the broad based criteria was amended vide notification dated February 29, 2000 to reduce the minimum number of investors required from 50 to twenty and increase maximum shares or units held by an investor from 5 per cent to 10 per cent. The matter was taken up with the Government which communicated its concurrence vide letter dated June 14, 1999. The regulations were amended after SEBI Board's approval.

37. SEBI had been receiving requests from eminent groups, such as Wallenburg family of Sweden, to allow foreign firms and individuals as sub-accounts. The matter was considered by the High Level Coordination Committee on Financial and Capital Markets, who approved the proposal. NRIs and OCBs were not permitted to be registered as sub-accounts. In February, 2000, the FII regulations were amended to permit foreign firms and high net-worth individuals to also invest as sub-accounts of SEBI-registered FIIs. Foreign firms and high net worth individuals fall outside the category of diversified investors. FIIs were also permitted to seek SEBI registration in respect of sub-accounts for their clients under the regulations. While initially, FIIs were permitted to manage the sub-account of clients, domestic portfolio managers or domestic asset management companies were also allowed to manage the funds of such sub-accounts and also to make application on behalf of such sub-accounts. Such sub-accounts could

be an institution, or a fund, or a portfolio established or incorporated outside India, or a broad-based fund, or a proprietary fund, or even a foreign corporate or individual. So, in practice there are common categories of entities, which can be registered as both FIIs and sub-accounts. However, investment in to a sub-account is to be made either by FIIs, or by domestic portfolio manager or asset management company, and not by itself directly.

38. While permitting foreign firms/individuals in February, 2000 to invest through SEBI registered FII/domestic fund managers, it was noted that there was a clear distinction between portfolio investment and FDI. The basic presumption is that FIIs are not interested in management control. To allay fears of management control being exercised by portfolio investors, it was noted that adequate safety nets were in force, for example, (i) transaction of business in securities on the stock exchanges are only through stock brokers who have been granted a certificate by SEBI, (ii) every transaction is settled through a custodian who is under obligation to report to SEBI and RBI for all transactions on a daily basis, (iii) provisions of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997, and (iv) monitoring of sectoral caps by RBI on a daily basis.

1.V. Plan of this Report

39. The plan of the report is as follows. Chapter II deals with determinants of FII flows, including linkages with exchange rate, interest rates and balance of payments. It includes a discussion of the relative importance of FDI compared to FII and vulnerability of the capital market to speculative flows. Chapter III deals with the issues of speculative flows and vulnerability, and includes some international experiences and crises experienced with capital flows. Policy options are discussed in Chapter IV. Chapter V concludes with recommendations.

CHAPTER 2. ENCOURAGING FII FLOWS

2.I. Rationale for encouraging FII flows

40. *Foreign investment – both portfolio and direct varieties – can supplement domestic savings and augment domestic investment without increasing the foreign debt of the country.* Such investment constitutes non-debt creating financing instruments for the current account deficits in the external balance of payments. *Capital inflows into the equity market give higher stock prices, lower cost of equity capital, and encourage investment by Indian firms.* Foreign investors often help spur domestic reforms aimed at improving the market design of the securities markets, and help strengthen corporate governance. These benefits do require concomitant policy effort in terms of improving financial regulation and corporate governance.

2.II. Determinants of FII flows

International

41. The classical capital asset pricing model (CAPM) predicts that, to maximize risk-adjusted returns, investors should hold a diversified market portfolio of risky assets, irrespective of their country of residence. In practice, however, the proportion of foreign assets in investors' portfolios tends to be very small, and there is a 'home bias.' There is evidence of the home bias decreasing over the years. The share of foreign stocks in the equity portfolio of US investors, for example, increased from an estimated 2 per cent in the late 1980s to about 10 per cent at the end of 1997, but is still far short of the 52 per cent of world stock market capitalization accounted for by non-US stocks. A part of the home bias is because of barriers to international investment. The international CAPM predicts that individuals should hold equities from around the world in proportion to market capitalizations. This is predicated on the assumption that there are no barriers to international investment. In practice, such barriers do exist, but they are falling over time, including in India.

42. Empirically, the dominant explanation for international portfolio flows is in terms of stock returns in dollar terms. Tesar and Werner (1994, 1995), Bohn and Tesar (1996), and Brennan and Cao (1997) examine estimates of aggregate international portfolio flows on a quarterly basis and find evidence of positive, contemporaneous correlation between inflows and returns. International investors may have a 'cumulative informational disadvantage' relative to local investors. In response to some new information, local investors may trade in stocks that results in a price change, and this price change in turn may lead to international portfolio flows. The problem with this evidence of contemporaneous correlation is that it does not shed much light on the direction of causality. Do international portfolio flows 'cause' dollar returns to change or vice versa?

43. There is some evidence that the impact of international portfolio flows on stock prices depends on whether such flows are 'expected' or 'unexpected' and the composition of such investment. For Mexico during the late 1980s through the crisis of 1993, Clark and Berko (1996) found evidence of unexpected inflows of 1 per cent of market capitalization driving

prices up by as much as 13 per cent. Warther (1995) found that in the U.S., only 'unexpected', not the 'expected', inflows correlated with contemporaneous returns. Furthermore, according to Warther (1995), a 1 per cent increase in mutual fund equity assets results in a 5.7 per cent durable increase in stock prices.

44. *Whether higher returns lead international portfolio flows or the other way round is a matter of some controversy.* While the hypothesis of 'cumulative informational disadvantage' of international investors vis-à-vis local investors should yield the result that returns lead flows, using daily data for 44 countries for the period August 1, 1994 to December 31, 1998, Froot, O'Connell, and Seasholes (2001) demonstrate that international capital flows 'predict', that is, lead price changes. A one-basis-point shock to international portfolio flows results in a 40 basis point increase in equity prices. This finding suggests that it is not the international investors, but the domestic ones that suffer from an informational disadvantage. If local, not global, information shocks drive emerging market returns, then flows would not 'covary' with returns.

45. *One of the worries stemming from the informational asymmetries between foreign investors and domestic investors is the problem of herding and overshooting. A positive feedback strategy leads to buys (sells) when prices are rising (falling) and can lead to prices spiraling up (down) and overshooting the equilibrium.* According to Froot, O'Connell, and Seasholes (2001), a one-basis-point shock to international portfolio flows generates an additional 1.5 basis point of additional inflow over the subsequent 45 days.

46. The data on daily cross-border flows for 44 countries from August 1, 1994 to December 31, 1998 that Froot, O'Connell, and Seasholes (2001) work with include the peso "Tequila" crisis in Mexico, the Asian crisis, and the Russian and Long Term Capital Management (LTCM) crisis.[5] They find evidence that "All crisis episodes are clearly associated with a strong attenuation of inflows in general, and of emerging market inflows in particular. It appears that foreign investors held fast during the Mexican crisis, slightly withdrew some resources in the midst of the Asian crisis, and were hardly fazed by the Brazilian crisis. Interestingly, the LTCM failure appears as the only shock that is associated with strong foreign equity selling. Russia's devaluation by itself seems to have left little imprint on flows. By contrast, during the intra-crisis periods, the inflows came rapidly, at an annual rate of approximately 50 basis points of market capitalisation."[6]

47. In his recent Presidential Address *The limits of financial globalization* to the American Financial Association, Rene Stulz has argued that the neoclassical framework overstates the benefits from global capital flows, owing to "twin agency problems" in developing countries at the level of firms and governments. These agency problems limit the extent to which dispersed shareholding firms are feasible in developing countries, and thus throw up limits on the extent to which global investors can own developing country stock. This argument suggests that the gains

[5] The Tequila crisis began with Mexico's sudden devaluation in December 1994 and continued through the spring of 1995, the Asian crisis begins with the Thai devaluation in July 1997 and continued through the spring of 1998, and the Russian/LTCM crisis occurred in late summer/fall of 1998 with Russia devaluing in August 1998 and LTCM failing in September 1998.
[6] Froot, O'Connell, and Seasholes (2001), p.10.

from financial globalization may be smaller as compared with those predicted by the ICAPM. This suggests that for India to fully capture these benefits, progress is needed on issues of corporate governance and the risks of expropriation by the State. Stulz (1999) does not offer a rationale in favour of capital controls.

India

48. Using a monthly data-set for the period May 1993 to December 1999, Chakrabarti (2001) found that the FII net inflows were not only correlated with the return in Indian equity market but was more likely the effect than the cause of the Indian equity market return. FIIs did not appear to be at an informational disadvantage compared to domestic investors in the Indian markets. Furthermore, the Asian crisis marked a regime shift. In the post-Asian crisis period, the return in the Indian equity market turned out to be the sole driver of the FII inflow, while for the pre-Asian crisis period, other covariates reflecting return in other competing markets were also correlated with FII net inflow.

49. Mukherjee, Bose and Coondoo (2002) explored the relationship of daily FII flows to the Indian equity market for the period January, 1999 to May, 2002 with two types of variables. The first type included variables reflecting daily market return and its volatility (representing risk) in domestic and international equity markets, based on the BSE Sensex, S&P 500 and the MSCI WI, as well as measures of co-movement of returns in these markets (the relevant betas). The second type of variables, on the other hand, were essentially macroeconomic like daily returns on the Rupee-Dollar exchange rate, short-term interest rate and index of industrial production (IIP); variables that are likely to affect foreign investors' expectation about returns in the Indian equity market. They distinguished among three kinds of daily FII flows, namely, FII flows into the country or FII purchases, FII flows out of the country or FII sales, and the net FII inflows into the country or FII net, and related these to the above mentioned variables along with their past history over different time frames, like a week or fortnight.

50. According to Mukherjee, Bose and Coondoo (2002), contrary to the general perception of FII activities having a strong demonstration effect and driving the domestic stock market in India, *evidence from causality tests suggests that FII flows to and from the Indian market tend to be caused by return in the domestic equity market and not the other way round*. "The regression analysis, in various stages, reveals that returns in the Indian equity market is indeed an important (and perhaps the single most important) factor that influences FII flows into the country. While, the dependence of net FII flows on daily return in the domestic equity market (at a lag, to be more specific) is suggestive of foreign investors' return-chasing behaviour, the recent history of market return and its volatility in international and domestic stock markets have some significant effect as well. However, while FII sale (and FII net inflow) is significantly affected by the performance of the Indian equity market, FII purchase is not responsive to this market performance. Looking at the role of the beta's of the Indian market with respect to the S&P 500 and MSCI indices, it is concluded that foreign institutional investors do not seem to use the Indian equity market for the purpose of diversification of their investments. It is also seen that return from exchange rate variation and fundamentals of the Indian economy may have some influence on FII decisions, but such influence does not seem to

be strong, and finally, daily FII flows are highly autocorrelated and this autocorrelation can not be accounted for by all or some of the covariates considered in the study."

51. Gordon and Gupta (2003) found both global and domestic factors important in determining portfolio flows. Global factor is the London Inter-bank Offered Rate (LIBOR), which inversely related to FII inflows. Among domestic factors, lagged stock market returns, rating downgrades and rupee depreciation affected FII flows adversely. They report "While we do not have data on company specific variables, and can not directly test the bottom-up hypothesis, we interpret the significance of domestic macroeconomic variables in the regressions as evidence that FII strategy is not purely bottom-up. In other words, India's macroeconomic fundamentals do affect FII flows."

52. Policy implications that emerge from the studies are that a move towards a more liberalised regime, in emerging market economies like India, should be accompanied by further improvements in the regulatory system of the financial sector. To fully reap the benefits of capital market integration, in India, the prime focus should be on improving investor confidence in the equity market so as to strengthen the domestic investor base of the market, which in turn could act as a built-in cushion against possible destabilizing effects of sudden reversal of foreign inflows.

53. Bose and Coondoo (2004) report that "Findings of several studies on FII flows to emerging equity markets over the world have shown the importance of financial market infrastructure such as the market size, market liquidity, trading costs, information dissemination, and legal mechanisms relating to property rights, etc. in attracting foreign portfolio investments into the emerging markets."[7]

2.III. Linkages with Exchange Rate, Interest Rate and Balance of Payments

Exchange rate

54. FIIs are attracted by returns calculated in foreign currency, say for example, in US dollars. Thus, what is relevant is the return on their investment in rupee terms and the movement of the exchange rate of the rupee. A high rupee return on equities can be neutralized, at least in part, by a depreciation of the rupee. For example, a 15 per cent rupee return on equities with a 7 per cent depreciation of the rupee results in an effective dollar rate of return of about 8 per cent only. Similarly, a relatively unattractive low rupee rate of return on equities can become attractive in dollar terms if the rupee appreciates vis-à-vis the dollar. Given everything else, FII flows go up (down) when there are expectations of domestic currency appreciation (depreciation).

Interest rate

55. FII investment in debt instruments depends on the relativity of the domestic interest rate vis-à-vis the world rate, adjusted for the exchange rate movement. Many developing countries,

[7] Bose and Coondoo (2004), p. 55.

including India, have high nominal interest rates compared to developed countries. For example, in India, the rate of interest on 10-year Central Government bonds was 7.15 per cent on October 3, 2005, when the corresponding rate on 10-year gilts in the US and Japan were 4.39 per cent and 1.57 per cent, respectively. The relevant differential, however, is not the difference between the nominal rates of interest, but the exchange rate adjusted differential or uncovered interest rate parity condition. For example, an investor can invest US$1 in the US and obtain $(1+r_{US})^T$ with zero risk in T years, where r_{US} is the annual yield from the US zero coupon yield curve for T years. Alternatively, the investor can convert US$1 into Rs.E at the going exchange rate of Rs. E per US$, invest the proceeds in India, and obtain $E(1+r_{IN})^T$ in rupees with zero risk in T years, where r_{IN} is the annual yield from the Indian zero coupon yield curve for T years, convert it back into US$ at the expected future exchange rate. If the expected future exchange rate indicates a higher (lower) return on investment in India, inflows (outflows) of debt capital can be expected to reduce (increase) r_{IN} until both investments yield the same rate of return. While there are quantitative restrictions on FII investments in debt instruments, the equity derivative market provides an alternative route for the FIIs to benefit from the interest rate differential.

56. Equity derivatives arbitrage constitutes a way for anyone to obtain quasi-GOI-bond riskless positions. As Kaldor (1939) puts it "While there is no limit, apart from expectations, to backwardation, i.e. to the extent to which the futures price may fall short of the current price, there is a limit to contango, in that the future price cannot exceed the current price by more than the cost of arbitrage, i.e. by more than the sum of interest plus carrying costs." With the 'domestic' cost of arbitrage determined by domestic rates of interest, FIIs have an opportunity through arbitrage operation to obtain a riskless rate of return on investment equal to the domestic rate of interest, which is higher than the 'world' rate of interest. It appears that some 'indirect' debt investments in India by FIIs have been implemented using cash-and-carry arbitrage. For example, if an FII buys Infosys shares on the spot and simultaneously sells them at a future date, the operation gives a locked-in return equal to the spot-futures basis on the Infosys futures. The return is independent of what happens to Infosys price in the future during the holding period. The return on this cash-and-carry arbitrage is much like the return on a debt instrument. In 2004, FIIs accounted for a total of 3.3 per cent of equity derivatives turnover. Arbitrage activities would be a subset of this total. This suggests that arbitrage by FIIs is a relatively small facet of the Indian equity derivatives market.

Balance of payments

57. India's balance of payments has strengthened almost continuously since the crisis of 1990-91, mainly because of a limited current account deficit more than compensated by a buoyant capital account. The external sector responded well to the liberalisation of trade and current account, removal of quantitative restrictions and a steady reduction in customs duty rates from a peak rate of over 300 per cent in 1990-91 to 20 per cent in 2004-05. The current account deficit as a proportion of GDP, after a high of 3.1 per cent in 1990-91, remained contained below 1.8 per cent of GDP until 2000-01, and actually turned into a surplus from 2001-02. The strength of the capital account, on the other hand, reflected the success of a cautious approach to

liberalisation with an opening up of the economy to FDI and FIIs, and restricting debt flows. FII flows have made an important contribution to the balance of payments.

58. FII inflows contributed US$ 40.33 billion between 1992-93 and September, 2005 to the balance of payments. This corresponds to 28.3 per cent of the foreign exchange reserves of US$ 143.1 billion at end-September 2005. In cumulative terms, between 1992 and December 2004, FII investment has been 1.06 times FDI inflows of US$ 34.5 billion. In 2004-05, gross portfolio flows amounted to as much as 1.48 per cent of GDP and was 1.85 times gross FDI inflows of US$ 5.54 billion.

59. Most commentators agree that while portfolio flows are sometimes considered volatile, in India's experience, there is no significant evidence of such volatility. However, there has been increasing complexity in monetary management with the triple objectives of maintaining orderly conditions in the exchange market, price stability and interest rates. This is related to the idea of the "impossible trinity", where liberalization of capital flows is difficult to reconcile with orderly conditions in the exchange market and autonomy of domestic monetary policy.

60. After net FII inflows (net) averaging around US$ 1.91 billion annually during 1993-94 to 1996-97, there was a sharp decline in such flows in 1997-98, and the flows turned negative in 1998-99. The decline in FII flows coincided with several adverse exogenous developments in the form of the East Asian crisis in mid-1997, imposition of economic sanctions subsequent to nuclear detonations at Pokhran (May 1998), and the Kargil War (June 1999). Partly as a response to this slowdown in FII inflows, during 1997-98 and 1998-99, quite a few significant policy decisions were announced. These included: enhancement of aggregate FII investment limit (April 1997), and permission to FIIs to invest in debt securities (April 1998) and equity derivatives (June 1998). It would not be incorrect to state that liberalisation of FII policy, starting from 1992, has in general coincided with weaknesses in the balance of payments. It is only in the early part of the new century, when there were vigorous signs of durable strength in the balance of payments, that the force of arguments – independent of balance of payments reasons – in favour of encouraging FII flows started to get tested.

61. Simultaneously, however, rather than being a convenient tool for financing the balance of payments deficit, FII flows started to complicate the pursuit of the triple objectives of maintaining orderly conditions in the exchange market, price stability and interest rates. After the Gujarat earthquake (January 2000), terrorist attack on the Indian Parliament (December 2001), the issue of travel advisories by Western nations due to tense situation in the country's neighborhood (May-June 2002), and a severe drought (July-August 2002), with overall growth of over 8 per cent, capital markets became heavily bullish in 2003-04. Buoyed by the positive sentiments, FII inflows shot up to an unprecedented US$9.95 billion in 2003-04. While the Government of India issued Market Stabilisation Bonds to the RBI to mop up excess liquidity flowing in through the balance of payments, questions regarding the need to 'encourage' FII flows started to be asked.

2.IV. FII versus FDI

62. According to the International Monetary Fund's Balance of Payments Manual 5, FDI is that category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor in the management of the enterprise. According to EU law, foreign investment is labeled direct investment when the investor buys more than 10 per cent of the investment target, and portfolio investment when the acquired stake is less than 10 per cent. Institutional investors on the other hand are specialized financial intermediaries managing savings collectively on behalf of investors, especially small investors, towards specific objectives in terms of risk, returns, and maturity of claims.

63. While permitting foreign firms/high net worth individuals in February, 2000 to invest through SEBI registered FII/domestic fund managers, it was noted that there was a clear distinction between portfolio investment and FDI. The basic presumption is that FIIs are not interested in management control. To allay fears of management control being exercised by portfolio investors, it was noted that adequate safety nets were in force, for example, (i) transaction of business in securities on the stock exchanges are only through stock brokers who have been granted a certificate by SEBI, (ii) every transaction is settled through a custodian who is under obligation to report to SEBI and RBI for all transactions on a daily basis, (iii) provisions of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 (iv) monitoring of sectoral caps by RBI on a daily basis.

64. There is often a popular preference for FDI over FII on the assumption that FIIs are fair-weather friends, who come when there is money to be made and leave at the first sign of impending trouble. FDI, by contrast, have a lasting interest in their company and stay with it through thick or thin. While there is some justified strength in this preference, some further arguments need to be taken into account while exercising the choice. First, all portfolio investors, whether domestic or foreign, are 'fair-weather' friends, and exit as soon as there is evidence that they will lose money by staying invested in a particular company. Extending the logic of FDI over FII leads to the prescription of preferring strategic domestic investors over domestic portfolio investors. Second, the strength of domestic home-grown entrepreneurship in India is widely acknowledged. Because of this strength, some commentators describe the Indian growth process as an organic one. This entrepreneur class may prefer to have portfolio investors who share the project and business risk without interfering in the critical management decisions of the company. Thus, there may be a preference for FII over FDI as far as this class is concerned. This preference has a close analogy with the choice between allowing a strategic investor to have management control in a public sector company and allowing a diversified mutual fund to hold a large part of the shares of such a company. Finally, if there is an intent to encourage FDI, then this constitutes a case for easing restrictions upon FDI-style control-oriented purchases by portfolio investors which is done through FII.

65. According to Shah and Patnaik (2004): "Net FDI flows into India have remained small, either when compared with Indian GDP or when compared to global FDI flows. In contrast with the Chinese experience, relatively little FDI has come into India in setting up factories which are

parts of global production chains. This may be associated with infirmities of Indian indirect taxes and transportation infrastructure. India is more important as a platform for services production as a part of global production chains, where difficulties of indirect taxes and transportation infrastructure are less important. However, services production is less capital intensive, and induces smaller net FDI flows. Given the size of the Indian economy, and the relative lack of correlation with the global business cycle, Indian equities have had low correlations with global risk factors. In addition, India has fared well in creating the institutional mechanisms of a modern, liquid equity market. Through these factors, portfolio flows have predominated. India's share in global portfolio flows is higher than India's share in global FDI flows, and net portfolio flows are substantial when compared to Indian GDP."

2.V. <u>Volume versus Vulnerability</u>

66. Liberalisation leads to increased capital flows. Bekaert and Harvey (2002), after analyzing data for 16 emerging markets conclude "..on average, liberalizations are associated with increased capital flows. In dollar terms, U.S. holdings increase ten-fold in the five years post-liberalization versus the five years pre-liberalization,…" Price flexibility, i.e. volatility, is a part and parcel of a market economy. Using data from many so-called "emerging" markets that have opened up their capital markets to foreign investors, Bekaert and Harvey (2000), found that across a range of specifications, the cost of capital always decreases after capital market liberalization with the effect varying between 5 and 75 basis points. However, increasing volumes also bring in its wake a fear of increasing vulnerability.

67. Prices react to new information and capital switches from one activity to another, sometimes across national boundaries and currency zones. FIIs have command over considerable funds, and volumes of FII inflows can be substantial in relation to the size of the capital markets in developing countries. The worries about vulnerability of developing country capital markets to FII inflows can be categorised into three parts: about 'hot money' flowing out and creating turmoil in both securities and foreign exchange markets, about too much coming in, and leading to upward pressure on either the exchange rate of the domestic currency or prices or both, and about 'foreigners' capturing a large part of the markets in securities. Two specific fears about turmoil caused by FIIs centre around the problems of "herding" – where many FIIs may trade in similar ways – and "positive feedback trading" where FIIs buy after positive returns and sell after negative returns, thus exacerbating market volatility.

Volatility through outflows

68. After the Asian crisis of 1997, the problem of volatility has been a matter of much discussion. In fact, Malaysia imposed severe capital controls on October 1, 1998 to thwart the perceived destabilizing actions of foreign speculators. FII inflows are popularly described as "hot money", because of the herding behaviour and potential for large capital outflows. Herding behaviour, with all the FIIs trying to either only buy or only sell at the same time, particularly at times of market stress, can be rational.[8] With performance-related fees for fund

[8] See Bikhchandani, S and S. Sharma (2000).

managers, and performance judged on the basis of how other funds are doing, there is great incentive to suffer the consequences of being wrong when everyone is wrong, rather than taking the risk of being wrong when some others are right. The incentive structure highlights the danger of a contrarian bet going wrong and makes it much more severe than performing badly along with most others in the market. It not only leads to reliance on the same information as others but also reduces the planning horizon to a relatively short one. Value at Risk models followed by FIIs may destabilize markets by leading to simultaneous sale by various FIIs, as observed in Russia and Long Term Capital Management 1998 (LTCM) crisis. Extrapolative expectations or trend chasing rather than focusing on fundamentals can lead to destabilization. Movements in the weightage attached to a country by indices such as Morgan Stanley Country Index (MSCI) or International Finance Corporation (W) (IFC) also leads to en masse shift in FII portfolios.

69. The extent to which FIIs affect the cost of capital is reflected in a common sense judgment about whether stock prices would be lower if all FIIs exited the country. In an authoritative empirical work on the subject, Bekaert and Harvey (2000) investigate the validity of the many perceptions of the role of foreign speculators in emerging equity markets—many of which are negative. They look at the various ways foreigners can access emerging market equity (ADRs, Country Funds, or direct participation in the local market) and try to assess the impact on expected returns, volatility, beta, and correlation. They conclude "One of the major conclusions of our work is that the capital market integration process reduces the cost of capital but perhaps by less than we exp ected. In fact, there are reasons to believe that the effect we measure is upwardly biased. We have taken liberalizations as an exogenous event, whereas policymakers would probably choose to liberalize when it is most advantageous to do so. Although policy endogeneity would suggest our estimates are biased upward (see Henry (2000) for a similar point), the effect we measure is less than one percent." They find some suggestive evidence that liberalization of equity markets to foreigners leads to decline (albeit smaller than predicted in theory) in the cost of capital. They also find evidence that investment as a proportion of GDP increases significantly with liberalisation.

70. On the question of volatility, Bekaert and Harvey (2000) find 'a small but mostly insignificant increase in the volatility of stock returns following capital market liberalizations.' They conclude: "Moreover, the effect becomes negative when potentially concurrent movements in the control variables are taken into account. Interestingly, there is only a small increase in correlation with the world market return. Many foreign investors are attracted to emerging markets for the diversification benefits. Although correlations increase after markets open up, the magnitude of the increase is unlikely to deter investors seeking diversification."

71. Bekaert and Harvey (2002) find much of the discussion of increased volatility of capital flows post liberalization (see Stiglitz (2000)), in many ways, "as odd". "The emerging countries start with little or no capital flows and move to an environment (post liberalization) with significant capital flows which are, as expected, subject to portfolio rebalancing. Consequently, it is no mystery that the volatility of capital flows increases". According to them "In fact, the segmentation model predicts that volatility should spike around the time of market liberalization, but should then subside once the large capital inflow has occurred. Of course, there is always the worry that portfolio flows are not as "sticky" as foreign direct investment

(FDI) and may disappear at a whim, causing a crisis in the process…." However, they find that, in terms of coefficient of variation, capital flows are more volatile in developed markets than in emerging markets.

Volatility through inflows

72. Traditionally, developing countries plagued by problems of financing the deficits in the balance of payments have been wary of FIIs because of the potential for large capital outflows generated by their herding behaviour. However, of late, some developing countries like China and India have also had a problem of sizeable surpluses on the balance of payments leading to upward pressure on the exchange rate or on domestic prices through excessive liquidity creation.

Foreigners capturing markets

73. The fear of foreigners capturing the securities markets has genuine content only if such foreigners act as in cahoots to destabilise the economy. Otherwise, fear of foreigners per se argues in favour of banning not only FIIs but FDIs and imports of merchandise as well.

CHAPTER 3. SPECULATIVE FLOWS AND VULNERABILITY

3.I. Speculation

74. According to Kaldor (1939), "Speculation ... may be defined as the purchase (or sale) of a good with a view to resale (repurchase) at a later date, where the motive behind such action is the expectation of changes in the relevant prices relatively to the ruling price, and not a gain relating to their use, or any kind of transformation effected on them, or their transfer between markets… What distinguishes speculative purchases and sales from other kinds of purchases and sales is the expectation of an impending change in the ruling market price as the sole motive of action. Hence "speculative stocks" of anything may be defined as the difference between the amount actually held and the amount that would be held if, other things being the same, the price of that thing were expected to remain unchanged; and they can be either positive or negative."

75. Anyone, apart from the owner-managers or promoters of a company, holding a share of a company can be termed a 'speculator'. Kaldor (1939) points out how and why there are only two classes of assets – raw materials and standardised future claims or titles to property – that are used for large scale speculation. "Bonds and shares are perfect objects for speculation; they possess all the necessary attributes to a maximum degree. They are perfectly standardised (one particular share of a company is just as good as any other); perfectly durable (if the paper they are written on goes bad it can be easily replaced); their value is very high in proportion to bulk (storage cost is zero or a nominal amount); and in addition they (normally) have a yield, which is invariant (in the short period at any rate) with respect to the size of speculative commitments." From a purely technical point of view, there is considerable difficulty in describing most but some stock market operations as anything but speculative. The only distinction that can be drawn is on the basis of investment horizon, and classifying investors as 'long-term' investors and speculators. It is on this basis of investment horizon, that the Income Tax Act, 1961 defines speculation as non-delivery based trades, which are settled within the day.

76. It is important to distinguish among three different functions of hedging, speculating and arbitraging. Kaldor (1939) points out ""Hedgers" are those who have certain commitments independent of any transactions in the forward market, either because they hold stocks of the commodity, or are committed to produce the commodity, or are committed to produce, in the future, something else for which the commodity is required as a raw material; and who enter the forward markets in order to reduce the risks arising out of these commitments. "Speculators", in general, have no commitments apart from those entered into in connection with forward transactions; they assume risks by entering the market. Both hedgers and speculators can be, in particular circumstances, buyers or sellers of "futures", but in both cases, it is the speculators who assume the risks and the hedgers who get rid of them. The possibility of arbitrage, i.e. buying spot and selling futures simultaneously and holding the stock until the date of delivery, arises when the relationship between the futures price and the current price ensures a riskless profit. Hence, any ordinary holder of stocks of a commodity becomes an "arbitrageur" in so far as the existence of the futures market tempts him not only to hedge the stocks he would

ordinarily hold, but to enlarge his stocks in relation to turnover owing to the advantageous terms on which they can be "hedged"."

3.II. Day trading

77. Section 43(5) of the Income Tax Act defines 'speculative transaction' to mean a transaction in which a contract for the purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled or otherwise than by actual delivery or transfer of the commodity or scrips. Day-trading, wherein purchases made earlier in the day are sold for a profit or loss within the day itself, without taking delivery, is 'speculative' according to the Income Tax Act, 1961. By the criterion of classifying investment as long-term or speculative on the basis of time horizons, day-trading qualifies as a speculative investment. It may be noted that the FIIs being required to transact on the basis of giving and taking deliveries, are prohibited from day trading. Hence, FIIs are barred from this extreme form of speculative activity.

3.III. Role of speculation

78. Bekaert and Harvey (2000): "Throughout history and in many market economies, the speculator has been characterized as both a villain and a savior. Indeed, the reputation of the speculator generally depends on the country where he does business. In well-functioning advanced capital markets, such as the United States, the speculator is viewed as an integral part of the free-market system. In developing capital markets, the speculator, and in particular the international speculator, is looked upon with many reservations."

79. Economic logic generally suggests that speculative activity enhances the informational and allocative role of asset markets and enhances the efficiency of markets. Speculation evens out price-fluctuations due to changes in demand or supply conditions. With better foresight than the average economic agent, speculators 'stock up' when there is a temporary excess supply and decumulate stocks when there is a transitory excess demand. Speculators' gains accrue for their services in terms of transfer of goods across time. By transferring goods 'temporally' from less important uses to more important uses, they deliver an entrepreneurial service.

80. Concerns about the adverse effects of speculation come from two sources. First, the possibility that speculation, instead of evening out price fluctuations, may end up exacerbating such fluctuations. Such exacerbation can arise only if the average speculator has worse foresight than the average person. While such an expectational underperformance would be attended by speculative losses in the aggregate than gains, and the elimination of the average speculator through bankruptcies, it could be sustained by some successful speculators concentrating on forecasting other speculators' expectations and indeed making profits. According to Kaldor (1939) "For the losses of a floating population of unsuccessful speculators will be sufficient to maintain permanently a small body of successful speculators; and the existence of this body of successful speculators will be a sufficient attraction to secure a permanent supply of this floating population."

81. Second, is the problem of speculation destabilising rather than stabilising prices and hence affecting resource allocation. Through speculation, future expected price not only depends on, but also has an impact on the spot price. Suppose, a bad monsoon is expected to depress agricultural output, leading to an increase in the price of agricultural goods next year. In the absence of speculation, prices would go up next year by 10 per cent. If speculators expect a 20 per cent rise in prices, then by building up stocks and pre-empting current supplies, they may push up the current price itself. And, if expectations further react to the increase in current prices, this may lead to further increase in both expected and current prices. The elasticity of expectations (how expected prices change because of a change in current prices) and elasticity of speculation (how much stocks are built up in response to a change in expected prices) are critical determinants of whether speculation is price-stabilising or destabilising.

82. The market for shares is subject to much larger fluctuations than the market for bonds or even commodities. Shares represent a share in the expected future profits of a company. When fortunes of companies – both in the short run as well as in the medium to long run – fluctuate, so do share prices. Uncertainty regarding the future leads to heavy discounting of future profits, and to focus on short-period expectations about capital value rather than long-period prospects of the company.

83. The effect of foreign speculative activity in emerging markets can be particularly beneficial if in the emerging market, liquidity is poor and manipulation rampant. First, the potential of market manipulation is acute in small emerging markets and liquidity is often poor. Although there are many policy initiatives that could increase liquidity and reduce the degree of collusion among large traders, there may not be a sufficient mass of domestic speculators to ensure market liquidity and efficiency. Second, opening the market to foreign speculators may increase the valuation of local companies, thereby reducing the cost of equity capital. The intuition is straightforward (Bekaert and Harvey (2000)). In segmented capital markets, the cost of equity capital is related to the local volatility of the particular market.

84. The consensus in the research literature argues in favour of the positive role of speculators in price discovery. Indeed, it is hard to conceive of a financial market without active information processing, forecasting and speculation. The literature has mixed results on the relative profits achieved by domestic versus foreign speculators.

3.IV. Hedge funds

85. In the last three years, there has been considerable interest in the regulatory questions associated with the participation by foreign hedge funds in the Indian equity market.

What are Hedge funds?

86. Hedge funds, which are private investment vehicles for wealthy individuals or institutional investors, have been in existence for over half a century. They, however, have little to do with hedging or eliminating risks arising from an underlying portfolio position. Hedge funds constitute an alternative to mutual funds in terms of being a vehicle for fund management.

Regulation of mutual funds, motivated by the need to protect small investors, induces significant costs of regulation. Hedge funds are prevented from accessing small investors, and are freed from this regulation. They are able to engage in a wider array of trading strategies, and contractual structures, as compared with mutual funds. They are the preserve of sophisticated investors who are able to take care of their own interests, and not rely on an intrusive regulatory framework designed at protecting small investors. If the costs of regulation of mutual funds are substantial, hedge funds would yield superior returns.

87. Albert Winslow Jones is credited with forming one of the first hedge funds in 1949. However, they came into prominence in 1966, when an article in Fortune reported how Jones' funds had substantially higher returns than other mutual funds. The U.S. Securities Exchange Commission found 215 investment partnerships in a survey for the year ending 1968 and concluded that 140 of these were hedge funds, with the majority formed that year. After this rapid expansion in 1967–1968, the industry suffered a substantial setback in the form of losses and capital withdrawals during the bear markets of 1969–1970 and 1973–74, and faded back into obscurity. Interest in hedge funds and formation of many new hedge funds resumed in 1986, when an article in *Institutional Investor* reporting how Julian Robertson's Tiger Fund had compounded annual returns of 43 per cent during its first six years of existence. The hedge fund industry has stayed opaque to the general public. The attack on the British Pound led by George Soros' Quantum Fund in mid-1992 and the collapse of Long-Term Capital Management in 1998 prompting intervention from US federal regulators heightened public interest in and apprehension about the hedge fund industry. By betting that the British Pound would drop out of the European Rate Mechanism (ERM) in September 1992, George Soros' Quantum Fund reputedly made US$ 1 billion.

88. According to the Wall Street Journal there are, presently, about 8,000 hedge funds with over $850 billion of assets under management. Further, there are over 40 registered "funds of hedge funds" which invested customer funds into a diversified portfolio of hedge funds. The funds traditionally have been investment outlets for the wealthy investors. But to attract smaller investors, funds of hedge funds, which invest in several hedge funds rather than individual securities, have sprung up since 2002 and offered lower minimum entry requirements than conventional hedge funds.

89. While hedge funds originated as an investment strategy for wealthy individuals, they have increasingly been accepted into portfolio choices of institutional investors such as pension funds, foundations and university endowment funds, who seek to maximize long-run returns. Twenty per cent of corporate and public pension plans in the US were found to be using hedge funds in 2002, up from 15 per cent in 2001. Other data indicate that pensions' investments in hedge funds have increased from $13 billion in 1997 to more than $72 billion so far in 2004, an increase of more than 450 per cent. Many university endowment funds – for example, Harvard University endowment fund – operates as hedge funds. Some of the well known funds are those managed by George Soros' Quantum Group, Julian Robertson's Jaguar Fund, Louis Bacon's Moore Global Fund, Leo Cooperman's Omega Overseas Fund, and Mark Kingdon's Kingdon Fund.

90. Expertise and superior performance have led to the accelerated growth of hedge funds. The average returns of hedge funds have often been higher than the average major market indices like the S&P index or the MSCI. As an example, a hedge fund may promise to replicate the volatility of the S&P 500 index, while outperforming the return of this index. Alternatively, a hedge fund might promise to replicate the volatility of a 10-year government bond, while outperforming the return of this bond.

Regulatory Environment

91. The discussion of regulatory environment of hedge funds here focuses on the United States, since hedge funds originated in the U.S. There are three sets of regulators in the U.S. overseeing the capital markets. The Securities Exchange Commission (SEC) oversees publicly traded securities, including the corporations that issue them, and the broker-dealers that help make markets for them. The Commodity Futures Trading Commission (CFTC) oversees the futures industry, while the Federal Reserve, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision oversee the commercial banking and thrift industry. These agencies were created to regulate institutions that deal with the general public. For example, the SEC aims ‘‘to protect investors in securities markets that operate fairly and to ensure that investors have access to disclosure of all material information concerning publicly traded securities.’’ Hedge funds are private investment vehicles for sophisticated wealthy investors and institutional investors, and do not deal with the public. Thus, hedge funds have traditionally been outside the direct jurisdiction of these regulators.

92. A hedge fund can claim the status of a private placement by not having more than 35 "non-accredited" investors and not engaging in solicitation. The numerical limitation is irrelevant if offering is to accredited investors since accredited investors are not counted for the purpose of determining whether the issuer has exceeded the 35 person limit. An accredited investor is one with more than US$1 million in financial wealth or an income of over US$200,000 in the previous two years. Under the safe harbor provision of Rule 506 in Regulation D, because of its private placement nature, most registration and disclosure requirements of the ‘‘truth in securities’’ law, namely the Securities Act of 1933, do not apply to hedge funds.

93. Under the U.S. Securities Exchange Act of 1934, because of the potential conflicts of interest in executing customer orders as well as trading on their own accounts, broker-dealers are required to maintain detailed records of their own trades as well as those of their customers. Hedge funds trade mostly on their own account and hence are usually exempted from registration as broker-dealers and the associated costly reporting requirements. Similarly, by having less than 15 clients and by not soliciting business from the general public, a hedge fund usually exempts itself from registration as an investment advisor and conforming to the statutory standards under the Investment Company Act of 1940 governing the regulation of the mutual fund industry by the SEC.

94. According to Fung and Hsieh (1999): "An important consideration is the question of ‘‘disclosure’’. Fund managers who believe that they have a ‘‘winning strategy’’ are obviously averse to be subjected to ‘‘full disclosure’’ on the functioning of the strategy. This precludes

organizational forms that must meet a high level of ‘‘transparency’’ and ‘‘disclosure, ’’ such as mutual funds, and favors ‘‘private vehicles’’ that have much lower transparency and disclosure requirements. An immediate consequence of this is the lack of ‘‘publicly offered’’ hedge fund products which is still the case today.”

95. With the growth of financial derivatives, and the regulation of all derivative instruments by the Commodity Futures Trading Commission (CFTC) in the US, commodity trading pools operated by commodity trading advisors have become more or less identical to hedge funds. The commodity trading advisers, who are firms or individuals registered with the CFTC through the National Futures Association, handle customer funds or provide advice for trading futures contracts or options on futures contracts. With the growth of derivatives in interest rates, currencies and stock indices, the simplistic traditional notion that funds operated by commodity trading advisers are limited to trading primarily futures contracts is no longer valid. Long-Term Capital Management (LTCM), for example, was registered as a commodity pool operator. This suggests that a fund’s regulatory registration has ceased to be a meaningful indication of the fund’s activities.

96. Not only are hedge funds in the US subject to very few regulatory controls, but also their fund managers are not required to register with the SEC and therefore are not subject to regular SEC oversight. Because of this lack of regulatory oversight, hedge funds historically have been available to accredited investors and large institutions and have limited their investors through high investment minimums. Although hedge fund investment advisers are subject to the antifraud provisions of the federal securities laws, they are not subject to any reporting or standardized disclosure requirements, nor are they subject to Commission examination.

97. The SEC has reportedly seen an increase in cases of fraud among the 5,700 or so hedge funds in the US, and has brought 40 enforcement cases against them in the last five years. The concerns about operation of hedge funds arise on account of use of excessive leverage, short selling, how their portfolios are valued and to whom they are marketed. The SEC Staff Report (Staff Hedge Fund Report: The Implications of the Growth of Hedge Funds, September, 2003) points out that their recent enforcement investigations into the role that hedge funds have played in late trading and market timing abuse scandals have highlighted the significant role that hedge funds played in the scandals and underscore the need for more scrutiny of this industry. According to the report, one of the staff’s primary concerns is that the Commission lacks information about hedge fund advisers that are not registered under the Investment Advisers Act of 1940 and the hedge funds that they manage. The staff is concerned that the Commission’s inability to examine hedge fund advisers makes it difficult to uncover fraud and other misconduct.

98. The types of frauds by these funds include gross overstatement of performance by hedge fund advisers, payment of unnecessary and undisclosed commissions and misappropriation of client assets by using parallel unregistered advisory firms and hedge funds. About 80 per cent of those cases involved hedge fund advisers that were not registered with the Commission. Other concerns are improper valuation of hedge fund assets by hedge fund advisers and market manipulation. Because of their use of leverage and rapid trading strategies, hedge funds can have a disproportionate impact on investors. Studies show that at times, a single hedge fund

manager has been responsible for an average of 5 per cent of the daily trading volume on the NYSE.

99. Effective February 10, 2005, US SEC has a new rule under the Investment Advisers Act, 1940 mandating that all hedge funds register with the agency, a move that would open their books to SEC examiners and make them subject to an array of regulations including accounting and disclosure requirements. The board approval would be placed in the public domain for comments before formal adoption. The SEC has recommended that hedge fund advisers may be mandated to register with the Commission under the Investment Advisers Act, 1940. This will enable the Commission to collect basic data regarding hedge funds and conduct examination of the hedge fund advisers' activities so as to better detect and prevent fraud, while at the same time imposing only minimal burdens on hedge fund advisers. It would allow the Commission to protect the interests of investors and the securities markets and improve compliance with the securities laws. Advisers, who are required to register under the new rule and rule amendments, must do so by February, 2006.

100. Relative to the US situation, the European environment is complex, with national authorities (including fiscal authorities) adopting differing approaches. This is exacerbated by barriers to distribution due to culture, such as attitudes to savings, tax disparities and differences in interpretation of common EU rules. The success of the hedge fund industry in the US, and to a lesser extent, the UK, relative to the European Union (EU), owe a lot to the stable regulatory environment and a light regulatory touch in the two jurisdictions, in addition to fund management expertise.

101. In most European countries, generally both hedge funds and conventional fund managers operate under the identical regulatory regime.[9] In some countries, managers can deal in offshore-domiciled hedge funds products, while in others they are restricted to managing domestic-domiciled hedge funds products only. The general approach of regulating such products is to prescribe minimum regulatory capital required to conduct business as a hedge fund manager. Minimum capital requirements vary across countries ranging from Euro 50,000 to Euro one million. Most hedge funds are domiciled "offshore" because generally their regulation is lighter and start up time is less. Further they are concentrated in offshore jurisdictions where the fund is not subject to tax. However, offshore centers are tightening their regimes primarily to comply with anti-money laundering controls and to ensure they are able to compete with the anticipated future demand for European-domiciled funds.

102. European-domiciled funds are expanding with many countries legislating a change permitting the formation of domestic, single manager hedge funds and/or funds of hedge funds. Domestic-domiciled funds are more strictly regulated than hedge funds domiciled offshore, with restrictions such as minimum subscription amount, minimum fund size and portfolio investment restriction. The approach taken by many regulators in Europe to protect smaller investors is to set a limit or minimum amount of investment reducing its access.

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[9] Germany is a significant exception.

Organisational structure

103. Hedge funds are 'unregulated' collective investment vehicles, often organized as private partnerships and resident offshore for tax and regulatory purposes. They are typically organized as limited partnerships, with investors as limited partners and managers as general partners. General partners usually invest a significant portion of their personal wealth into the partnership to eliminate the moral hazard problem. Investors to the partnership are charged a performance-based fee. Performance-based payouts to successful managers are common and can be much higher than the fixed management fee.

Investment strategy, leveraging and fee structure

104. The legal status of hedge funds places few restrictions on their portfolios and transactions, leaving their managers free to use short sales, derivative securities and leverage to raise returns and cushion risk. Unlike mutual funds, they are not required to report on their holdings of specific securities. And, their 'secret' positions change on a daily and even intra-daily basis. The investment strategies of hedge funds are the least understood, leading to a public perception of risk and uncertainty about their investment activity. For starters, they are not, as one might suppose, funds that hedge their bets through a prudent combination of investments. The first reported hedge fund by Albert Winslow Jones engaged in "pairs trading", a hedged trading strategy which involved (say) buying Infosys and simultaneously selling Wipro. But even early imitators became more notable for borrowing money to speculate than for hedging. Interestingly, despite their name, the institutional innovation that hedge funds constitutes does not lie in the use of "hedged" trading strategies.

105. Hedge funds deploy dynamic trading strategies, and not the static buy-and-hold strategy employed by most mutual funds. They also leverage their bets by margining their positions and through the use of short sales. In contrast, the use of leverage is often limited if not restricted for mutual funds. In the U.S., the Investment Company Act 1940 restricts a mutual fund's ability to leverage or borrow against the value of securities in its portfolio. By having no more than 99 investors, or no more than 499 investors with at least US$5 million assets each, a hedge fund is not an investment company and is exempt from the leverage restrictions pertaining to investment companies.

106. The 'fulcrum' rule of gains and losses having a symmetric effect on incentive fees of mutual fund managers do not apply to the performance-based fees of hedge fund managers. The only restrictions on hedge fund managers' fees are those imposed by the private investors. Typically, hedge fund managers receive positive incentive fees for gains but are not required to rebate fees to investors for losses. A typical format of hedge fund fees is "2+20", which denotes 2 per cent of assets under management per year as fees, plus 20 per cent of the return obtained (if positive returns arise). According to Fung and Hsieh (1999): "This embedded ''put option'' remains a highly debated issue on hedge fund managers' compensation. On the one hand, the significant amount of personal wealth that hedge fund managers place at risk alongside investors inhibits excessive risk taking. On the other hand, there are extreme circumstances where the disproportional payout from the incentive fee may outweigh the risk of losing personal wealth even if reputational risks are taken into account. Thus, under what conditions hedge fund

managers are enticed to take the ‘‘Hail Mary’’ toss and roll the dice against unreasonable odds remains an important question for future research.”

107. According to Managed Accounts Report (MAR)/Hedge, one of the most reputed sources of information on hedge funds, there are seven different investment styles: event-driven, global, global/macro, market neutral, sectors, short-sellers, and long only. Event-driven investors take positions on corporate bankruptcies, reorganisations and mergers and acquisitions. Global investors put their money on non-US stocks and bonds, while global/macro investors, by relying on macroeconomic analysis, take bets on currencies, interest rates and stock indices. Many top academic economists in the areas of finance and macroeconomics in American universities are now closely associated with hedge funds as advisors and/or entrepreneurs. Market neutral investors avoid major risks and rely on long-short equity, and arbitrage. The last three styles are self explanatory, the respective styles specialise in sectoral, short sale and longs. As far as targets are concerned, hedge funds operate with either absolute return targets or return targets relative to some market index such as S&P; but absolute return targets are more dominant. Hedge fund managers are expected to deliver results irrespective of market conditions.

108. Fung, Hsieh, and Stsatsaronis (2000) state the problem of hedge funds in emerging markets succinctly as follows: “By their very nature, hedge funds employ opportunistic trading strategies on a leveraged basis. A small bet by large hedge funds may amount to a sizable transaction that can affect a market, especially one that has limited liquidity; it is natural to find their footprints in most major market events. On one level, the presence of hedge funds is no more disruptive than that of any other group of large speculators. Speculation is part and parcel of an open capital market, and the presence of hedge funds is, for that reason, to be expected. However, highly leveraged trading strategies practiced by many market participants, if left unchecked, can lead to a convergence of bets. This, in turn, can leave markets vulnerable to disruption when confidence erodes and participants head for the exit.” This is a problem that is addressed in the following section on episodes of vulnerability.

3.V. <u>Episodes of vulnerability</u>

109. Excess volatility induced by foreign investors is often adduced as an argument against liberalizing the foreign investment regime in general and FII investment in particular. Do foreign investors in general and FIIs in particular destabilize capital markets beyond a level that the changes, if any, in fundamentals warrant? The two most common examples of such destabilisation by portfolio investors in general and hedge funds in particular are the attack on the ERM in 1992 and the East Asian crisis of 1997. A common feature of these episodes is that they involved speculative attacks on fixed or tightly pegged exchange rate regimes. By and large, the focus of these episodes was not the equity market. Hedge funds were noticeably absent from the financial news during the Mexican peso devaluation of 1994.

ERM crisis of 1992

110. The high-profile ERM crisis of 1992 came with speculators betting that the member countries of the European Monetary System (EMS) were converging to the European Monetary Union (EMU), and high-inflation countries would have to realign their exchange rates, but the

extent of depreciation would be less than the interest rate differential between the high-inflation and low-inflation countries. The expectation regarding the extent of exchange rate adjustment led to 'carry trade' – borrowing from the low interest ERM countries and lending to the high interest countries, or in the forward currency market, taking a long position in the higher-yielding currency and shorting the lower-yielding currency.

111. Fung, Hsieh, and Stsatsaronis (2000) report "George Soros, manager of the Quantum Fund, was widely reported to have held a $10 billion short position on the British pound (often referred to in the foreign exchange market as the sterling) and to have made $1 billion for his fund as a result of the pound's September devaluation…..As might be expected, other hedge funds were active during the crisis and had estimated positions of $1.7 billion. Altogether, "large" hedge funds are estimated to have held short sterling positions totaling $11.7 billion, a position more than twice that of the U.K. current account deficit in third quarter 1992 ($5.4 billion), equal to its financial account deficit during the same quarter ($11.4 billion), and in excess of 25 percent of the government's official reserves in 1992 ($40 billion). Even in the broader context of the entire ERM, an $11.7 billion position was sizable. As of August 1992, the official reserves of the eight countries involved in the ERM crisis (France, Germany, Italy, Ireland, Portugal, Spain, Sweden, and the United Kingdom) totaled $268 billion. By the end of September, the official reserves of the six countries that remained in the ERM had fallen by $17.8 billion, while their central banks had spent $82.6 billion in defending their currencies. The United Kingdom issued private debt of Euro Currency Unit (ECU) 10 billion and Sweden issued ECU 11 billion (a total of $29.4 billion in intervention) to bolster their reserve positions. The German Bundesbank is estimated to have spent another DM 92 billion, or $53.2 billion, to support the ERM currencies. By September 1992, central bank interventions in the ERM totaled roughly $100 billion. The hedge fund positions amounted to 4.4 percent of the official reserves of the ERM central banks and 11.7 percent of the amount the banks spent to support their currencies. On the basis of these amounts, it is reasonable to conclude that the estimated $11.7 billion short sterling position generated a material impact on the exchange rate and on the external value of the British pound."

112. In spite of the material impact of hedge fund activities in the ERM crisis, Fung, Hsieh, and Stsatsaronis (2000) conclude that, because of their primary focus on traditional equity markets during the late 1980s and early 1990s, the role of the hedge funds in the crisis was limited. The practice of extending lines of credit to offshore entities on a nonrecourse basis against collateral was not widely accepted by most banks, and foreign exchange trading was primarily an inter-bank activity. "Therefore, although the speculative hedge funds may have nudged sterling over the ERM band, it was more likely the unwinding of sizable carry positions by proprietary trading books in commercial and investment banks that pushed the higher-yielding currencies toward their respective ERM limits." This is consistent with the logic of the speculative attack on a fixed/pegged exchange rate. When it is felt that an exchange rate regime is unsustainable, it is efficient for a broad class of economic agents, ranging from hedge funds to banks to individuals, to try to earn profits from the impending appreciation or depreciation of the exchange rate. Such position-taking is innate in the modern financial market, where economic agents are free to form portfolios based on their views about the future course of financial prices.

East Asian crisis of 1997

113. Foreign investors were often blamed for the dramatic difficulties of the East Asian countries at the times of the 1997 crisis. Stiglitz (1998), for example, in the context of the 1997 crisis, argued that "…developing countries are more vulnerable to vacillations in international flows than ever before," and called for greater regulation of capital flows. A variety of reasons are adduced to explain why foreign investors can have a destabilizing effect on capital markets in emerging economies. Foremost among them are the pursuit of a positive feedback strategy, that is buying when prices are rising and selling when prices are falling, thereby exacerbating both the upswings and downswings. Positive feedback leads to bubbles when prices depart from fundamentals and to crashes when bubbles burst. Panic is the extreme form in which such a positive feedback can manifest itself, and Radelet and Sachs (1998) attribute the East Asian economic crisis to financial panic. Prime Minister Mahathir Mohammad of Malaysia accused hedge funds of being the modern equivalent of "highwaymen" in breaking the Asian currencies.

114. After ten years (1986–97) of pegging of the Thai baht to the U.S. dollar, on July 2, 1997, the peg had to be abandoned, and this created pressure on other Asian currencies, and eventually brought down the Malaysian ringgit, the Indonesian rupiah, the Philippine peso, and the Korean won. By end-1997, these currencies had lost between 44 and 56 percent of their value against the U.S. dollar, bankrupting many Asian corporations and banks that had borrowed in foreign currencies, and leading to a significant contraction of the economies. This episode is known as the East Asian crisis or Asian crisis.

115. Adams, Mathieson, Schinasi, and Chadha (1998) trace the increasingly aggressive flow of the carry trade down the credit spectrum in Asia during the 1990s — from sovereign credit, to top-tier domestic commercial banks, to lower-tier commercial banks and finance companies, and finally to firms. The excessive build-up of foreign debt, they attribute to the confidence of domestic companies and banks in the fixed official exchange rate. FII investment in equities had little role to play in the crisis. Fung, Hsieh, and Stsatsaronis (2000) report "At the height of the episode, some Asian government officials accused speculators and hedge funds of attacking the currencies and causing their downfall. A public debate ensued, and the International Monetary Fund (IMF) responded by examining the role of hedge funds in the Asian currency crisis. The resulting study by Eichengreen, Mathieson, Chadha, Jansen, Kodres, and Sharma (1998) considers three potential causes of market disruptions: (1) a trader holding a single large position, (2) positive feedback trading (that is, the strategy of adding positions as the market moves in favor of existing positions), and (3) "herding" by traders mimicking other traders. Through interviews with market participants, Eichengreen and his coauthors conclude that hedge funds did not play a central role in causing the Asian currency crisis." In their own study with daily and weekly data, Fung, Hsieh, and Stsatsaronis (2000) find no evidence of, among other things, positive feedback trading, and conclude "The Thai central bank was betting that the foreign currency loans could be rolled over, while speculators were betting the contrary. The central bank was wrong. Did hedge funds play a role in the crisis? Of course they did. Did hedge funds cause the crisis by causing investors to flee the Asian carry trade? No." Furthermore, they state "Although it is tempting to extrapolate from the speculative activities of hedge funds at the peak of a crisis, it would be erroneous, on that evidence alone, to attribute the market's disruption solely to hedge funds that came in at the end of a trade. As is often the case,

the proverbial straw that broke the camel's back is no more responsible than any of the other straws."

Episodes of Volatility in India

116. There have been four episodes of vulnerability in India, which are negative shocks affecting the economy, and influencing the behavior of investors. These are: the East-Asian crisis in 1997, the Pokhran Nuclear explosion (May 1998) and the attendant sanctions, the stock market scam of early 2001, and the Black Monday of May 17, 2004.[10] The investment behavior of the FIIs vis-à-vis the movements of the stock market indices during these episodes are given in Tables 4-7.

Table 4. India: FII Behaviour During East Asian Crisis

MONTH	BSE INDEX FOR THE MONTH	FII INVESTMENTS (Rs. crore)
July 1997	4256.11	1002.8
August 1997	4276.31	493.66
September 1997	3944.78	598.59
October 1997	3991.75	641.59
November 1997	3611.83	-289.87
December 1997	3515.54	-182.38
January 1998	3472.87	-374.97
February 1998	3402.96	629.05
March 1998	3816.89	472.22

117. FII investment behavior during these four specific events indicates that these events did affect the behaviour of the foreign portfolio investors. But, these events did affect domestic investors' behaviour as well. The critical question to ask is: whether there was any perceptible difference, particularly with a bias towards destabilization, in the behaviour of the FIIs vis-à-vis that of domestic investors?

[10] In May 2004, the Indian market experienced extreme volatility and on May 17 2004, in the wake of a sharp fall in the index, there were market halts for the first time after the introduction of circuit breaker rules. Net sales by FIIs amounted to roughly Rs.500 crore on this day, a small proportion of the total trading volume of NSE and BSE, spot and derivatives. The risk management system withstood volatility of 8 sigma or above as against the normal built-in capacity of withstanding only 3-6 sigma variations internationally. There were no defaults by brokers and no drawal of the settlement guarantee funds. The robustness of the risk management system was acclaimed internationally.

Table 5. India: FII Behaviour in the aftermath of Pokhran Nuclear Explosion

MONTH	BSE INDEX FOR THE MONTH	FII INVESTMENTS (Rs in crores)
May 1998	3911.95	-557.45
June 1998	3317.49	-896.30
July 1998	3271.73	104.68
August 1998	2988.40	-390.82
September 1998	3089.88	111.09
October 1998	2866.55	-552.46

Table 6. India: FII Behaviour during the Stock Market Scam 2001

MONTH	BSE INDEX FOR THE MONTH	FII INVESTMENTS (Rs in crores)
November 2000	3928.10	1090.11
December 2000	4081.42	-461.78
January 2001	4152.39	3971.58
February 2001	4310.13	1574.14
March 2001	3807.64	2204.80

Table 7. India: FII Behaviour around Black Monday, May 17, 2004

MONTH	BSE INDEX FOR THE MONTH	FII INVESTMENTS
May 2004	5204.65	-3151.29
June 2004	4823.87	511.00
July 2004	4972.88	1292.83

118. These experiences show that FII outflow of as much as a billion dollars in a month – which corresponds to an average of $40 million or Rs.170 crore per day – has never been observed. These values – Rs.170 crore per day – are small when compared with equity turnover in India. In calendar 2004, gross turnover on the equity market of Rs.88 lakh crore contained Rs.5 lakh crore of gross turnover by FIIs. This suggests that as yet, FIIs are a small part of the Indian equity market. Transactions by FIIs of Rs.5 lakh crore in a year might have been large in

1993, but the success of a radical new market design in the Indian equity market have led to enormous growth of liquidity and market efficiency on the equity market. Through this, India's ability to absorb substantial transactions on the equity market appears to be in place.

CHAPTER 4. POLICY OPTIONS

4.I. Benefits and costs of FII investments

119. The terms of reference asking the Expert Group to consider how FII inflows can be encouraged and examine the adequacy of the existing regulatory framework to adequately address the concern for reducing vulnerability to the flow of speculative capital do not include an examination of the desirability of encouraging FII inflows. Yet, for motivating the consideration of the policy options, it is useful to briefly summarise the benefits and costs for India of having FII investment. Given the Group's mandate of encouraging FII flows, the available arguments that mitigate the costs have also been included under the relevant points.

Benefits

Reduced cost of equity capital

120. FII inflows augment the sources of funds in the Indian capital markets. In a common sense way, the impact of FIIs upon the cost of equity capital may be visualised by asking what stock prices would be if there were no FIIs operating in India. FII investment reduces the required rate of return for equity, enhances stock prices, and fosters investment by Indian firms in the country .

Imparting stability to India's Balance of Payments

121. For promoting growth in a developing country such as India, there is need to augment domestic investment, over and beyond domestic saving, through capital flows. The excess of domestic investment over domestic savings result in a current account deficit and this deficit is financed by capital flows in the balance of payments. Prior to 1991, debt flows and official development assistance dominated these capital flows. This mechanism of funding the current account deficit is widely believed to have played a role in the emergence of balance of payments difficulties in 1981 and 1991. Portfolio flows in the equity markets, and FDI, as opposed to debt-creating flows, are important as safer and more sustainable mechanisms for funding the current account deficit.

Knowledge flows

122. The activities of international institutional investors help strengthen Indian finance. FIIs advocate modern ideas in market design, promote innovation, development of sophisticated products such as financial derivatives, enhance competition in financial intermediation, and lead to spillovers of human capital by exposing Indian participants to modern financial techniques, and international best practices and systems.

Strengthening corporate governance

123. Domestic institutional and individual investors, used as they are to the ongoing practices of Indian corporates, often accept such practices, even when these do not measure up to the international benchmarks of best practices. FIIs, with their vast experience with modern corporate governance practices, are less tolerant of malpractice by corporate managers and owners (dominant shareholder). FII participation in domestic capital markets often lead to vigorous advocacy of sound corporate governance practices, improved efficiency and better shareholder value.

Improvements to market efficiency

124. A significant presence of FIIs in India can improve market efficiency through two channels. First, when adverse macroeconomic news, such as a bad monsoon, unsettles many domestic investors, it may be easier for a globally diversified portfolio manager to be more dispassionate about India's prospects, and engage in stabilising trades. Second, at the level of individual stocks and industries, FIIs may act as a channel through which knowledge and ideas about valuation of a firm or an industry can more rapidly propagate into India. For example, foreign investors were rapidly able to assess the potential of firms like Infosys, which are primarily export-oriented, applying valuation principles that prevailed outside India for software services companies.

Costs

Herding and positive feedback trading

125. There are concerns that foreign investors are chronically ill-informed about India, and this lack of sound information may generate herding (a large number of FIIs buying or selling together) and positive feedback trading (buying after positive returns, selling after negative returns). These kinds of behaviour can exacerbate volatility, and push prices away from fair values. FIIs' behaviour in India, however, *so far* does not exhibit these patterns. *Generally, contrary to 'herding', FIIs are seen to be involved in very large buying and selling at the same time. Gordon and Gupta (2003) find evidence against positive-feedback trading with FIIs buying after negative returns and vice versa.*

BoP vulnerability

126. There are concerns that in an extreme event, there can be a massive flight of foreign capital out of India, triggering difficulties in the balance of payments front. India's experience with FIIs *so far*, however, suggests that across episodes like the Pokhran blasts, or the 2001 stock market scandal, no capital flight has taken place. A billion or more of US dollars of portfolio capital has never left India within the period of one month. When juxtaposed with India's enormous current account and capital account flows, this suggests that there is little evidence of vulnerability *so far*.

Possibility of taking over companies

127. While FIIs are normally seen as pure portfolio investors, without interest in control, portfolio investors can occasionally behave like FDI investors, and seek control of companies that they have a substantial shareholding in. Such outcomes, however, may not be inconsistent with India's quest for greater FDI. Furthermore, SEBI's takeover code is in place, and has functioned fairly well, ensuring that all investors benefit equally in the event of a takeover.

Complexities of monetary management

128. A policymaker trying to design the ideal financial system has three objectives. The policy maker wants continuing national sovereignty in the pursuit of interest rate, inflation and exchange rate objectives; financial markets that are regulated, supervised and cushioned; and the benefits of global capital markets. Unfortunately, these three goals are incompatible. They form the "impossible trinity." India's openness to portfolio flows and FDI has effectively made the country's capital account convertible for foreign institutions and investors. The problems of monetary management in general, and maintaining a tight exchange rate regime, reasonable interest rates and moderate inflation at the same time in particular, have come to the fore in recent times. The problem showed up in terms of very large foreign exchange reserve inflows requiring considerable sterlisation operations by the RBI to maintain stable macroeconomic conditions. The Government had to introduce a Market Stabilisation Scheme (MSS) from April 1, 2004.[11]

129. With the foreign exchange invested in highly liquid and safe foreign assets with low rates of return, and payment of a higher rate of interest on the treasury bills issued under MSS, sterilisation involves a cost. With a rapid rise in foreign exchange reserves, and the need for having an MSS-based sterilisation involving costs, questions have been raised about the desirability of encouraging more foreign exchange inflows in general and FII inflows in particular. *While there is indeed the issue of timing the policy of encouragement appropriately, to avoid the pitfalls of throwing the baby with the bath water, 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.

4.II. The guiding principles of public policy

130. Before turning to policy choices, it would be important to enunciate the principles of public policy that must guide the choices. India has followed a general strategy of liberalisation of the economy, giving greater role to market mechanism and financial deregulation. *Any*

[11] Under the MSS, Treasury Bills and dated securities of the Central Government are issued for conducting sterilisation operations. Money raised under the MSS is held by the Government in a separate identifiable cash account maintained and operated by the RBI. The amount held in this account would be appropriated only for the purpose of redemption and/or buyback of the Treasury Bills and/or dated securities issued under the MSS.

recommendation made today *should be consistent with this broad strategy of further liberalisation, and not look like or be a rollback of reforms.*

131. A recent investment climate survey of World Bank covering 53 countries indicates that policy uncertainty and macro instability are seen as major obstacles to investment. Firms are forward looking, and investment decisions are made on the basis of expectations about cash-flows in the deep future. Any departure from the general direction of reforms will contribute to policy uncertainty, and thereby adversely affect investment. Rolling back reforms would constitute an extreme form of departure from the path of reform and raise questions of time consistency. Thus, policies should be consistent and stable, and evolve along a predictable and fully articulated trajectory, that is extensively discussed and well understood by the public and the investor community. *This does not mean inflexibility even in the face of extreme situations. A sovereign always has the power to evolve policies, and take suitable actions in emergency situations. Apart from such emergencies, the broad direction of reforms since 1991 should be preserved.*

132. From an analytical perspective, policies towards FIIs should be formulated after answering the following questions. Is a liberalization of the FII regime in the interest of the Indian investors, especially small investors? Is such liberalization likely to affect market integrity? And, is such liberalization likely to augment systemic risk?

Consumer protection

133. The cardinal principle to ensure 'consumer protection' – in this case, investor protection – is to ensure that small Indian investors receive adequate information about the risks of their investments. Since small Indian investors are not customers of FIIs or of foreign hedge funds, there is no direct issue of consumer protection as far as encouraging FII inflows is concerned. Protection of foreign investors requires full access to the cashflows that go out to every shareholder, the same rights and obligations under takeover regulations, full repatriability of profits in convertible currency and full access to the same risk management tools available to domestic investors. *Indian investors are indirectly affected by FII flows to the extent that it enhances or diminishes the security prices in the Indian market. In general, enlarging the demand side of Indian securities is beneficial not only for Indian investors but also the firms that raise money from the capital markets. The only exception is when such FII flows run the risk of adversely impacting market integrity.*

Market integrity

134. *Regulations covering issues of market integrity are designed to obtain market efficiency thorough undistorted price discovery.* These regulations apply to all market participants, including FIIs and hedge funds. These rules include position limits, ongoing surveillance and investigation at the level of exchanges and the regulator, and continuous strengthening of disclosure since asymmetric information lies at the heart of market manipulation. Market integrity concerns motivated several recommendations of the Joint Parliamentary Report on Stock Market Scam (JPC). The JPC, after observing misuse of Overseas Corporate Bodies (OCBs) and some sub-accounts of FIIs in manipulating the stock market, recommended a policy

review based on comprehensive empirical analysis by RBI. Based on the analysis, and in view of the perceived inability to take regulatory action against such OCBs incorporated in foreign jurisdictions, the ban on OCBs to invest in Indian Capital Market put in November, 2001 was continued. *There is a lurking fear that such entities, which are not registered with home country regulator (in this case financial regulator), may be difficult to regulate. In addition, reporting requirements have been imposed on FIIs and currently PNs cannot be issued to un-regulated entities abroad.*

135. There is some apprehension that some unethical individuals who might have taken unaccounted money out of the country at an earlier date may bring back such money in the garb of FII inflows in general or sub-accounts in particular and use it to ramp up some particular share prices, including those in which they have already large shareholdings. This is a genuine concern. But, this needs to be avoided by rigorously enforcing the KYC requirement, tightening the regulatory regime for sub-accounts, and doing some vigorous investigations and sample checks in cases where there is prima facie evidence of wrong-doing. *With the policy of market regulation being the encouragement of broad-based funds to invest in the country, high net-worth individuals fall outside the category of diversified investors. In order to address the market integrity concerns arising out of allowing some entities, which do not have reputational risk or are unregulated, there is merit in prohibiting such entities from getting registered. Such existing entities may be given sufficient time to wind up the position.*

Systemic risk

136. Systemic risk is contained by prudential regulations on large institutions, typically banks, brokers and other financial intermediaries. Such regulations are designed to ensure that the intermediaries are adequately monitoring and managing their exposure to counterparties and extending credit prudently. *With the prudential regulations applying to FIIs* as well, *the dimension of systemic risk* – apart from herding behaviour – *appears to be limited.*

4.III. Policy possibilities

137. The mandate of encouraging FII inflows, while addressing regulatory concerns about reducing the vulnerability of capital markets to the flow of speculative capital, rules out ‘a no change, business as usual’ scenario. The possible policy directions, along with some sense about their pros and cons, can be grouped under encouraging flows and reducing vulnerabilities.

Encouraging FII flows

Redefining FII sectoral limits

138. *In terms of encouraging FII flows, one aspect of difficulty lies in the treatment of FDI sectoral limits and FII sectoral limits. The Committee on Liberalisation of Foreign Institutional Investment has proposed reforms aimed at separating these two.* FIIs act as agents on behalf of their principals – as financial investors maximizing returns. There are domestic laws that effectively prohibit institutional investors from taking management control. For example, US law prevents mutual funds from owning more than 5 per cent of a company’s stock.

139. Unlike FDI, which is that category of international investor that has the objective of obtaining a lasting interest in an enterprise in another economy, FIIs are specialized financial intermediaries managing savings collectively on behalf of investors, especially small investors, towards specific objectives in terms of risk, returns, and maturity of claims. *Any potential abuse of the FII route by strategic investors of foreign direct investors should be prevented by strictly enforcing the broad-based nature of the FIIs through appropriate regulation of PNs and sub-accounts.*

140. *Thus, FII investment ceilings, if any, may be reckoned over and above prescribed FDI sectoral caps. The 24 per cent limit on FII investment imposed in 1992 when allowing FII inflows was exclusive of the FDI limit. The suggested measure will be in conformity with this original stipulation.*

141. *As a transitional arrangement, the current policy of a composite cap, wherever it exists, for both FDI and FII investment limits, may be continued. However, attempt should be made, in consultation with the Ministries concerned, that this composite cap is at a sufficiently high level.*

Enhancing the supply side of equities

142. Most FIIs are large institutions who find a lot size of US$100 million to be the minimum that justify their research and transaction costs and overheads. *Non-availability of good quality equities in adequate volume appears to impede FII flows. FII flows would be encouraged by greater volume of issuance of securities in the Indian market. This would be assisted by PSU disinvestment.* The success of initial public offerings (IPOs) of Gas Authority of India Limited (GAIL), Oil and Natural Gas Corporation (ONGC) and National Thermal Power Corporation (NTPC) last year clearly point the way forward for deepening the markets. The response of institutional investors, including FIIs registered with SEBI to such issues, has been extremely positive

143. *Companies executing large projects in the infrastructure sector and telecom sector should also be encouraged to access the domestic capital markets.*

Reducing vulnerability to speculative flows

Moving from QR to price-based contingent restrictions

144. While a good set of regulations properly enforced should reduce the risk of vulnerability to speculative flows, the risk of some volatility can not be ruled out, especially in response to external shocks such as a financial crisis in some other country or great turbulence in international interest rates. It is necessary to have a set of policies for such contingencies. Extreme situations warrant extreme measures, and some contingencies may require the imposition of some temporary capital controls. Temporary capital controls can be imposed through either quantitative restrictions (QRs) or price-based measures. The arguments in favour or against any of these two options are analogous to the same two options in the area of foreign trade.

145. Quantitative controls generally give rise to economic rents: an entity which is permitted by India to be an FII or a sub-account in such a contingent situation earns a rent from other prohibited entities. QRs also place onerous responsibilities upon the arms of government which are charged with formulating limits and enforcing them. A major strategic policy alternative would be the imposition of price-based hurdles. One example of this is the Chilean-style policy of requiring that a certain fraction of capital that comes into the country is placed in an interest-free one-year deposit with RBI. This would reduce the incentives for debt-oriented and particularly short-term debt flows.

146. Chile's Unremunerated Reserve Requirements (URR) have attracted support of prominent scholars like Richard Portes, Takatoshi Ito and Joseph Stiglitz, since these are market-oriented price-based controls. It may be noted that while Chile embarked on the URR in 1991, it was abandoned in 1999 in favour of a consistent policy framework comprising floating exchange rate, full capital account convertibility, and a monetary regime of inflation targeting.

147. The Tobin tax is another policy alternative. This is a proposal to impose a tax such as 0.1 per cent on all currency spot market transactions. While this was proposed many decades ago, it has not been adopted in any country till date. The three difficulties with the Tobin tax are: (a) taxation of financial transactions drives turnover out to untaxed venues, such as the derivatives market or offshore markets, (b) taxation of financial transactions directly reduces the liquidity of financial markets, which is counter to the goals of financial sector policy and (c) a modest tax rate like 0.1 per cent could considerably hurt normal users of the financial market while not being large enough to deter speculators who anticipate large profits, such as those associated with the change in a currency regime.

<u>Filtering unclean money: negative list of tax havens</u>

148. Market integrity concerns could get heightened when funds of unknown source or funds arising out of laundered money are involved. *Consistent with the recommendations of the Financial Action Task Force (FATF), it must be ensured that only clean money through recognized banking channels is permitted in the securities market*.

149. The policy on allowing investment from weakly regulated tax havens should be driven by such market integrity criteria in a substantial manner. *Hence, one policy possibility is that of having a negative list of tax havens, whereby entities registered in these jurisdictions are prevented from attaining FII status.*

150. The International Organisation of Securities Commissions (IOSCO) has prescribed a model MOU which allows signatories to exchange sharing of information in case of regulatory or enforcement actions. SEBI is a signatory to this MOU with securities regulators of major markets. This gives India an enhanced ability to engage in investigations and enforcement activities with respect to entities regulated with these countries. This suggests that India should have a bias in favour of participation in the Indian market by finance companies registered in the countries with which SEBI has signed MOUs for cooperation.

Participatory notes

151. PNs raise concerns about the nature of entities to whom FIIs are issuing such notes. While the Indian regulatory structure would like to have information about the end-investors, there is a need to recognize that there are innate limits to the extent to which these regulations can achieve their goals. One international experience in this regard is that of Taiwan, which introduced disclosure requirements on PNs in December 1999, and eliminated them in June 2000. Hong Kong and Singapore have no restrictions or requirements on PNs.

152. In January 2004, SEBI stipulated that PNs are not to be issued to any non-regulated entity, and the principle of "know your clients" (KYC) must be strictly adhered to. SEBI has indicated that the existing non-eligible PNs will be permitted to expire or to be wound-down on maturity, or within a period of 5 years, whichever is earlier. Besides, reporting requirement on a regular basis has been imposed on all the FIIs. Policy options on PNs include:
(1) Winding down non-eligible PNs within three years instead of five years.
(2) Winding down all existing PNs within five years.
(3) Removing eligibility criteria for PNs.

153. *The current dispensation for PNs*, which was approved after careful examination of the High Level Coordination Committee for Capital and Financial Markets and SEBI's Board, *may continue. SEBI should have full powers to obtain information regarding the final holder/beneficiaries or of any holder at any point of time in case of any investigation or surveillance action. FIIs should be obliged to provide the information to SEBI.*

Hedge funds

154. Policy options on the participation of hedge funds in the Indian market include:
(1) Retaining existing FII registration rules, which define which entities can become FIIs or sub-account holders.
(2) Permitting a wide class of hedge funds to attain FII status.
(3) Prohibiting offshore hedge funds from participating on the Indian market.

155. In the context of anti-money laundering rules, the multi-jurisdictional nature of the hedge fund product, its distributional channels and the location of key service providers, such as administrators and transfer agents, present challenges in establishing which entity has the relationship with the investor and as such has the responsibility for carrying out anti-money laundering checks.

156. A concept of a Domestic Hedge Fund may be created, through appropriate SEBI regulations, to play a comparable role in the market based on purely rupee investments. SEBI has suggested a policy framework for hedge funds in India based on transparent and regulated access with abundant caution. However, there are certain concerns, which warrant that, for the time being, these funds may not be registered in India. There is merit in *closely watching the regulatory developments with regard to hedge funds in the US and elsewhere, including Europe, and formulating policy on the basis of experiences of these countries at a later date. Only those*

funds which are otherwise eligible to be registered as FIIs/sub-accounts under SEBI (FIIs) Regulations, 1995 may be continued to be allowed.

Domestic pension funds participation

157. *The participation of domestic pension funds in the equity market would augment the diversity of views on the market. This would also end the anomaly of the existing situation where foreign pension funds are extensive users of the Indian equity market but domestic pension funds are not.*

Sub-accounts

158. A single FII may have many customers, with sub-accounts. The FII may be a prominent advisor shaping the decisions of all these sub-accounts. This may lead to difficulties if there is "herding" – that is a situation where all these sub-accounts behave in a correlated way. In order to address this, *the existing limit of 10 per cent holding in any one firm by any one FII may be extended to cover the sum of the holdings of any one FII and all such sub-accounts coming under that FII which have common beneficial ownership as the FII. The onus for establishing that a sub-account does not have a common beneficial ownership will lie with the FII. This requirement may be phased in over a five-year period, with a limit of 20 per cent by December 2005, 18 per cent by 2006, 16 per cent by 2007, 14 per cent by 2008, 12 per cent by 2009 and 10 per cent by 2010.*

159. The market integrity concern may force a rethinking of some aspects of FIIs sub-account policy. Since the sub-accounts are mostly likely to be client funds, there is force in the argument of banning sub-accounts altogether. However, with over 90 per cent of FII investment in India through the sub-account route, such an outright ban will be unsettling for the market. A possible alternative to address the market integrity concerns is that *some entities, which do not have reputational risk or are unregulated, may be prohibited to be registered as sub-accounts. Such entities may be given sufficient time to wind up the position.*

160. *The stability of foreign investment in India will be enhanced if FIIs are able to switch between equity and debt investments in India, depending on their view about future equity returns. Greater flexibility for FIIs to participate in the bond market will induce more "balanced" strategies, and mixing of equity and debt. Such FII investment in debt will indeed be a part of India's external debt, but with an important difference, namely that such debt will be in domestic currency. Keeping this important difference in mind, there is merit in progressive liberalization with amendment of the quantitative restriction upon debt flows to a cap on the annual flow from the present ceiling on the aggregate portfolio value.*

Greater research

161. FDI and portfolio investment into India marks a new phase in India's globalisation. This calls for new kinds of research and knowledge related activities, in order to better analyse India's empirical experiences, understand the new relationships in financial sector, benefit from cross-country experiences, and build a consensus in the country on the future of India's policies

on the capital account. Although there is scant evidence of FII flows destabilizing Indian capital market so far, just because it has not happened, does not mean that it can not happen in the future. Thus, the recommendations of the Expert Group have been guided by the conservative principle of "erring on the side of caution." With a view to building a consensus on the future of India's policies on the capital account, the *Department of Economic Affairs should initiate a research program on "Capital flows and India's Financial Sector: Learning from theory, international experience, and Indian evidence."*

CHAPTER 5. RECOMMENDATIONS

I. Encouraging FII flows:

162. In terms of encouraging FII flows, one aspect of difficulty lies in the treatment of FDI sectoral limits and FII sectoral limits. The Committee on Liberalisation of Foreign Institutional Investment has proposed reforms aimed at separating these two (para 138). Any potential abuse of the FII route by strategic investors of foreign direct investors should be prevented by strictly enforcing the broad-based nature of the FIIs through appropriate regulation of PNs and sub-accounts (para 139).

163. Thus, FII investment ceilings, if any, may be reckoned over and above prescribed FDI sectoral caps. The 24 per cent limit on FII investment imposed in 1992 when allowing FII inflows was exclusive of the FDI limit. The suggested measure will be in conformity with this original stipulation (para 140). As a transitional arrangement, the current policy of a composite cap, wherever it exists, for both FDI and FII investment limits, may be continued. However, attempt should be made, in consultation with the Ministries concerned, that this composite cap is at a sufficiently high level (para 141).

164. Non-availability of good quality equities in adequate volume appears to impede FII flows. FII flows would be encouraged by greater volume of issuance of securities in the Indian market. This would be assisted by PSU disinvestment (para 142). Companies executing large projects in the infrastructure sector and telecom sector should also be encouraged to access the domestic capital markets (para 143).

II. Vulnerability to FII flows

Strengthening domestic institutional investors

165. The participation of domestic pension funds in the equity market would augment the diversity of views on the market. This would also end the anomaly of the existing situation where foreign pension funds are extensive users of the Indian equity market but domestic pension funds are not (para 157).

Participatory Notes

166. The current dispensation for PNs may continue. SEBI should have full powers to obtain information regarding the final holder/beneficiaries or of any holder at any point of time in case of any investigation or surveillance action. FIIs may be obliged to provide the information to SEBI (para 153).

Hedge Funds

167. Regulatory developments with regard to hedge funds in the US and elsewhere, including Europe, may be closely watched to formulate policy on the basis of experiences of these countries at a later date. Only those funds which are otherwise eligible to be registered as FIIs/sub-accounts under SEBI (FIIs) Regulations, 1995 may be continued to be allowed (para 156).

Ceiling on FII and sub-accounts

168. The existing limit of 10 per cent holding in any one firm by any one FII may be extended to cover the sum of the holdings of any one FII and all such sub-accounts coming under that FII which have common beneficial ownership as the FII. The onus for establishing that a sub-account does not have a common beneficial ownership will lie with the FII. This requirement may be phased in over a five-year period, with a limit of 20 per cent by December 2005, 18 per cent by 2006, 16 per cent by 2007, 14 per cent by 2008, 12 per cent by 2009 and 10 per cent by 2010 (para 158).

Broad basing of eligible entities

169. With the policy of market regulation being the encouragement of broad-based funds to invest in the country, high net-worth individuals fall outside the category of diversified investors. In order to address the market integrity concerns arising out of allowing some entities, which do not have reputational risk or are unregulated, there is merit in prohibiting such entities from getting registered. Such existing entities may be given sufficient time to wind up the position (para 135).

Operational flexibility to impart stability to the market

170. The stability of foreign investment in India will be enhanced if FIIs are able to switch between equity and debt investments in India, depending on their view about future equity returns. Greater flexibility for FIIs to participate in the bond market will induce more "balanced" strategies, and mixing of equity and debt. Such FII investment in debt will indeed be a part of India's external debt, but with an important difference, namely that such debt will be in domestic currency. Keeping this important difference in mind, the quantitative restriction upon debt flows may be progressively amended to a cap on the annual flow from the present ceiling on the aggregate portfolio value (para 160).

Negative list of tax-havens

171. Consistent with the recommendations of the Financial Action Task Force (FATF), it must be ensured that only clean money through recognized banking channels is permitted in the securities market (para 148). There should be a negative list of tax havens, whereby entities registered in these jurisdictions are prevented from attaining FII status (para 149).

Knowledge activities

172. Department of Economic Affairs should initiate a research program on "Capital flows and India's Financial Sector: Learning from theory, international experience, and Indian evidence" (para 161).

(Pratip Kar) (Vinay Baijal)

(P.K.Deb) (U.K.Sinha)

(Dr.Ashok K. Lahiri)

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Annex I. Office Order Constituting the Expert Group

F.No. 9/11/SE/-2004
Government of India
Ministry of Finance
Department of Economic Affairs
CM, ECB & PR Division
Stock Exchange Section

North Block, New Delhi
November 2, 2004

OFFICE ORDER

The National Common Minimum Programme, lays down that FIIs will continue to be encouraged while the vulnerability of the financial system to the flow of speculative capital will be reduced. While reviewing the implementation of NCMP, Prime Minister has desired that the Expert Group should be set up to look into these issues and provide an Action Plan for time-bound implementation.

2. Accordingly, it has been decided, with the approval of Finance Minister, to form an Expert Group consisting of:

i)	Chief Economic Advisor	Chairman
ii)	Chief General Manager, RBI (to be nominated by Governor, RBI)	Member
iii)	Executive Director, SEBI (to be nominated by Chairman, SEBI)	Member
iv)	Joint Secretary (CM)	Member
v)	Joint Secretary (FB)	Member

3. Terms of Reference of the Group would be as follows:

(i) To consider how FII inflows into the country can be encouraged;
(ii) To examine whether existing regulatory framework adequately addresses the concern for reducing the vulnerability of capital market to the flow of speculative capital;
(iii) To suggest further regulatory measures as may be considered necessary.

4. The Group shall submit its report latest by 30 November, 2004.

5. This issues with the approval of Finance Minister.

(Anuradha Guru)
Deputy Director (SE)
Tel:23093322

Annex II. Restrictions on FII Operations

Investment Restrictions on FIIs in the Spot Market

FIIs overall	24 per cent	Sectoral cap under special procedure#
Individual FIIs	10 per cent	-

By passing a special resolution by the Board of Directors followed by passing of a special resolution by the General Body of a company.

Sectoral caps on FDI and FII can be of five types:

I) ban on both FDI and FII (e.g. lottery business, gambling and betting),

II) non-zero separate caps on both FDI and FII ([e.g., DTH-broadcasting]), [DTH has composite ceiling with a sub-ceiling for FDI at 20 per cent]

III) a composite non-zero cap on FDI and FII (banking, insurance, telecom,), and

IV) ban on FDI with a non-zero cap on FII (e.g., Terrestrial broadcasting FM, retail trading).

Sectoral caps on FDI and FII in the Spot Market

Ban on FDI and FIIs	Separate caps for FDI and FIIs	Composite cap for FDI and FIIs	Ban on FDI and separate cap for FIIs
Lottery business, gambling and betting	FDI/NRI/FII = 49 per cent and FDI =20 per cent in DTH Broadcasting	Banking = 20 per cent Private sector Banking = 74 per cent Insurance = 26 per cent Telecom = 74 per cent Uplinking, Cable Network = 49 per cent Print Media =26 per cent FDI/FII/NRI/PIOs = 20 per cent (FM Radio Broadcasting),	24 per cent (Retail Trading)

Exposure Monitoring and Position Limits for Derivatives Market

	Index Options	Index Futures	Stock Options	Stock Futures
Exposure Limit	33.33 times the liquid net-worth of the member. Liquid net-worth is the total liquid assets deposited with the Exchange/ Clearing Corporation towards initial margin and the capital adequacy, LESS initial margin applicable to the total gross position at any given point of time of all trades cleared through the clearing member.	33.33 times the liquid net-worth of the member.	Higher of 5 per cent or 1.5 sigma of the notional value of gross open position.	Higher of 5 per cent or 1.5 sigma of the notional value of gross open position.
		Position Limits		
Client Level	15 per cent disclosure level for clients	15 per cent disclosure level for clients	1 per cent of free float market cap or 5 per cent of open interest which-ever is higher	1 per cent of free float market cap or 5 per cent of open interest whichever is higher
Trading Member Level/FII	15 per cent of the total Open Interest of the market or Rs. 250 crores whichever is higher.	15 per cent of the total Open Interest of the market or Rs. 250 crores whichever is higher.	If market-wide limit = Rs. 250 crore then 20 per cent of market wide limit. If market wide limit > Rs. 250 crore, then Rs. 50 crore.	If market-wide limit = Rs. 250 crore then 20 per cent of market wide limit. If market wide limit > Rs. 250 crore, then Rs. 50 crore.
Market wide			30 times the average number of shares traded daily, during the previous calendar month, in the relevant underlying security in the underlying segment or 20 per cent of the number of shares held by non-promoter i.e. 20 per cent of the free float, in terms the	30 times the average number of shares traded daily, during the previous calendar month, in the relevant underlying security in the underlying segment or 20 per cent of the number of shares held by non-promoter, i.e., 20 per cent of the free float,

			numbers of shares in the relevant underlying security whichever is lower.	in terms the numbers of shares in the relevant underlying security whichever is lower.

Annex III. Participatory Notes (PNs) Issuance[1]

(in Rs. crore, unless stated otherwise)

Month	Value of Underlying Equity	Value of Underlying Debt Securities	Total Equity + Debt	As a proportion of Net FII Investment (at the end of month)	Value of Underlying Derivatives	Total Equity + Debt + Derivatives
	A	B	C = (A+B)	D	(E)	(A+B+E)
Financial Year 2003- 04						
Sep-03	19,125	1,215	20,340	26.05%	1,703	22,043
Oct-03	19,900	1,240	21,140	25.13%	2,025	23,165
Nov-03	21,179	1,312	22,492	25.02%	2,389	24,881
Dec-03	24,627	1,351	25,978	27.61%	3,052	29,030
Jan-04	24,531	1,223	25,754	26.29%	2,999	28,754
Feb-04	25,018	1,359	26,377	26.21%	2,595	28,972
Mar-04	29,088	1,018	30,106	28.11%	1,769	31,876
Financial Year 2004- 05						
Apr -04	30,437	826	31,263	27.47%	4,482	35,746
May -04	25,172	667	30,146	27.34%	1,607	31,753
Jun -04	27,301	440	28,344	25.77%	1,358	29,702
Jul -04	27,997	198	29,489	26.64%	1,182	30,671
Aug -04	30,912	337	32,562	28.76%	3,164	35,726
Sep -04	34,251	287	35,057	30.27%	1,936	36,993
Oct -04	37,940	277	38,217	32.44%	6,369	44,586
Nov -04	49,516	600	50,117	39.77%	3,400	53,517
Dec -04	63,070	722	63,791	46.85%	4,095	67,886
Jan -05	50,061	500	50,561	37.22%	4,489	55,050
Feb -05	50,055	482	50,537	34.84%	4,405	54,941
Mar-05	52,958	475	53,434	34.93%	5,693	59,127
Financial Year 2005- 06						
Apr -05	46,279	106	46,386	30.62%	3,071	50,650
May -05	59,131	479	59,610	39.71%	4,979	64,589
Jun -05	60,536	480	61016	39.27%	5,128	67,187
Jul -05	73,299	482	73781	45.23%	7,552	81,333
Aug -05	77,905	485	78390	46.73%	9,449	87,839

[1] Monthly PN data is available from September 2003 onwards

Annex IV. RBI's Dissent Note on the recommendations of the Expert Group

RBI's dissent note on the report in the form of a letter is reproduced below (paragraph references are to the Executive Summary):

FED.CO.FID/9692/11.01.001/2005-06 October 28, 2005

Dr Ashok Lahiri
Chief Economic Adviser
Department of Economic Affairs
Ministry of Finance
Government of India
North Block
New Delhi-110001

Dear Sir
Expert group on FIIs
Please refer to the discussions on the revised draft report held by the Group on 19th October 2005.

2. The draft recommendations of the Group have been examined by us. The report has succinctly brought out several relevant issues concerning FII flows, with the recommendations focusing on policy measures needed to deal with these issues. While the thrust of the report is towards encouraging FII flows, sufficient attention also needs to be given to address the macro economic implications of volatility of capital flows in the context of the mandate of the Group to address the issues arising from vulnerability of capital markets to speculative flows. Further, there is a need to examine the likely implications of excessive inflows and outflows on macroeconomic management and suggest contingency measures to deal with such situations.

3. Reserve Bank is of the view that in order to maintain the financial integrity of the Indian markets, there is a need to take suitable measures to address the growing international concerns regarding origin and source of investment funds flowing into the country. Such measures would undoubtedly enhance the confidence of the foreign investors and regulators alike in the Indian financial system, given the fact that adherence to best practices and standards are important determinants for assessment of the quality of regulation.

4. In the light of the concerns highlighted by us during the discussions of the Group from time to time and based on our written responses, we suggest that the following points should be considered while finalizing the recommendations of the Group:-

A) Measures to contain volatility

In view of macroeconomic implications, impact on financial stability, especially on exchange rate, and fiscal vulnerability, apart from monetary management, a special group may be constituted to study measures to contain large volatility in FII flows as a priority. The recommendations of such a special group may be finalized and further actions considered together. Such a package is necessary since the present report does not address the issue of volatility comprehensively.

B) Measures to encourage FII Flows (Para IX and X)

As already indicated in the earlier report of the Committee on Liberalisation of Foreign Institutional Investment, caps can be of three types viz (i) a separate cap on FDI, (ii) a separate cap on FII *and* (iii) a composite cap on FDI and FII combined together.
The separate caps on FDI and FII, in turn, can be of five types:

I. Zero cap, i.e., ban on both FDI and FII (e.g. lottery business, gambling and betting)
II. Non-zero separate caps on both FDI and FII (e.g., DTH-broadcasting. DTH has composite ceiling with a sub-ceiling for FDI at 20 per cent)
III. Composite non-zero cap on FDI and FII (e.g., banking, insurance, telecom)
IV. Ban on FDI with a non-zero cap on FII (e.g., Terrestrial broadcasting FM, retail trading), *and*
V. Ban on FII with a non-zero cap on FDI (e.g. print media which has since been relaxed).

Based on these stipulations, the following scenarios emerge:

a) In the case of sectors where FDI is permitted up to 100 per cent, the FII limit is 24 per cent, which, however, can be raised up to the extent actual FDI falls short of 100 per cent by passing appropriate resolutions by the company concerned. In other words, FII over and above the actual FDI in such cases is possible.
b) For sectors where FDI ceiling is less than 100 per cent, the FII limit is 24 percent which can be increased up to the FDI cap in accordance with the prescribed procedure. Here too, FIl over and above the actual FDI is possible.
c) In some cases the FDI and FII taken together is subject to a composite limit. In such cases the administrative Ministry and /or the concerned regulator has to be consulted to address sectoral concerns and implications. In regard to financial services sector including banking, the current policy may continue.
d) In some cases, like retail trading where FDI is not allowed, the limit for FII investments is 24 percent. Here, increase in FII limits by the company will not be possible.

Further, we are of the view that the requirement of special resolutions to be passed by both the shareholders (in an EGM) and the board of a company for enhancing the FII limit beyond 24 per cent, wherever applicable under the present policy guidelines should continue. The data available with us show that out of the 5499 companies, which have FII investments, only 100 companies have passed resolutions to permit increase in FII holding beyond the limit of 24 per cent.

Finally, since retraction of policy is not possible, the Government should keep the option of keeping separate FII limits without allowing any interchange. In fact current stipulations reflect current concerns which are likely to persist.

C) Winding down of Participatory Notes (PNs) (Para XIII)

The Reserve Bank's stance has been that the issue of Participatory Notes should not be permitted. In this context we would like to point out that the main concerns regarding issue of PNs are that the nature of the beneficial ownership or the identity of the investor will not be known, unlike in the case of FIIs registered with a financial regulator. Trading of these PNs will lead to multi-layering which will make it difficult to identify the ultimate holder of PNs. Both conceptually and in practice, restriction on suspicious flows enhance the reputation of markets and lead to healthy flows. We, therefore, reiterate that issuance of Participatory Notes should not be permitted.

D) Hedge funds (Para XIV)

We agree with the recommendation that regulatory developments with regard to hedge funds in the USA and elsewhere, including Europe, need to be watched closely before we consider our policy. Since hedge funds in general and by their very nature are not regulated, it would be surprising if such funds are registered under SEBI (FII) Regulations. In case there are any such funds which are believed to be hedge funds and are registered with SEBI, such cases would need to be looked at closely for deregistration.

E) Ceiling on holding of shares by FII and sub-accounts (Para XV)

We agree with the recommendation that individuals should be permitted to invest as sub account and that the existing limits of 10 per cent holding in or by any one FII may be extended to cover the sum of holdings of any one FII and all the sub-accounts coming under that FII. We suggest that the period prescribed for unwinding of the investments should be three years in line with the dispensation proposed in the case of PNs. As this process of winding down becomes operational, sub-accounts complying with FII norms may consider the option of registering as FIIs which may be considered. In cases where sub-accounts are not eligible to register as FIIs, it may not be advisable to permit any new registration under the sub- account category.

F) Operational flexibility to impart stability to the markets (Para XVII)

Operational flexibility is required to facilitate the liquidity management of FIIs arising from mismatch in their cash flows as a consequence of their investment operations in equity markets. We would endeavour to make it clear that the intent in this regard is not to encourage FII investments in debt securities *per se*, as long as there is a wedge between the Indian inflation and debt yield with the rest of the world. It would, therefore, not be appropriate to permit FII to treat debt securities (both government and corporate

debt) as an investment avenue. *Since the requirement for operational flexibility is narrow one, the ceiling should be on the total stock of FII investment in debt and not on an incremental basis as suggested.* We suggest that the recommendation may be deleted.

5. We would appreciate if these suggestions are accepted and suitably incorporated in the report. In case it is not possible to do so, the same could be incorporated as a dissent note from the Reserve Bank on the recommendations.

6. *Since most of the recommendations of the Group have significant macro economic implications and also because policy actions based on them will be irreversible, considerable thought is needed to be applied before their implementation. We, therefore, suggest that the Expert Group Report as well as the Report of the Special Group indicated in paragraph 4(A) above, along with the Reserve Bank's comments are placed in the public domain, for wider debate and consultation, before processing the proposals further.*

Yours faithfully

(Vinay Baijal)
Chief General Manager