

## COMMENT LETTER

March 12, 2004

# ICI Comment Letter on Indian Regulations Governing Institutional Investors, March 2004

March 12, 2004

D. Chanda  
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Securities and Exchange Board of India  
Mittal Court 'B' Wing, First Floor  
224, Nariman Point  
Mumbai 400 021

Dear Mr. Chanda:

On behalf of the Institute and its members, I would like to again thank you for meeting with me and Bob Grohowski during our trip to India last month. We appreciated the opportunity to talk to you and Narendra Rawat about the suggestions the Institute made in [a letter dated February 7, 2003](#), on ways in which India's rules relating to investments in India by Foreign Institutional Investors might be improved.

During our meeting, it became clear that many of the issues mentioned in our letter have been addressed since the letter was submitted. In particular, we were very pleased to learn of changes in the following areas:

- The licensing process. Our letter made a number of recommendations to streamline the FII licensing process for initial licenses and for adding subaccounts. It appears that many licensing issues have been successfully addressed, with turnaround times of less than a week for initial applications and less than two days for subaccount applications. Documentation requirements also have been streamlined.
- FII access to initial public offerings. We were pleased to learn that FIIs no longer have to tender funds to an escrow account to participate in IPOs.
- Investments in futures and options. We were pleased to learn that FIIs can now invest in futures and options on equal terms with domestic institutional investors.
- Securities lending. We were pleased to learn that SEBI is considering allowing securities lending. We understand that this is being considered in a different division within SEBI, but we hope that if and when securities lending is permitted, it is permitted on equal terms for FIIs and domestic investors.

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## Specific Recommendations

During our meeting you invited us to provide information and recommendations on the issues that remain of concern to Institute members investing in India. We believe the following issues still remain:

### **A. Licensing Fees and Terms**

We recognize that the \$5,000 fee for initial FII applications has been reduced, but we continue to believe that it is excessive. Other countries with FII regimes, such as Taiwan and China, do not charge any application fee. We therefore would continue to recommend that the fee be eliminated. If that is not possible, we recommend that SEBI set the fee at a level commensurate with the costs of processing the FII applications. It is our sense that FIIs would have no objection to paying a nominal fee to cover the costs of returning processed applications by international overnight mail, for example.

We also continue to believe that FII licenses should be of indefinite duration. You mentioned during our meeting that SEBI currently is looking into that issue. If there is any further information that we could provide to assist you in your analysis, please let us know.

### **B. Litigation Over Dematerialized Shares**

During our meeting, we briefly discussed our members' concerns about possible litigation over shares that were purchased in physical form and subsequently dematerialized. You asked for more information on the basis of these claims.

We are not privy to the specific details of the cases, but we understand that if a claim of prior ownership is made, it is generally brought against the issuer and the shareholder that submitted the shares to be dematerialized. That shareholder is compelled to defend its ownership of the shares since, as we understand it, a lack of a response can be taken by a court as a tacit acknowledgement of the claim. The shareholder is thus put in the position of having to present evidence to establish that its shares were acquired for consideration duly paid and without notice of any underlying fraud. It cannot rely on the verification of its ownership that had been done as part of the dematerialization process.

We understand that resolution of these claims can take up to five years or longer and that there may not be any applicable statute of limitations. As a result, there is an ongoing fear among FIIs, many of whom submitted shares to be dematerialized, that their ownership of Indian securities could be indefinitely subject to challenge by those who would use the threat of litigation to force a quick settlement. As we recommended in our earlier letter, we

believe that the only way to allay these fears is for SEBI to adopt a rule that bars claims of prior ownership to dematerialized shares or requires such claims to be brought against a centralized guarantee fund.

### **C. Electronic Filing**

As we discussed during the meeting, we believe that a secure electronic filing system would be a significant improvement over the way many applications and documents currently are filed with SEBI. You noted during our meeting that SEBI was studying the possibility of implementing such a system. We would strongly encourage SEBI to proceed with such a system.

### **D. Disclosure of Details of Bulk Trades**

Since our meeting, we have learned of a new SEBI policy that took effect on February 17, 2004 that requires brokers to contemporaneously disclose the details of certain large trades to the stock exchanges, and requires the stock exchanges to disseminate those details to the general public on their websites the same day. Disclosure is required if an investor trades more than 0.5% of the number of equity shares of a company listed on the stock exchange in a single trading day, either in a single trade or cumulatively.

We believe that this disclosure has the potential to harm FII's and strongly recommend that SEBI reconsider the application of the rule to institutional investors. Specific daily disclosures of an FII's transactions would expand opportunities for speculators and other professional traders to exploit the information in ways that are detrimental to the FII. Specifically, these new disclosures significantly increase the risk of "front running" by investors that would use the information to successfully anticipate the FII's trades and capture the price impact by trading ahead of the FII. Front running can result in higher prices for the FII's purchases of securities and lower prices for the FII's sales and can facilitate the ability of other investors to obtain for free the benefits of the FII's research and investment strategies. In addition, "free riders" could duplicate the FII's portfolio strategies, which also might prevent the FII from fully realizing the potential returns from its research efforts by moving security prices before the FII has a chance to fully implement its investment strategies. These free riders expropriate the results of the FII's proprietary research and strategies.

## **Conclusion**

Finally, you asked during our meeting for information about the way other countries tax capital gains by foreign investors. It is the experience of our members that the overwhelming majority of countries do not impose capital gains tax on U.S. institutional investors. The Institute does not have definitive, current information on the number of countries, other than India, that impose this tax. According to a survey we provided to members in December 2002,<sup>1</sup> U.S. institutional investors were potentially subject to capital gains taxes at that time in fewer than ten of the 51 countries surveyed. Of these, most imposed capital gains taxes only in very limited circumstances or at a very low rate. For example, in four countries (Australia, Israel, Mexico, and Spain), a foreign investor was exempt from capital gains tax unless it has a significant ownership interest in the company. In Turkey, capital gains only were imposed on investments with holding periods of less than three months. In Greece, the capital gains rate was set at a de minimis rate of 0.6%. In four of the countries in which our 2002 survey indicated that U.S. investors were subject to capital gains taxes (Brazil, China, Greece, and Malaysia), more recent information that we have seen suggests that they may be exempt from those taxes. Accordingly, we believe

that India may be one of very few countries that impose substantial capital gains tax on U.S. institutional investors.

Thank you again for your time and careful consideration of the issues that we have raised. If you have any questions or need additional information, please do not hesitate to contact us.

Sincerely,

Mary S. Podesta  
Senior Counsel

cc: Narendra Rawat

**ENDNOTES**

[1](#) December, 2002, is the last time we sought to assemble this information. There is no single source for this information and we have found that it is difficult for the Institute to compile and maintain timely, reliable information in this area.

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