

COMMENT LETTER

July 31, 2006

Letter on Issues of Concern for Institutional Investors in India (pdf)

July 31, 2006 Via Federal Express Ms. Usha Narayanan Chief General Manager FIIs & Custodians Division Securities and Exchange Board of India Mittal Court 'B' Wing, First Floor 224, Nariman Point Mumbai 400 021 Dear Ms. Narayanan: The Investment Company Institute¹ has enjoyed a long and productive dialogue with SEBI on ways that India's rules relating to foreign institutional investors (FIIs) might be improved.² FII issues are of great interest to us, as many of our members hold FII licenses and are significant investors in the Indian markets. We commend SEBI on the great progress that it has made in recent years with respect to the regulation of the Indian securities markets and, in many respects, the regulation of FIIs. We appreciate, for example, the recent flexibility shown by SEBI in applying the new PAN requirement to FIIs.³ Nevertheless, there are several issues that we would like to respectfully raise for your consideration: 1. The application of new anti-money laundering rules to FIIs; 2. The recent increases in the fees for FII licenses and FII subaccounts; 3. The daily disclosure of large trades; and 4. The high rate of "close-outs" in the clearance and settlement of trades. Our concerns and recommendations with respect to each of these issues are discussed in detail below. As always, we appreciate your willingness to consider the issues that we raise. Anti-Money Laundering New anti-money laundering rules in India require banking companies, financial institutions and other "intermediaries" to perform prescribed anti-money laundering (AML) functions, including filing suspicious transaction reports and verifying the identity of clients.⁴ The new rules also require firms to designate an officer as "Principal Officer" responsible for ensuring AML compliance.⁵ The term "intermediary" is defined to include all persons registered under Section 12 of the Securities and Exchange Board of India (SEBI) Act, 1992. This definition includes, among others, domestic stockbrokers, domestic share transfer agents, domestic mutual funds, and FIIs. We urge SEBI to reconsider direct application of the new AML rules to FIIs. While we strongly support SEBI's efforts to ensure that money laundering does not take place in India, we believe that SEBI could take a different approach that would fulfill this policy goal in a manner that recognizes the true position of FIIs in the Indian financial markets. Unlike local banks, brokers, or mutual funds, FIIs do not have Indian clients and are not acting as "intermediaries" in the same sense as local financial institutions. Rather,

FII are merely investors in Indian markets. We are unaware of any other country in the world that attaches AML obligations to investors; instead, other countries treat foreign investors as clients of local financial institutions for purposes of local AML regulations.⁶ We recommend that SEBI take that same approach—treating FIIs as clients of local firms rather than intermediaries for purposes of the AML rules. To implement this approach, SEBI could exempt FIIs from the rules and direct local banks, brokers, and other domestic financial institutions to take a risk-based approach to their FII clients, applying an appropriate level of AML scrutiny depending on the type of FII involved.⁷ This is the same approach taken under US law, where US banks, brokers, ⁴ See the Prevention of Money Laundering Act, 2002 (PMLA 2002) and the rules thereunder. See also SEBI's Guidelines for Anti-Money Laundering Measures, dated January 18, 2006. ⁵ See SEBI Circular ISD/CIR/RR/AML/1/06, dated January 18, 2006. ⁶ We are very concerned with the precedent that SEBI's approach sets for the AML compliance regimes of other countries. Indeed, if all countries treated foreign investors as local financial intermediaries subject to local AML reporting requirements, the compliance burdens for international investing could become prohibitively expensive. ⁷ For example, a local broker executing trades for an FII that is a US mutual fund or a European UCITS fund might treat that FII as a relatively low-risk type of client, recognizing the full range of AML responsibilities that apply to it under US law. The same broker may treat another FII client, such as a hedge fund or individual investor, as having a higher risk profile for AML purposes. Ms. Narayanan, SEBI July 31, 2006 Page 3 of 6 and mutual funds are specifically required to perform a risk assessment on accounts they maintain for clients that are foreign financial institutions, and to treat those clients with an appropriate level of AML scrutiny.⁸ We respectfully suggest that the approach outlined above would be effective at controlling money laundering activity while avoiding the duplication of effort for FIIs that are subject to a full range of AML responsibilities under their home-country laws. For example, US mutual funds must maintain a written AML compliance program, designate an AML compliance officer, and verify the identity of all new investors. US mutual funds also will be required to monitor for and report suspicious activity beginning on November 1, 2006. The approach we suggest would minimize the compliance burden for low risk FIIs like us mutual funds, while preserving the strength of India's AML regime by requiring local intermediaries to subject higher risk FIIs to greater security. The Fees for FII Licenses and FII Subaccounts On June 26, 2006, SEBI announced that fees for FII licenses had increased from \$5,000 to \$10,000 and that fees for each FII subaccount had increased from \$1,000 to \$2,000. SEBI also announced that licenses must be renewed every three years, rather than every five years under the previous fee schedule. The new policy, which took effect immediately, effectively tripled the fees FIIs must pay to invest in India. SEBI's FII fees are discriminatory (as they are charged only to foreign institutional investors), excessive, and in our view largely unnecessary. India is the only country in the world, to our knowledge, that charges foreign investors significant fees to be able to invest in its markets. Other countries that have, or have had, foreign investor licensing regimes charged nominal filing fees to cover the administrative costs associated with registration. SEBI's fee is not nominal. Several of our members will incur FII fees in excess of \$100,000 every three years. Renewals are particularly unnecessary, as SEBI regulations already require FIIs to notify SEBI of any change in the information previously furnished. The process of renewals thus appears to be little more than a way to raise additional ongoing revenue from FIIs. We strongly reiterate our long-standing recommendation that the fees be eliminated or, at the very least, set at a level commensurate with the costs of processing the FII applications.⁹ We also ⁸ See 31 C.F.R. 103.175 (containing definitions) and 103.176 (containing the rule), adopted and explained at 71 Fed. Reg. 496 (Jan. 4, 2006) (available at <http://www.fincen.gov/finalrule01042006.pdf>). Attachment C contains the text of section 103.176. ⁹ 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 express mail, for example. Ms. Narayanan, SEBI July 31, 2006 Page 4 of 6 reiterate our recommendation that FII licenses be of indefinite duration, eliminating the need for renewals every three years.

Disclosure of Details of Bulk Trades We remain concerned about a 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. In our letter to Mr. Chanda on March 12, 2004, we suggested that this disclosure has the potential to harm institutional investors such as FIIs. Near real-time disclosures of an institutional investor's transactions expand opportunities for speculators and other professional traders to exploit the information in ways detrimental to the institutional investor. Specifically, the disclosure significantly increases the risk of "front running" by investors that would use the information to successfully anticipate the institutional investor's trades and capture the price impact by trading ahead of the institutional investor. Front running can result in higher prices for the institutional investor's purchases of securities and lower prices for the institutional investor's sales and can facilitate the ability of other investors to obtain for free the benefits of the institutional investor's research and investment strategies. In addition, "free riders" could duplicate the institutional investor's portfolio strategies, expropriating the results of the institutional investor's proprietary research and strategies. Trading by free riders could move security prices before the institutional investor has a chance to fully implement its investment strategies, preventing the institutional investor from fully realizing the potential returns from its research efforts. In response to these concerns, we understand that institutional investors that wish to trade more than 0.5% of a company's shares often use multiple brokers to execute a large trade, rather than a single broker that would be required to disclose the details of that trade. This technique is more burdensome and less efficient than using a single broker, and often may result in poorer overall execution of the trade. During our discussion in March, Mr. Chanda indicated that the intent of the bulk trading disclosure rule was to provide the market with information on large off-exchange trades. While we understand SEBI's reasons for increasing market awareness of such trades, we believe that a more tailored rule may achieve the desired policy result without creating the front running and free riding problems described above for institutional investors trading on the exchanges. Accordingly, we reiterate our strong recommendation that SEBI reconsider the application of the rule to institutional investors and seek a more tailored approach to the disclosure of bulk trades, at least with respect to the transactions executed on an exchange.

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Mandatory Clearinghouse Settlement – Close-outs Although we commend SEBI for its recent moves to encourage the mandatory use of clearinghouse settlement, we are concerned about the relatively high rates of partial settlement and the resulting close-outs that occur in the Indian markets. Partial settlements occur when a seller fails to deliver to the clearinghouse on the settlement date shares purportedly sold to a purchaser. Both the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) go through an auction process to resolve partial settlements. If shares are not obtained during the auction process, the exchange transfers cash in lieu of the missing shares, a process known as a "close-out." Close-outs occur five days after the trade (T+5) on the NSE and six to seven days after the trade (T+6 to T+7) on the BSE. Close-outs are important to us because FIIs often trade large blocks of shares, and are thus at a much higher risk of being affected by a significant close-out than other types of investors in the Indian markets. Close-outs present a number of trading, tax, and recordkeeping problems for institutional investors. Purchasers make ongoing trading

decisions based on affirmed purchases, and for obvious reasons, seek to avoid situations where part of a purchase has to be unwound in a close-out. More importantly, the close-out process results in a taxable transaction¹⁰ and additional recordkeeping to reflect the sale and receipt of cash-in-lieu. Indeed, FII's with whom we discussed this issue cited the administrative costs, such as recordkeeping, as their primary complaint with the close-out process. To alleviate the problem of close-outs, we recommend that SEBI require the clearinghouse to facilitate the fulfillment of trade orders through the use of a mandatory securities borrowing and lending program.¹¹ This recommendation is consistent with international standards for the clearance and settlement of securities trades. Indeed, in the 2001 Bank of International Settlements (BIS) and International Organization of Securities Regulators (IOSCO) report, the BIS and IOSCO specifically recommend that "securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for expediting the settlement of securities transactions."¹² * * * * *

¹⁰ FII purchases are affirmed, reflected on the FII's books, and reported to SEBI on T+1. A close-out thus results in the sale of securities held by the FII, rather than simply the return of the cash used to fund the FII's purchase.

¹¹ We understand that SEBI is working on a regulatory framework for securities borrowing and lending. We support SEBI's efforts in this regard. As you know, we have long recommended that securities borrowing and lending be permitted in India.

¹² See Recommendation 5 of the BIS and IOSCO report entitled "Recommendations for Securities Settlement Systems" (Nov. 2001), available at <http://www.bis.org/publ/cpss46.pdf>. Ms. Narayanan, SEBI July 31, 2006

Page 6 of 6 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, /s/ Robert C. Grohowski Robert C. Grohowski Senior Counsel - International Affairs Attachments cc: Mr. M. Damodaran, Chairman Securities and Exchange Board of India Dr. K.P. Krishnan, IAS, Joint Secretary, Department of Economic Affairs Ministry of Finance, Government of India Mr. Anoop Mishra, Minister (Economic) Embassy of India, Washington D.C.