

COMMENT LETTER

April 14, 2008

Institute's Letter to Securities and Exchange Board of India - Margining of Institutional Trades (pdf)

April 14, 2008 Via Federal Express and Electronic Mail Shri C.B. Bhave Chairman, Securities and Exchange Board of India SEBI Bhavan Plot No. C4-A, G-Block Bandra Kurla Complex, Bandra (East) Mumbai 400 051 chairman@sebi.gov.in Dear Mr. Bhave, We are writing to share the significant concerns of the Investment Company Institute (ICI)¹ regarding circular no. MRD/DoP/SE/Cir-06/2008 dated March 19, 2008, issued by the Securities and Exchange Board of India (SEBI) regarding “Margining of institutional trades in the cash market” (Circular). The Circular is of considerable interest to our members because many of our members hold Foreign Institutional Investor (FII) licenses and are significant investors in the Indian market. US- registered investment companies, in the aggregate, hold billions of dollars of assets in Indian securities. The ICI has enjoyed a long and productive dialogue with SEBI on ways that India’s rules relating to FIIs, including US-registered investment companies, may be improved and we commend SEBI for the progress and stability of the Indian FII regime. Our primary concerns regarding the Circular are outlined below. The US Investment Company Act of 1940 (Act) identifies specific entities that are permitted to act as a custodian of a registered investment company’s assets. With respect to fund assets that are foreign securities, the registered investment company must maintain those securities with an “eligible foreign custodian” as defined under the Act. For example, certain banks are eligible foreign custodians ¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$12.34 trillion and serve almost 90 million shareholders. Shri C.B. Bhave Chairman, Securities and Exchange Board of India April 14, 2008 Page 2 of 4 and, in some cases, a foreign securities depository, may be eligible to hold a registered investment company’s assets.² To the extent that the organization holding the assets deposited as margin is not an eligible foreign custodian under the Act, US-registered investment companies will be prohibited from purchasing or selling securities on the Indian market. This is an issue with serious implications and, consequently, our members are carefully evaluating whether the Indian entity that will be holding the margin is an “eligible foreign custodian” under US law.³ In addition to the custody issues discussed above, our members are concerned that US- registered investment companies will suffer adverse performance returns as a result of the new rules. First, a significant portion of an FII’s assets will need to be reserved for use as margin for purchase and sale transactions.

These assets will not be available for investment purposes, thereby forgoing potential profitable investment opportunities, nor will they accrue interest while they are used as margin.⁴ Second, the overall cost of executing a transaction in the Indian market will significantly increase. We understand that the margin requirements could be very high. Third, the margin requirements will likely inhibit a portfolio manager's trading flexibility and will result in execution delays, potentially lowering an FII's performance returns. Further, with respect to index funds and exchange-traded funds (ETFs), the increased costs, combined with the retention of significant cash for margin as well as earning no credit interest from local custodians, will increase the potential for large tracking errors in these funds. The margin requirements will further harm US-registered investment companies by greatly increasing an FII's foreign exchange risk and the cost of investing in the Indian market. Because an FII will be required to convert additional funds into INR and reconvert such funds back to USD upon release of the margin or maintain a surplus long balance in INR, the FII will be subject to additional expenses and exposed to fluctuations in INR with respect to the margin amount. Further, foreign exchange requirements and time zone constraints will likely limit an FII's ability to obtain the most favorable exchange rate and time zone issues add substantial complexity to an FII's communications.² See United States Investment Company Act of 1940 Section 17(f). Rules 17f-5 and 17f-7 under the Act detail the requirements that must be met for an entity to be an "eligible foreign custodian" or a "foreign securities depository."³ We note that in order to meet redemption requests a US open-end investment company must limit its holdings of illiquid securities. If the new margin requirements pose a custody problem under the Act, US -registered investment companies could be unable to sell their securities on an Indian stock exchange and may have to characterize those securities as "illiquid." Faced with such a possibility, funds could consider disposing of their Indian securities before the new rules are effective, which could depress the value of those holdings and have a negative effect on Indian stock markets.⁴ Although, to our knowledge, the specific percentage margin requirements have not yet been determined, it is our understanding that the margin requirements will be a substantial percentage of the trade. It is also our understanding that, unlike retail investors that may obtain financing from their broker to pay the margin, institutional investors are unable to avail themselves of this option due to Indian regulatory restrictions. Shri C.B. Bhavé Chairman, Securities and Exchange Board of India April 14, 2008 Page 3 of 4 with its global and local custodians. Since exchange controls prohibit the extension of credit to FIIs by their custodians and also limit FIIs' ability to trade the INR with third parties, FIIs will be especially vulnerable to the risk of failing to meet margin payments by the stated deadlines. Members also have concerns about potential delays associated with the repatriation of refunded margin payments. FIIs will also be subject to an increased risk of exposure to front running by other market participants and risk of non-compliance with the margin requirements. Subsequent to June 16, 2008, the collection of margins will be required on an up-front basis, in effect requiring an FII to potentially reveal some aspect of the contemplated transaction, which would increase an FII's risk of exposure to front running by other investors. In addition to that risk, FIIs will also be subject to an increased risk of non-compliance with the margin requirements due to the possible dynamic nature of the margins, the timing of the levying of the differential margin, and the limited availability of the foreign exchange market, which together create significant operational difficulties for FIIs. The possible custody issues for US-registered investment companies, the negative effect of the margin requirements on performance returns and the increased risks involved with an investment in the Indian market, will result in the Indian market being substantially less attractive to US-registered investment companies. Indeed, there exists a substantial likelihood that many US-registered investment companies may limit their transactions in the Indian market and may, to the extent possible, invest in Indian issuers through other

means. In our view, the diminished attractiveness of the Indian market will have a detrimental impact on US-registered investment companies individually, as well as the Indian market as a whole. For the reasons described above, we respectfully request that SEBI reconsider the imposition of margins for institutional trades as contemplated by the Circular. In particular, we strongly urge SEBI to recognize the unique consequences of the margin requirements on US-registered investment companies and consider other alternatives to address SEBI's concerns. For example, as an alternative to requiring US-registered investment companies to deposit margin, we would respectfully suggest that, if SEBI believes that it is necessary for US-registered investment companies to post margin notwithstanding what we believe to be their favorable record of prompt settlement, it may be possible to structure such margin deposits in a manner where the margins could be held by the US-registered investment company's current custodian bank. If, despite the concerns expressed above, the margin requirements applicable to institutional investors are not rescinded or modified, we respectfully request that SEBI postpone the implementation of the margin requirements until no earlier than June 21, 2008, or such time as adequate procedures have been established, with upfront margining at the time of execution of the trade being postponed for an additional three months thereafter. There is widespread and genuine concern that the short interval between the announcement of the margin requirements and the implementation date does not provide sufficient time for market participants to institute effective procedures for complying with the requirements, given the operational complexities involved. Further, Shri C.B. Bhavne Chairman, Securities and Exchange Board of India April 14, 2008 Page 4 of 4 it is our understanding that, as of April 14, 2008, the Indian stock exchanges have not yet issued official procedures and guidelines for the new margin requirements. Market participants will, therefore, have very limited time to develop the processes and procedures necessary for complying with the margin requirements. A delay in the implementation of the margin requirements would also allow additional time to ensure that the new rules do not pose custody issues for US-registered investment companies. * * * * * We appreciate the opportunity to express our views on these important new rules. If you have any questions about our comments or need additional information, please contact me at solson@ici.org or at (202) 326-5813. Sincerely,

/s/ Susan M. Olson Susan M. Olson Senior Counsel, International Affairs cc: Dr. T.C. Nair, Whole-Time Member, Securities and Exchange Board of India David Grim, Assistant Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission