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Should Sebi ban unregulated hedge funds? Clip

[TUESDAY, JANUARY 27, 2004 12:46:43 AM]

SANDEEP GUPTA, CEO, Deutche Asset Management Pvt Ltd

IT is my view that the regulator is justified in seeking information on beneficial ownership of the entity that invests in Indian capital markets. As bankers and investment bankers we always do that. We always try to establish the identity of the person or the entity that we are associated with. It is, therefore, essential for any regulator to get adequate information on the source of the funds. This is in line with the international best practices of "Know your client".

Sebi has clearly pointed out that FIIs may issue participatory notes only to "regulated entities". What probably it means by "regulated entities" is to determine whether the said entity has been registered with any regulatory authority or any governmental agency so that Sebi can take recourse to seeking more details on the same. I think what the market is worried about is the definition of the term "regulated entity". Does it make it restrictive for overseas investors to invest in India ? What kind of disclosures would be required? Would it tantamount to delaying the entire process?

I think Sebi would like to distinguish between the offshore entities that are registered with any recognised governmental agency versus individuals or corporate bodies where the source of funds is not clearly established.

I am sure the definition of "regulated entities" will be clearly defined by Sebi in due course to bring about more clarity in this issue. I am also of the view that Sebi would clearly spell out the type of investors that are discouraged to use the participatory note route to invest in India .

In my opinion this would be positive step to bring about greater transparency into the markets. Sebi, in the last three months had already cautioned the market players about its intention to regulate the markets regarding issue of participatory notes. The market was well aware of the fact that the regulators will soon clamp down on any undisclosed source of funds given the past instances in this market.

Sebi decided to move in stages before issuing any specific notifications. This has allowed the markets to make suitable adjustments rather than turning nervous. I do not believe that the clarifications issued by Sebi on 23 January is any different from that was spelt out earlier. Sebi has, in fact, allowed a clear time-table for various participants to provide necessary information to comply with the notifications.

I, therefore, do not believe that there would be much of an impact on the markets on account of Sebi's recent directive. There are a large number of overseas investors who are turning

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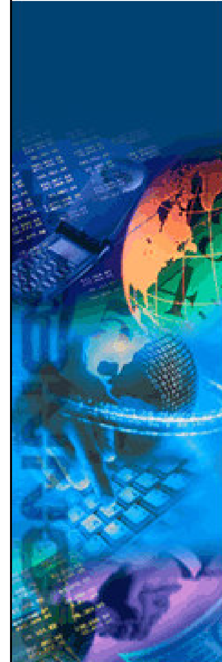


to India given its robust economy growth propelled by consumer demand. In the next few months I anticipate all round participation by a larger number of FIIs and offshore funds in the Indian equity market.

In the meanwhile, I am confident that Sebi would work towards providing greater clarity on this matter to put to rest any speculations. Sebi has all along been proactive and ensured that it provides adequate control and discipline to the market rather than acting as a stumbling block.

Participatory note is just an instrument used by foreign funds and investors who are not registered with Securities & Exchange Board of India but are interested in taking exposure to Indian markets. It is, therefore, not fair to assume that all the investors who have been using participatory notes are unregulated entities.

In my opinion, investors around the world would stay invested in a country or a stock as long as the valuations appear attractive. Today, India is in a commanding position given its robust growth in economy and the investors are attracted to this market because of its long-term growth prospects.

If India continues to remain more attractive compared to other markets, I am sure every kind of investor would stay invested in India . On the other hand, if there is another compelling story, overseas investors will reduce their exposure to India and chase other markets.

The volatility in the markets can be attributed to several factors. Why should we, therefore, single out PNs as the source of hot money?

JAYANTH R VARMA, Professor, IIM, Ahmedabad

SEBI's decision to ban investment through participatory notes by unregulated entities provides an opportunity to rethink our policy towards foreign investment in our capital market. A moment's reflection would show that the issue has nothing to do with capital market regulation and everything to do with capital account convertibility. The question being asked is, how open our capital account should be and to whom should it be open.

The idea of banning participatory notes stems from the confluence of two mistaken ideas regarding capital account convertibility. The first is the belief that portfolio investment by foreign financial institutions, mutual funds and pension funds is good, while investment by hedge funds and other unregulated entities is bad. The second is the Indian state's deep-rooted distrust of its own citizens and the fear of capital flight.

Many people argue that a hedge fund has a short investment horizon and that its investments would be volatile — hot money — while the regulated FII has a longer horizon and its investments would be less volatile. However, as finance theory teaches us, correlations are usually more important than volatility. Investments by regulated FIIs tend to be highly correlated because they face common redemption pressures and common home country regulatory environments. Hedge funds by contrast tend to be contrarian and their strategies are less correlated with each other and with regulated FIIs. In other words, hedge funds are less subject to herding behaviour than regulated FIIs. It is, therefore, paradoxical but true that by

welcoming hedge funds, we would make the aggregate foreign inflows into our markets more stable.

Another often stated reason for fearing hedge funds is that they may become vehicles for exercising covert control over an Indian company. This fear is real, but in this respect, hedge funds are no different from regulated FIIs. Last month, in its suit against Vivendi, the US SEC described how Vivendi circumvented Poland 's anti-trust law by parking part of its controlling stake in the Polish telecom company Elektrim Telekomunikacja with an investment fund administered by a large well-reputed French bank.

I now turn to the fear about capital flight and the perception that participatory notes are used to bring back the Indian money that has been stashed abroad. Even if for a moment we accept the fear of capital flight, should we not be trying to prevent the money from leaving India , instead of trying to prevent its returning to India ? I fail to see how India is better off if Indian money stashed abroad chases foreign stocks instead of Indian stocks.

At a deeper level, I think the time has come to stop worrying about capital flight. Capital flight is most prevalent in economies with closed capital accounts and consists essentially of the elite taking their money out while leaving ordinary citizens stranded. The obvious solution to this is to make it equally easy for everybody to take their money out. That has the added advantage of forcing the government to pursue sensible policies.

Resident individuals should have complete freedom to invest wherever in the world they choose. Indian companies already have a great deal of freedom both to borrow abroad and to invest abroad. We should now extend this to complete capital account convertibility especially to resident individuals. Since individuals are unregulated, their behaviour tends to be different from each other and from that of more regulated players. This divergence (low correlations once again) is a very useful thing and contributes to greater economic stability. When Korea faced its currency crisis because of its reckless companies borrowing abroad and investing abroad, Korean women queued up to sell their jewellery to the government to help build up the country's external reserves.

Today, our $100 billion forex reserves gives us a wonderful opportunity to end exchange controls and eliminate a great deal of corruption and economic distortion. We should allow anybody anywhere in the world to buy our stocks and to trade participatory notes and other derivatives on them. Indians too should be free to trade stocks and derivatives from around the world here and abroad.

V V L N SASTRY , Country Head, Firstcall India Equity Advisors

OVER the past six months, when the market had been soaring, we attributed it to the feel-good factor, economic recovery and so on. The regulatory body too publicly announced that the contribution of participatory notes (PNs)towards markets is minimal and that PNs do not have any influence on the market. Even the finance ministry said several times that the markets are going up mainly on the basis of India Shining story, economic recovery and the fundamentals of Indian companies.

Suddenly why have our regulators started feeling bad about

investment through participatory notes? Why this move to ban the so-called unregulated PNs? True, the market lost 600 points in a short span of time but that was followed by fresh buying by FIIs. That is how markets work. Sebi or finance ministry need not worry about such movements which happen in the stock markets. When the purchases in the markets are delivery based and when enough margins are built in for derivatives trading, it clearly safeguards the system from any negative fall out one may anticipate.

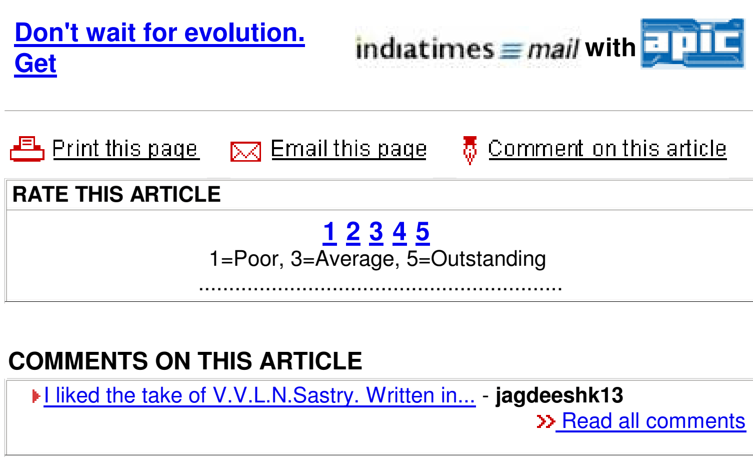
Then, the next biggest fear and the million dollar question is — what will happen to the markets if the FIIs exit? This fear is uncalled for as FIIs just can't exit at once. If FIIs book normal profits even for a day or two, why should it lead to an over all fear psychosis on the part of investors? The regulator need not over react by coming up with unwarranted steps to curb PN investments. The regulator's intention may be to improve the morale of the investors, but it invariably ends up having the opposite effect. There is no point in scaring away foreign investors when everything is going well for the markets and the economy. The government and regulator must tread cautiously on such sensitive issues.

What is whole debate on participatory notes about? Especially at this point of time, nearly six months after the markets started moving up rapidly. Why should one wait till around Rs 20,000 crore is pumped into the market through unregulated PNs, to take cognisance of the same and to stop them from further investments? This is one question, which still does not find a clear answer. Except that we have invented a new term " unregulated participatory notes" from "participatory notes".

Markets in India gained more than 3000 points mainly due to the FII investments through participatory notes or through any of their clients' investments. It is clear and acknowledged by all that the FIIs have been the main drivers of the market in 2003. Then why go after those who ushered in the feel good factor in the markets? The retail investor is clearly absent in the market. Domestic mutual funds till recently were net sellers in the markets, who have gained substantially in improving their NAVs from the FII-led bull run. Domestic institutions and banks are the other segments that have benefited from the debt markets, and this has boosted their other income and thus net profits enabling them to write off their bad debts. All this has happened on the back of liquidity provided by the FIIs. If everyone is benefiting, why blame the PN investors. Once bitten retail investors who lost their shirt, got an opportunity to exit from their investments profitably in this bull run.

So what is wrong if FIIs are trying to book some profits? Unfortunately for them, even after investing about $16 billion in the Indian markets, they are unable to sell beyond Rs 20 crore to 75 crore in a day. The reason is simple: you don't have any buyers from the Indian side. The only option for FIIs is to trade among themselves. If they don't trade among themselves and try to sell aggressively, they cannot exit from the market in the first instance. There is also the danger that they may lose value of their investments if they sell in a big way.

Moreover, as per research done by eminent economists, the capital that has seen flight from India is estimated at about $120 billion since 1970s. Even if some portion of it comes in the form of unregulated participatory notes or whatever you may call it, in what way is it going to have a negative impact on our markets? On the contrary, it is good for us because the money, which has gone out, is coming back. We must welcome this.



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I liked the take of V.V.L.N.Sastry. Written in... - **jagdeeshk13**

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