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EXECUTIVE SUMMARY

There is no exact definition to the term "Hedge Fund"; it is perhaps undefined in any securities laws. There is neither an industry wide definition nor a universal meaning for "Hedge Fund". Hedge funds, including fund of funds, are unregistered private investment partnerships, funds or pools that may invest and trade in many different markets, strategies and instruments (including securities, non-securities and derivatives) and are not subject to the same regulatory requirements as mutual funds.

The term "hedge funds", first came into use in the 1950s to describe any investment fund that used incentive fees, short selling, and leverage. Over time, hedge funds began to diversify their investment portfolios to include other financial instruments and engage in a wider variety of investment strategies. However, hedge funds today may or may not utilize the hedging and arbitrage strategies that hedge funds historically employed, and many engage in relatively traditional, long only equity strategies.

Other unregistered investment pools, such as venture capital funds, private equity funds and commodity pools, are sometimes referred to as hedge funds. Although all of these investment vehicles are similar in that they accept investors' money and generally invest it on a collective basis, they also have characteristics that distinguish them from hedge funds. Hedge Fund Investment strategies tend to be quite different from those followed by traditional asset managers. Moreover, each fund usually follows its own proprietary strategies.

Hedge funds have attracted significant capital over the last decade, triggered by successful track records. The global hedge funds volume has increased from US $ 50 billion in 1988 to US $ 750 billion in 2003 yielding an astonishing cumulative average growth rate (CAGR) of 24 %. The global hedge fund volume accounts for about 1% of the combined global equity and bond market. Hedge funds are a growing segment of asset management industry and increasingly becoming popular not only with high net worth individual investors but also with institutional investors including university funds, pension funds, insurance and endowments. Hedge funds are sometimes perceived to be speculative and volatile. However, not all funds exhibit such characteristics.

Hedge funds can provide benefits to financial markets by contributing to market efficiency and enhancing liquidity. They often assume risks by serving as ready counter parties to entities that wish to hedge risks. Hedge fund can also serve as an important risk management tool for investors by providing valuable portfolio diversification.

Some jurisdictions are gradually moving towards allowing the marketing of hedge fund and fund of funds products to retail investors. Those jurisdictions have simultaneously imposed disclosure requirements to ensure that investors understand the complexity and associated risk of investing in hedge funds. Realizing the growing importance of hedge funds, several emerging market regulators have opened their markets to offshore hedge funds by providing authorization as registered foreign investors.

The role played by some of the large hedge funds has often been associated with major financial crisis that took place in the 90's. However, subsequent research could not produce robust evidence implicating the hedge funds for precipitating the crisis. Researchers have, however, attributed the negative public perception of the role of hedge fund managers in crisis partly to the limited information available about what they actually do.

In view of the increasing popularity among the institutions as well as their increasing interest in the Indian market, it might be time to provide a limited window to this growing segment of asset management industry within the existing framework of the SEBI (Foreign Institutional Investors) Regulations. The approach adopted in formulating the policy suggestions put forth in Section IV of this report has been that of transparent and regulated access with abundant caution. The suggestions are intended to widen the FII window to allow these alternatives invest pools to our securities markets in a transparent and orderly manner. In addition, the suggestions also provide for adequate safety measures to address legitimate concerns associated with these funds. The alternative invests pools if allowed to investment in Indian markets will be a source of additional liquidity and will also diversify the pool of foreign investments in Indian market.

I. HEDGE FUND

1.1 Defining the Hedge Fund:

There is no exact definition to the term “Hedge Fund”; it is perhaps undefined in any securities laws. There is neither an industry wide definition nor a universal meaning for “Hedge Fund”. Hedge funds, including fund of funds are unregistered private investment partnerships, funds or pools that may invest and trade in many different markets, strategies and instruments (including securities, non-securities and derivatives) and are NOT subject to the same regulatory requirements as mutual funds, including mutual fund requirements to provide certain periodic and standardized pricing and valuation information to investors.

The term can also be defined by considering the characteristics most commonly associated with hedge funds. Usually, hedge funds:

- are organized as private investment partnerships or offshore investment corporations;
- use a wide variety of trading strategies involving position-taking in a range of markets;
- employ as assortment of trading techniques and instruments, often including short-selling, derivatives and leverage;
- pay performance fees to their managers; and
- have an investor base comprising wealthy individuals and institutions and relatively high minimum investment limit (set at US $100,000 or higher for most funds).

The term “hedge funds”, first came into use in the 1950s to describe any investment fund that used incentive fees, short selling, and leverage. Over time, hedge funds began to diversify their investment portfolios to include other financial instruments and engage in a wider variety of investment strategies. Today, in addition to trading equities, hedge funds may trade fixed income securities, convertible securities, currencies, exchange – traded futures, over the counter derivatives, futures contracts, commodity options and other non-securities investments. Furthermore, hedge funds today may or may not utilize the hedging and arbitrage strategies that hedge funds historically employed, and many engage in relatively traditional, long only equity strategies.

1.2 Hedge Fund and Other Pooled Investment Vehicles:

Hedge funds are sometimes called as ‘rich man’s mutual fund’. In addition, other unregistered investment pools, such as venture capital funds, private equity funds and commodity pools, are sometimes referred to as hedge funds. Although all of these investment vehicles are similar in that they accept investors’ money and generally invest it on a collective basis, they also have characteristics that distinguish them from hedge funds.

1.2.1 Mutual Fund or Registered Investment Companies

In many ways, hedge funds are similar to mutual funds. Both entities issue units or securities to investors, hold pools of securities to diversify investment, have professional asset manager and may, at times, have similar investment strategies. At the same time, they also differ in a number of ways. Mutual funds are registered with securities markets regulator and are subject to the provisions of the relevant regulations such as, offer/issue of units/securities, disclosure and reporting requirement, valuation for the purpose of computation of NAV, conflict of interest issue and limit leverage. Hedge funds are not required to be registered and therefore, are not subject to similar regulatory provisions.

1.2.2 Private Equity Fund

A private equity fund, like a hedge fund, is an unregistered investment vehicle in which investors pool money to invest. Private equity funds concentrate their investments in unregistered (and typically illiquid) securities. Both private equity funds and US based hedge funds are typically organized as limited partnerships (LLP). Like hedge funds, private equity funds also rely on the exemption from registration of the offer and sale of their securities. Both private equity and hedge funds. The investors in private equity funds and hedge funds typically include high net worth individuals and families, pension funds, endowments, banks and insurance companies. Private equity funds, however, differ from hedge funds in terms of the manner in which contribution to the investment pool is made by the investors. Private equity investors typically commit to invest a certain amount of money with the fund over the life of the fund, and make their contributions in response to "capital calls" from the fund's general partner. Private equity funds are long term investments, provide for liquidation at the end of the term specified in the fund's governing documents and offer little, if any, opportunities for investors to redeem their investments. A private equity fund may distribute cash to its investors when it sells its portfolio investment, or it may distribute the securities of a portfolio company.

1.2.3 *Venture Capital Fund*

Venture capital pools are similar to hedge funds or private equity; they attract the same class of investors. Venture capital funds, however, invest in the start-up or early stages of a company. Unlike hedge fund advisors, general partners of venture capital funds often play an active role in the companies in which the funds invest. In contrast to a hedge fund, which may hold an investment in a portfolio security for an indefinite period based on market events and conditions, a venture capital fund typically seeks to liquidate its investment once the value of the company increases above the value of the investments.

1.2.4 Commodity Pool

Commodity pools are investment rusts, syndicates or similar enterprises that are operated for the purpose of trading commodity futures. The investment concentration in commodity futures distinguishes commodity pools from hedge funds.

1.3 Domestic and Offshore Hedge Fund:

1.3.1 *Domestic Hedge Fund*

Domestic hedge funds are usually organized (in USA) as limited partnerships to accommodate investors that are subject to U.S. income taxation. The fund's sponsor typically is the general partner and investment adviser. Hedge funds may also take the form of limited liability companies (LLC) or business trusts. LLPs, LLCs and business trusts are generally not separately taxed and, as a result, income is taxed only at the level of the individual investors. Each of three firms also limits investors liability; LLCs offer the additional benefit of limited liability for fund advisors (general partners).

1.3.2 *Offshore Hedge Fund*

Offshore hedge funds are typically organized as corporations in countries such as the Cayman Islands, British Virgin Islands, the Bahamas, Panama, The Netherlands Antilles or Bermuda. Offshore funds generally attract investments of US. tax exempt entities, such as pension funds, charitable trusts, foundations and endowments, as well as non-U.S. residents. U.S. tax-exempt investors favor investments in offshore hedge funds because they may be subject to taxation if they invest in domestic limited partnership hedge funds.

1.4 Fund of Funds

Rather than investing in individual securities, a Fund of Funds invests in other hedge funds. Technically any fund that pools capital together, while utilizing two or more sub managers to invest money in equity, commodities, or currencies, is considered a Fund of Funds. Investors are allocating assets to Fund of Funds products mainly for diversification amongst the different managers' styles, while keeping an eye on risk exposure. Fund of Funds are structured as limited partnerships, which afford advantages to the investor. One of the advantages is due diligence. Due diligence is a primary advantage because the fund of funds manager may spend his whole day evaluating strategies and speaking with individual fund managers. This would be an extremely hard task for an individual. The fund of fund also may combat risk by achieving manager diversity, because of the different strategies employed by the underlying managers. For example, some fund of funds may have exposure to a long/short fund, a distressed fund, and a private equity fund. By investing within the fund of funds, the investor is given the opportunity to have a unique asset allocation product, while trying to limit the risk on the downside.

Fund of funds have some drawbacks however. The first to come to mind is the double layer of fees. When dealing with fund of funds, an investor must understand that the underlying funds charge a fee, as well as the fund of funds manager. This translates to "layers" of fees before the investor receives his first rupee return. Transparency issues are also important. Research such as the individual manager's background and reputation, not to mention the nature of the investments that they are utilizing, are all issues a fund of fund manager must investigate. Therefore, investors have to rely on the fund of funds manager's talent and expertise in choosing managers, when investing in a fund of funds. Investors look for Fund of funds because hopefully, they provide more stable returns while reducing risk.

1.5 Hedge Funds by Strategy Types:

Hedge Fund Investment strategies tend to be quite different from those followed by traditional asset managers. Moreover, each fund usually follows its own proprietary strategies which do not always fit within neat definitional categories. However, the FSA, UK stated that the hedge funds could be distinguished by the following three broad types:

1.5.1 Event driven - funds investing in securities to take advantage of price movements generated by corporate events. This group includes *merger arbitrage funds* and *distressed asset funds.*

1.5.2 Global macro – funds that take long and short positions in major financial markets based on views influenced by economic trends and events.

1.5.3 Market neutral – funds where the manager attempts to minimize (or significantly reduce) market risk. This category includes *long / short equity funds, convertible bonds arbitrage funds,* and *fixed income arbitrage*.

Another approach of classifying hedge funds by strategy types is that of the following table which briefly summarizes the data base according to a classification system recently adopted by FRM[1] and MSCI, Inc. Given the wide range and idiosyncratic nature of hedge fund specialties, any classification system will not completely characterize some managers, but the following one is generally considered to be a reasonable description of the universe.

A Taxonomy of Hedge Fund Strategies

Strategy	***Description***
Directional Trading	Based upon speculation of market direction in multiple asset classes. Both model-based systems and subjective judgment are used to make trading decisions.
Relative Value	Focus on spread relationships between pricing components of financial assets. Market risk is kept to minimum and many managers use leverage to enhance returns.
Specialist Credit	Based around lending to credit sensitive issuers. Funds in this strategy conduct a high level of due diligence in order to identify relatively inexpensive securities.
Stock Selection	Combine long and short positions, primarily in equities, in order to exploit under and overvalued securities. Market exposure can vary substantially.

1.6 Size of the Hedge Fund Market:

Since hedge funds do not register with SEC their actual data cannot be independently followed; therefore hedge fund data is self reported. Despite the ambivalent image, hedge funds have attracted significant capital over the last decade, triggered by successful track records. The global hedge funds volume has increased from US $ 50 billion in 1988 to US $ 750 billion in 2003 yielding an astonishing cumulative average growth rate (CAGR) of 24 %. The global hedge fund volume accounts for

[1] Financial Risk Management Limited (FRM)

about 1% of the combined global equity and bond market. The number of hedge funds increased from 1500 to about 8000 between 1998 and 2003. Estimates of new assets flowing into hedge funds exceed US $25 billion on average for the last few years. In the next five to ten years, hedge fund assets have been predicted to exceed US $ 1 trillion.

In Europe the overall hedge fund volume is still small with about US $ 80 billion in 2003 which accounts for about 11% of the global hedge fund volume. The number of hedge funds in Europe is about 600. Within Europe, hedge funds become particularly popular in France and Switzerland where already 35% and 30% of all institutional investors have allocated funds into hedge funds. In 2003, Italy’s hedge fund industry nearly tripled in size as assets grew from Euro 2.2 billion to Euro 6.2 billion. Germany is at the lower end with only 7% of the institutional investors using hedge funds. But the Investment Modernization Act, may well trigger rising interest from German investors. Overall, hedge fund assets are estimated to increase ten fold in Europe over the next 10 years. The acceptance of hedge funds seems to be growing through out Europe, as investors have sought alternatives that are perceived as less risky during the last three years equity bear market.

This trend is also evident in Asia, where hedge funds are starting to take off. According to AsiaHedge magazine, some 150 hedge funds operate in Asia, till year 2002 which together managed assets estimated at around US $ 15 billion. In Japan, too hedge funds are becoming the focus of more attention. Recently, Japan’s Government Pension Fund one of the world’s largest pension fund with US $ 300 billion has announced plans to start allocating money to hedge funds. Industry participants believe that Asia could be the next region of growth for the hedge fund industry. The potential of Asian hedge funds is well supported by fundamentals. From an investment perspective, the volatility in the Asian markets in recent years has allowed long-short and other strategic players to out perform regional indices. The relative inefficiency of the regional markets also presents arbitrage opportunities from a demand stand point US and European investors are expected to turn to alternatives in Asia as capacity in their home markets diminish. Further, the improving economic climate in South East Asia should help foreign fund managers and investors to refocus their attention on the region. Overall, hedge funds look set to play a larger role in Asia.

1.7 Reasons for Rapid Growth of Hedge Fund Industry

While high net worth individuals remain the main source of capital, hedge funds are becoming more popular among institutional and retail investors. Funds of funds (hedge funds) and other hedge fund-linked products are increasingly being marketed to the retail investors in some jurisdictions. There are a number of factors behind the rising demand for hedge funds. The unprecedented bull run in the US equity markets during the 1990s swelled investment portfolios this lead both fund managers and investors to become more keenly aware of the need for diversification. Hedge funds are seen as a natural "hedge" for controlling downside risk because they employ exotic investments strategies believed to generate returns that are uncorrelated to asset classes.

Until recently, the bursting of the technology and telecommunications bubbles, the wave of scandals that hit corporate America and the uncertainties in the US economy have lead to a general decline in the stock markets worldwide. This in turn provided fresh impetus for hedge funds as investors searched for absolute returns.

The growing demand for hedge fund products has brought changes on the supply side of the market. The prospect of untold riches has spurred on many former fund managers and proprietary trades to strike out on their own and set up new hedge funds. With hedge funds entering the main stream and becoming 'respectable', an increasing number of banks, insurance companies, pension funds, are investing in them.

1.8 Performance of Hedge Fund Industry:

Hedge fund performance has varied through time, with lower figures in the most recent five-and-a half years. Volatility has also appears to have increased in more recent periods. In general, however, the risk-adjusted performance of the universe of hedge funds appears to have been superior to traditional active managers and passive benchmarks over the last ten years.

Performance from 1990 through June 2000

	All Hedge Funds	**Directional Trading**	**Relative Value**	**Specialist Credit**	**Stock Selection**	**S&P 500**
Annualised Return	12.2%	17.8%	12.3%	14.5%	18.9%	17.2%
Annualised Volatility	7.7%	13.6%	5.7%	9.3%	13.4%	13.7%
*Sharpe Ratio**	1.6	0.9	1.3	1.0	1.1	0.9

** Assume 5% hurdle rate*

It turns out that the hedge fund managers exhibit much lower correlation with one another than traditional active managers. The average correlation among Lipper large cap mutual funds managers has been on the order of 90%, while hedge funds resemble S&P 500 stocks with an average correlation on the order of 10% (its about 20% on average for stocks). There could be a large idiosyncrasies component to the returns of hedge fund managers, even within a particular strategy, whereas Lipper managers tend to be more correlated with their benchmarks and hence with each other. The low average correlation among hedge fund managers suggest that pooling funds into portfolios or indexes can significantly reduce their total risk, providing distinct advantages relative to traditional active strategies.

1.9 Market Benefits of Hedge Funds:

Hedge funds can provide benefits to financial markets by contributing to market efficiency and enhance liquidity. Many hedge fund advisors take speculative trading positions on behalf of their managed hedge funds based extensive research about the true value or future value of a security. They may also use short term trading strategies to exploit perceived mis-pricings of securities. Because securities markets are dynamic, the result of such trading is that market prices of securities will move toward their true value. Trading on behalf of hedge funds can thus bring price information to the securities markets, which can translate into market price efficiency. Hedge funds also provide liquidity to the capital markets by participating in the market.

Hedge funds play an important role in a financial system where various risks are distributed across a variety of innovative financial instruments. They often assume risks by serving as ready counter parties to entities that wish to hedge risks. For example, hedge funds are buyers and sellers of certain derivatives, such as securitised financial instruments, that provide a mechanism for banks and other creditors to un-bundle the risks involved in real economic activity. By actively participating in the secondary market for these instruments, hedge funds can help such entities to reduce or manage their own risks because a portion of the financial risks are shifted to investors in the form of these tradable financial instruments. By reallocating financial risks, this market activity provides the added benefit of lowering the financing costs shouldered by other sectors of the economy. The absence of hedge funds from these markets could lead to fewer risk management choices and a higher cost of capital.

Hedge fund can also serve as an important risk management tool for investors by providing valuable portfolio diversification. Hedge fund strategies are typically designed to protect investment principal. Hedge funds frequently use investment instruments (e.g. derivatives) and techniques (e.g. short selling) to hedge against market risk and construct a conservative investment portfolio – one designed to preserve wealth.

In addition, hedge funds investment performance can exhibit low correlation to that of traditional investments in the equity and fixed income markets. Institutional investors have used hedge funds to diversify their investments based on this historic low correlation with overall market activity.

From time to time, allegations are made by market participants about collusion among hedge funds to manipulate markets. Like all other market participants, hedge funds are covered by both criminal and civil regimes that outlaw various forms of market manipulation and abuse.

II. HEDGE FUNDS IN DIFFERENT JURISDICTIONS

2.1 Hedge fund regulation in other markets :

2.1.1 United States of America (USA):

Organisation and offering by hedge fund:

Hedge funds are typically organized by professional investment advisors that manage investments for hedge funds. Hedge funds distribute securities in private offerings, traditionally "marketing" their interests through word of mouth and the personal relationships with the hedge fund's advisory personnel. Broader marketing, including use of the Internet, has become more frequent in recent years.

Hedge fund advisors typically receive, as compensation, a management fee based on the amount of hedge fund assets (commonly 1-2 percent), plus a share of the capital gains and capital appreciation (commonly 20 percent) or some other allocation based on the fund's investment performance. Hedge funds typically agree to repurchase their own interests from investors on a limited, periodic basis, such as quarterly, often following an initial "lock-up period" during which time investors are not permitted to liquidate their investments.

Because hedge funds are not registered investment companies, they generally are not required to meet prescribed disclosure requirements. Hedge fund advisors, however, typically provide potential hedge fund investors with a private placement memorandum that discloses information about the investment strategies the hedge fund is permitted to use and an overview of how the hedge fund operates. The private placement memorandum also generally provides the adviser with the maximum flexibility in selecting, shifting and modifying its strategies. In addition, the private placement memorandum often provides the hedge fund adviser with broad discretion in valuing the hedge fund's assets. Hedge fund investors generally receive some ongoing performance information, risk analyses and portfolio profiles from their hedge fund advisors. Although not required, most hedge funds retain an auditor to conduct an annual independent audit, which, if certified, is prepared using generally accepted accounting principles (GAAP).

For tax and other considerations, some hedge fund advisors create one or more "offshore" hedge funds that are organized in a foreign jurisdiction, in addition to maintaining U.S. based hedge funds.

Hedge funds do not register the offer and sale of their interests under the Securities Act. As such, hedge funds may not offer their securities publicly or engage in a public solicitation. Instead, hedge funds generally sell their interests in private offerings.

Investment Company Act 1940 and hedge fund

Most hedge funds have substantial investments in securities that would cause them to fall within the definition of investment company under the Investment Company Act, 1940. Hedge funds, however, typically rely on one of two statutory exclusions from the definition of investment company, which enables them to avoid the regulatory provisions of that Act.

Section 3(c)(1) of the Investment Company Act, 1940 excludes from the definition of investment company any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 investors and which is not making and does not presently propose to make a public offering of its securities.

Section 3(c)(7) of the Investment Company Act, 1940 excludes from the definition of investment company any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers, and which is not making and does not at that time propose to make a public offering of its securities. A hedge fund relying on Section 3(c)(7) may accept an unlimited number of qualified purchasers[2] for investment in the fund. As a practical matter,

[2] Qualified purchasers : are defined by SEC to mean "accredited investors". "Accredited investors" is defined to include individuals who have a net worth with their spouse, above US $ 10,00,000 or have

however, most funds relying on Section 3(c)(7) have no more than 499 investors in order to avoid the registration and reporting requirements of the Securities Exchange Act of 1934 ("Exchange Act").

The principals of hedge funds normally have no interest in encouraging resale of interests in their funds. In the usual case, therefore, transfers of the interests are prohibited without the written consent of the general partner or other manager, and there is limited liquidity of the interests through sales and redemptions by the hedge funds.

The Exchange Act and hedge funds:

The Exchange Act contains registration and reporting provisions that may apply to hedge funds. Section 12 of the Exchange Act and the rules promulgated there under govern the registration of classes of equity securities traded on an exchange or meeting the holder of record and asset tests of Section 12(g) and related rules. Section 12(g) and Rule 12g-1 there under require that an issuer having 500 holders of record of a class of equity security (other than an exempted security) and assets in excess of $10 million at the end of its most recently ended fiscal year register the equity security under the Exchange Act. Registration of a class of equity security subjects domestic registrants to the periodic reporting requirements of Section 13, proxy requirements of Section 14 and insider reporting and short swing profit provisions of Section 16 of the Exchange Act. Although hedge fund interests fall within the definition of equity security under the Exchange Act, most hedge funds seek to avoid Exchange Act registration by having fewer than 500 holders of record (which in the case of hedge funds are also generally the investors).

Due to the power a hedge fund's adviser may exercise over the equity securities held by the fund, both the hedge fund and its advisor generally will be deemed to beneficially own any equity securities owned by the hedge fund. The beneficial ownership reporting rules under sections 13(d) and 13(g) of the Exchange Act generally require that any person who

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income above US $ 20,00,000 in the previous two years (or joint income with their spouse above US $ 30,00,000). Institutional investors with assets exceeding US $ 5,000,000 are considered "accredited investors".

beneficially owns greater than five percent of the class equity securities, file a beneficial ownership statements (schedule 13D or 13G). In certain specified circumstances, the hedge fund and its advisors may file a short form beneficial ownership statement.

In addition, hedge fund advisors also may be subject to the quarterly reporting obligations of Section 13(f) of the Exchange Act, which apply to any "institutional investment manager" exercising investment discretion with respect to accounts having an aggregate fair market value of at least $100 million in equity securities. An "institutional investment manager" includes any person (other than a natural person) investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person.

Section 16 applies to every person who is the beneficial owner of more than ten percent of any class of equity security registered under Section 12 of the Exchange Act and each officer and director of the issuer of the security (collectively, "reporting persons" or "insiders"). Upon becoming a reporting person, a person is required by Section 16(a) to file an initial report with SEC disclosing the amount of his or her beneficial ownership of all equity securities of the issuer. Section 16(a) also requires reporting persons to keep this information current by reporting to SEC changes in ownership of these equity securities, or the purchase or sale of security-based swap agreements involving these securities. Hedge funds are also subject to the short swing profit provisions of Section 16(b) of the Exchange Act.

Investment Advisers Act 1940 and hedge funds

Many hedge fund advisors, however, avoid registering with the SEC by relying on the Advisors Act's *de minimis* exemption under Section 203(b) of that Act. That section excludes from registration investment advisors that have had fewer than 15 clients during the preceding 12 months, do not hold themselves out generally to the public as an investment adviser and are not an investment advisors to a registered investment company. For purposes of Section 203(b), current SEC rules provide that investment advisors may count a "legal organization," such as a hedge fund, as a single client. Thus, an adviser may manage up to 14 hedge funds before being required to register with SEC as an investment adviser, so long as it satisfies the “no holding out” condition. Investment advisors that are exempt from registration nevertheless are subject to the antifraud provisions of the Advisors Act.

A number of hedge fund advisors, however, do register as investment advisors under the Advisors Act. Some are required to register because they have 15 or more advisory clients, or they advise one or more registered investment companies, and therefore are ineligible for the *de minimis* exemption. Others have registered with the Commission voluntarily because their investors demand it or for competitive reasons.

The Commodities Exchange Act and hedge fund

As a result of recent CFTC rule options, many hedge fund advisors can now qualify for exemptions from Commodity Pool Operator (CPO) and Commodity Trading Advisor (CTA) registration. Regulations under the Commodity Exchange Act (CEA) provide an exemption from registration to CPOs operating pools that engage in limited commodity futures activities and sell interests solely to certain qualified individuals. Regulations under the CEA also provide an exemption from registration to CPOs that operate pools that sell interests to certain highly sophisticated pool participants. Investment advisors to hedge funds that operate in reliance upon Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act may be able to rely upon one of these CFTC exemptions. In addition, the CEA provides a *de minimis* exemption from CTA registration that is similar to the Investment Advisors Act’s *de minimis* exemption from investment adviser registration. Consequently, hedge fund advisors that are exempt from registration as an investment adviser also are usually exempt from registration as a CTA. Hedge fund advisors that meet the definition of CPO or CTA, but that are exempt from registration as such, are required to keep books and records, but are not subject to disclosure, periodic reporting or audit requirements that apply to a registered CPO or a registered CTA.

ERISA[3] and hedge funds

An investment advisor to a hedge fund is an ERISA plan fiduciary if it exercises discretionary authority over the management of "plan assets." The assets of a hedge fund are deemed to be "plan assets" if an ERISA plan's investment in that hedge fund is "significant." An ERISA plan's investment is deemed to be significant if, immediately after the most recent acquisition of any equity interest in the hedge fund, more than 25 percent of the value of any class of equity interests in the hedge fund is held collectively by the employee benefit plan investors. Many hedge fund advisors take measures to ensure that employee benefit plan investments in hedge funds do not exceed this 25 percent threshold in order to avoid being subject to regulation as an ERISA fiduciary.

Some hedge fund advisors, however, accept regulation under ERISA because they view ERISA plans as attractive to investors for the hedge funds they advise. As a result, they permit the investment of significant amounts of employee plan assets in the hedge funds. Before investing plan assets in such a hedge fund, however, the non-adviser ERISA plan fiduciary typically will require assurances from the hedge fund adviser that it will not be liable under ERISA for any misconduct on the part of the hedge fund adviser in managing the plan assets. Generally, a hedge fund adviser can shield ERISA plan fiduciaries from liability for its misconduct by registering as an investment adviser under the Advisors Act, and by qualifying as an "investment manager" under ERISA.

Other Regulations and hedge funds

Pursuant to authority granted by the Exchange Act, the Treasury Department has adopted rules that govern the reporting of large positions in U.S. Treasury securities by persons who participate in the government securities market, including registered investment advisors and hedge funds. Pursuant to these rules, the Treasury Department periodically provides notices of Treasury security issues for which large position information must be reported ("reportable position") and the applicable large position threshold for that issue. Hedge funds that have a reportable

[3] Employees Retirement Income Security Act of 1974 (ERISA).

position in a noticed government securities issue that is equal to or greater than the large position threshold must file a report with the Federal Reserve Bank of New York ("FRBNY") containing certain prescribed information relating to that issue of securities. Hedge funds may also be required to make and keep certain records related to their large position reports.

Section 352 of the USA Patriot Act requires every "financial institution" to establish an anti-money laundering program that meets certain minimum requirements. In connection with Section 352, the Treasury has proposed a rule that would require hedge funds, among other entities, to adopt anti-money laundering procedures. In addition to adopting an anti-money laundering program, these entities would be required to provide a written notice to the Treasury within 90 days of becoming subject to the rule.

A hedge fund advisor that is subject to state investment adviser laws is likely to face regulations similar to SEC's, as state regulation of investment advisers is generally similar to the Advisors Act. Broadly speaking, the investment adviser must register with authorities and must provide certain disclosures to clients. The adviser is also subject to rules designed to protect investors and prevent fraud, and may be subject to periodic examination by regulators.

2.1.2 United Kingdom (UK):

Assets in the European hedge fund industry increased by around 40% last year to reach $64bn by end-2001. Last year, $11bn of the inflows in Europe went to existing funds, while new start-ups attracted $6.6bn. the number of hedge funds managed in Europe rose significantly during 2001, from 317 to 446.

The main investors in hedge funds have been (and continue to be) high net worth individuals (HNWIs) and private endowment funds, pension funds and insurance companies are also a significant source of inflows to hedge funds.

Almost all hedge funds are located in offshore jurisdictions. The UK is not a domicile of choice for hedge funds, primarily because the tax regime is unfavourable. A UK-domiciled hedge fund would be liable for corporation tax on income and capital gains. This provides hedge funds with strong incentives to set up in offshore jurisdictions to benefit from favourable tax regimes. The administration of funds is also usually based offshore. Many of these offshore funds are structured with onshore managers and advisors to inform investment strategy and provide other defined services to the offshore fund. There are significant numbers of hedge fund managers in the US (in particular) and the UK. Many of the investors in hedge funds, both institutional and individual, are also located in onshore jurisdictions.

FSA does not have legal responsibility for, or oversight of, the operation of a hedge fund established and operated outside the United Kingdom, even if a fund employs one or more UK investment managers. However, while the funds themselves are outside the FSA's jurisdiction, they oversee the marketing of hedge fund products in the UK and the regulation of UK-based hedge fund managers.

There is no specific regulatory regime for the marketing of hedge fund products in the UK. Where a hedge fund is structured as a limited partnership or as an open-ended investment company, it would usually be classified as an unregulated collective investment scheme for regulatory purposes. Chapter 3 of the Conduct of Business Sourcebook (COB), and the provisions of the Unregulated Collective Investment Scheme (CIS) Order, govern the manner in which authorised persons may market unregulated schemes. This does not allow the free marketing of these funds to the general public. But it does allow funds to be marketed to intermediate customers, market counterparties or to private customers where a firm has taken reasonable steps to ensure that the fund is suitable.

Firms that are authorised and which may give advice to their clients on the merits of hedge fund investment will need to consider the requirements of COB and in particular the restriction on financial promotion. The vast majority of hedge funds have minimum investment amounts, typically of

US$100,000 or more. This requirement, which the industry itself chooses to apply, would be an insurmountable hurdle to many private customers and is itself a barrier to retail investment in hedge funds. Again, FSA requires regulated firms to undertake thorough due diligence before taking such action.

A hedge fund manager must meet the threshold conditions for authorisation as set out in the Act, both at the time of authorisation and on an ongoing basis. Above and beyond this, the firm must also comply with other regulatory requirements relevant to its business. FSA regime puts particular emphasis on systems and controls, which firms are required to put in place and maintain adequate systems and controls appropriate to the business it conducts. When considering an application for a permission from a hedge fund manager, the FSA will focus on its resources and competence to manage the assets of funds in line with its mandate from the operators of the underlying fund.

Other features of the authorisation process include checks on whether a hedge fund manager has adequate procedures in place to show compliance with UK regulations. FSA also require hedge fund managers to keep clear records of any marketing material distributed along with a clear audit trail showing how they meet the criteria laid down in the relevant regulatory regime.

Authorised hedge fund managers, as with all regulated firms, are required to satisfy the threshold conditions for authorisation on a continuing basis and comply with FSA rules, including requirements on systems and controls as well as training and competence. FSA takes appropriate action against any authorised firm, including hedge fund managers, which causes significant risks to its statutory objectives. It must be clarified, that authorisation of hedge fund managers by FSA does not imply any oversight of the underlying hedge fund or funds.

Other financial institutions have exposures to hedge funds that arise through several transmission mechanisms, including counterparty trading, derivatives activity, the provision of brokerage services, direct equity investments, and (very occasionally) direct lending. A number of UK-authorised firms offer finance to hedge funds, most commonly as a prime broker, although the number of UK owned firms providing finance in this way is relatively small. The FSA seeks to ensure that, following Basel and IOSCO guidelines, credit providers to hedge funds follow appropriate risk management practices.

FSA continues to monitor trends in the hedge fund sector, and developments in counterparty risk management arrangements. Both market surveillance and periodic discussions with hedge funds and credit providers help to inform our assessment of the risks. FSA also meets periodically with hedge fund trade associations and industry analysts to help inform its views of the market.

Hedge fund managers or operators based in the UK have been subject to the Money Laundering Regulations 1993 since 1994, even if the assets that they manage are held overseas. The Regulations oblige them by law to know their customers, including indirect customers introduced to them by intermediaries.

The market impact of the few hedge funds that are both large and leveraged is a global issue. As stated above, it was analysed in considerable depth following the collapse of Long Term Capital Management at the end of 1998, by a number of bodies including the Financial Stability Forum (FSF) Working Group on Highly Leveraged Institutions (HLIs).

At its seventh meeting in March 2002, the FSF discussed how far previous concerns about HLIs had been allayed by the implementation of its previous recommendations. The FSF noted that several developments – including improved counterparty risk management, strengthened regulatory oversight and enhanced information flows – have helped to reduce the risks that hedge funds could pose to the international financial system. But the FSF urged continued improvements in public disclosures by hedge funds to improve market discipline and reduce systemic risk.

Some concerns have been raised recently about the effects on markets of short selling by hedge funds and others. FSA's position on this important issue can be summarized in its own words : “If we were to introduce regulatory provisions to deal with concerns about short selling, we would have to consider their costs and benefits. Indeed, there are good reasons why we would not wish to constrain short selling.” FSA noted in its latest assessment that it can be “an equilibrating and efficiency-enhancing market practice”. Short selling can provide the market with two important benefits; market liquidity and pricing efficiency. FSA therefore sees no case for any outright ban on short selling, a practice which in its judgment a necessary and desirable underpinning to the liquidity of the UK market.

From time to time, allegations are made by market participants about collusion among hedge funds to manipulate markets. Like all other market participants, hedge funds are covered by both the criminal and civil regimes that outlaw various forms of market manipulation and abuse. The FSA also takes steps to investigate evidence of any such collusion.

2.1.3 Switzerland:

The Swiss Investment Funds Act introduced the concept of ‘other funds with special risks’, which enables Swiss and foreign based hedge funds to be licensed by the Federal Banking Commission (FBC). There is no statutory minimum investment level but, the minimum investment has never been below S*fr* 10,000 and is normally considerably higher. Only funds domiciled in a recognized jurisdiction with ‘equivalent supervision’ can be sold in Switzerland – the FBC has deemed that member states of the European Economic Area, the USA, Guernsey and Jersey meet the standard. Although it is the hedge fund that is authorized, much of the regime focuses on the actions and competence of the hedge fund manager. For example, the decision on whether to license a hedge fund is based on a qualitative assessment of managers, risk management systems and internal controls.

2.1.4 Germany

The Investment Modernisation Act was approved by the German Parliament on November 7, 2003 and became effective from January 1, 2004. One key measure under the Modernisation Act is the admission of hedge funds as the alternative investment vehicle. So far only hedge fund certificates (products with payout linked to the performance of hedge funds) were allowed to be distributed in Germany. The act is expected to catalyze the development of German hedge fund industry and is a response to the interest in hedge funds among institutional and retail investors.

Following the approval of the new investment act, the BaFin will issue guidelines that will outline the issues related to setting up a hedge fund or a fund of funds. The new regulations will stipulate that KAGs (Kapitalan Lagegessellschaften) may now launch “investment funds with additional risks” (i.e. hedge funds) or “fund of funds with additional risks” (i.e. funds of hedge funds). There are a few additional requirements for existing KAGs to comply before establishing such funds, for example, due expertise of an asset manager and risk assessment models must be in place. Hedge funds and fund of hedge funds may also be launched by the newly introduced investment stock companies with variable capital.

The German market, to a certain extent is now open to foreign hedge funds and provides the opportunity to admit public distribution of certain foreign hedge funds. The Investment Act stipulates that only foreign funds of hedge funds may be publicly distributed in Germany. The single hedge funds still remain barred from public distribution, although it is possible to distribute them by private placement. As regards investment policy, foreign funds of hedge funds must largely follow the same regulations as German funds of hedge funds under the Investment Act.

2.1.5 Offshore Centers (Bahamas, Bermuda, The Bristish Virgin Islands and the Cayman Island)

Offshore administrators assist a hedge fund adviser to set up an offshore hedge fund in accordance with applicable foreign laws and also assist the fund in complying with such laws on an ongoing basis. They also provide accounting, record keeping and reporting services, as well as assist in calculating fees and accruals. Certain offshore jurisdictions regulate offshore hedge fund administrators operating within their borders. The regulation of offshore hedge fund administrators subject them to licensing, auditing and record keeping requirements. For example, many offshore hedge funds are domiciled in the Bahamas, Bermuda, The British Virgin Islands and the Cayman Islands. These jurisdictions generally apply certain laws regulating the operations and conduct of investment pools and investment pool administrators to hedge funds and hedge fund administrators : The Bahamas Mutual Fund Act, 1995 (June 2001 Revision); Bermuda Monetary Authority Act 1969; Bermuda Companies Act 1981, Part XII A (Mutual Fund Companies); Bermuda Monetary Authority (Collective Investment Scheme Classification) Regulations 1998; British Virgin Islands Mutual Funds Act, 1996 (as amended 1997) and Cayman Islands Mutual Fund Law (2003 Revision). These laws generally require fund administrators to be licensed and three of the four jurisdictions (except Bermuda) require licensed fund administrators to have their accounts audited by an auditor approved by the regulator. Each of these jurisdictions also subjects licensed fund administrators to anti-money laundering provisions. These provisions set forth client identification and record keeping requirements in addition to obligations to report any suspicious activity with respect to the funds they administer to the relevant authority in that jurisdiction.

2.1.6 Ireland:

Hedge fund managers setting up an offshore fund can seek a listing for the fund's shares on the Irish Stock Exchange. This does not generally extend the categories of investor with whom shares of hedge fund can be privately placed. But often a listing is sought because it is believed that institutional investors can invest a larger proportion of their assets in listed (as distinct from unlisted) shares. Hedge funds seeking a listing must impose a minimum investment amount per investor of US $100,000, unless the hedge fund is set up under the law of EU member states, Hong Kong, the Isle of Man, Jersey, Guernsey or Bermuda. The investment manager must show that the fund has adequate and appropriate expertise and experience in managing investments; in practice this means the manager must already be managing $100 million in third party funds on a discretionary basis. Hedge funds seeking a listing must also have appointed a custodian with responsibility for the safe keeping and custody of the fund's assets.

2.1.7 Singapore:

In response to interest expressed by the financial industry, The Monetary Authority of Singapore (MAS) issued in June 2001 guidelines allowing hedge funds to be sold to the public. The rationale is, according to the MAS, is : "to provide more investment choice for those who understand the higher risks associated with the prospect of significantly higher returns from such funds". The key requirements for public offerings of hedge funds are a minimum initial subscription of $100,000 per investor, adequate and prominent disclosure in the prospectus of the high risks of investing in hedge funds, and investment managers must have expertise in managing such funds.

2.1.8 Hong Kong:

In October 2001 the Hong Kong Securities and Futures Commission (HKSFC) issued a consultation paper on the offering of hedge funds, which considered various different approaches. The consultation exercise has concluded and, from 17 May 2002, funds seeking authorization as hedge funds need to comply with several new provisions. Under these guidelines, managers of single hedge funds and funds of hedge funds will be required to be managing assets of at least US $100 million, and have five years' general experience in "hedge fund strategies". The minimum individual investment in single hedge funds is US $50,000, and US $10,000 for funds of hedge funds. No minimum subscription level applies to schemes providing 100% capital guarantees. Hedge fund offering documents must display warning statements on the front cover, noting the special risks associated with these investments.

2.1.9 Taiwan:

There was no guideline/regulation/rule to regulate hedge funds existing within Taiwan's regulatory framework, even though hedge fund issue was the top priority concern to SFC, Taiwan's regulator. SFC used to apply a self declaration like form to screen hedge funds from Foreign Institutional Investors but it did not seem to be so effective. SFC turned around the policy toward hedge funds, when it eventually approved two hedge funds' application a month ago after one-month review and consideration.

SFC has now given a guideline to the Taiwan Stock Exchange (TSE) that, other than those internationally recognized "unfriendly" hedge funds, those which meet the certain criteria shall be in principle allowed to obtain a foreign institutional investor (FINI) status for investment in Taiwan's securities market.

The hedge fund provides, in its application for FINI, memorandum and articles of association or agreement for establishment of the fund, and explanation of its investment or trading strategies which can sufficiently prove that the fund is not engaged in market manipulation. The fund shall also declare that it will not use unjust measures to affect the fairness or order of the financial / securities market.

The SFC feels that as long as hedge funds can provide true and accurate information in their applications and follow local regulations, and that the exchanges can monitor and track their activities effectively, hedge funds shall not create adverse impacts on the local securities market.

2.1.10 <u>Thailand:</u>

There is no specific guidelines or rules to restrict overseas hedge fund to invest in Thai capital market. However, overseas hedge funds who wish to invest in Thai Stock of Exchange need to subject to SEC laws, in particular, in chapter 8, regarding unfair securities trading practices and acquisition of securities for business Takeovers.

SEC, Thailand treats hedge fund equal to ordinary investors in Thai Stock Exchange Market. The regulator does not have special checking on any hedge funds but checks for unusual transactions of all categories of investors equally by :

- ❖ checking unusual movement in SET (stock exchange) which may caused by unfair securities trading in the market.
- ❖ checking through investors report submitted to SEC for the disclosure of the holding of securities above the threshold (5% of total number of securities).

The impact of these changes on fund location and investment profiles has, to date, been small when compared to the size of the global hedge fund market. However, the changes above are recent developments and funds operating under these regimes may, over time, account for a greater proportion of the industry's funds under management.

2.1.11 IOSCO

In February 2003, the IOSCO Technical Committee approved for public release the report entitled *Regulatory and Investor Protection Issues Arising from the Participation from Retail Investors in (Funds of) Hedge Funds*. While summarizing its recommendation the Technical Committee highlighted that the possibilities for retail investments in hedge funds have significantly grown over the past years. Some jurisdictions allow forms of direct retail investment and many jurisdictions allow indirect retail investment.

Where the jurisdiction does permit the marketing and selling of hedge funds to retail investors, the key regulatory concerns that arise are :

1. The retail investor may not adequately understand the risk involved in or the complexity of the product; and
2. That the managers may not have the competence or the processes and controls to adequately manage the fund and explain this clearly to his investors.

The committee recommended that the hedge funds marketed and sold directly to retail investors should be subject to the same disclosure requirements as other Collective Investment Schemes (investment companies in USA and Mutual Funds in India). The management and internal control process of hedge funds may require additional attention of the regulator. The regulator should consider the adequacy of skills such as ability to manage complexity of investment strategies and risks, while accepting that it is impossible to second-guess the commercial judgments being made by the manager and for which the manager is responsible.

2.1.12 Highlights of Regulatory Review:

1) Hedge funds are a growing segment of asset management industry and increasingly becoming popular not only with high networth individual investors but also with institutional investors including university funds, pension funds, insurance and endowments. Some of the jurisdictions, have even initiated policies to provide hedge fund or fund of funds as alternative investment options to retail investors.
2) Hedge funds, are sometimes perceived to be speculative and volatile. However, not all funds exhibit such characteristics. There are hedge funds which provide capital protection feature to the investors.
3) Hedge funds themselves are not registered in most of the developed markets but investment managers/advisors managing hedge funds could be registered as investment advisors under the relevant regulations. However, the registration of the investment advisors does not necessarily involve substantive supervision over the funds operations.
4) Some jurisdictions are gradually moving towards allowing the marketing of hedge fund and fund of funds products to retail investors. Those jurisdictions have simultaneously imposed disclosure requirements to ensure that investors understand the complexity and associated risk of investing in hedge funds.
5) Hedge funds in search of high returns are also investing in emerging markets.. Realizing the growing importance of hedge funds, several emerging market regulators have opened their markets to offshore hedge funds by providing authorization as registered foreign investors.

6) All hedge funds though are not regulated like mutual funds, they are nevertheless subject to market abuse laws and anti-money laundering procedures.

III FINANCIAL CRISIS AND HEDGE FUNDS

In spite of difference of views, the role played by some of the large hedge funds have often been associated with major financial crisis that took place in the 90's.

3.1 East Asian Crisis

The impact of the East Asian crisis which materialized in the middle of 1997, and the subsequent turbulence that swept the world's financial markets over the next 12-18 months, has been significant not only in terms of the financial, economic and social consequences that these events wrought on emerging market economies, but also in terms of drawing the world's attention to outstanding issues concerning the structure, operation and regulation of the international financial system.

Causes of the crisis remain among the most contentious issues and continue to be debated at the academic as well as policy level. The Emerging Markets Committee of IOSCO identified multiple causes of the East Asian crisis. The Committee also made a reference to the role played by some hedge funds : "complex trading strategies involving futures were thought by some authorities to have exerted a destabilizing influence on market performance in their jurisdictions. Currency speculators pursued a so-called "double play" aimed at playing off the Hong Kong currency board system against the administrations stock and futures markets."[4] However, subsequent research could not produce robust evidence implicating the hedge funds for precipitating the crisis. Researchers have, however, attributed the negative public perception of the role of hedge fund managers in crisis partly to the limited information available about what they actually do.

3.2 Long Term Capital Management (LTCM)

Another major financial crisis involving a large hedge fund was that of the huge loss (US $ 4 billion) suffered by LTCM in 1998. LTCM built its

[4] Causes, Effects and Regulatory Implications of Financial and Economic Turbulence in Emerging Markets – Emerging Markets Committee, IOSCO, November 1999.

positions on sophisticated arbitrage trading strategies. In addition, it used a significant degree of leverage to increase its expected return. In August, and September of 1998, as the global financial crisis worsened, it became clear to LTCM that many of the assumptions inherent in the arbitrage positions it held were incorrect. Due to LTCM's leverage (which at one point has exceeded 50 to 1), those incorrect assumptions resulted in substantial losses for the firm and eroded its capital base[5]. Liquidation of LTCM's positions could have potentially disrupted the financial markets, resulting in losses for other participants in those markets. Finally, a consortium of banks worked out a rescue plan facilitated by the Federal Reserve Bank of New York, acknowledged that LTCM's potential impact on the world's financial markets raises legitimate questions about the activities of hedge funds in general, as well as the proper role that regulators should play with respect to those activities. However, he also asserted that it was too soon to tell whether LTCM's investment strategies represent the norm in the hedge funds industry or, whether LTCM was an overly aggressive player among otherwise responsible market participants.

In response to the near collapse of Long-Term Capital Management, LP (LTCM), the Technical Committee of the IOSCO formed a special Task Force on Hedge Funds and Other Highly Leveraged Institutions to address regulatory issues relating to the activities of highly leveraged institutions (HLIs) or hedge funds. The Committee in its report underlined that HLIs, like other institutional investors, can provide benefits to global financial markets. It also highlighted the combination of characteristics typically associated with HLIs such as significant leverage, and the legal and other uncertainties arising out of the extensive operations in offshore centers posing particular challenges which need to be managed carefully in order to avoid risks to the financial system. The committee, as a defense against systemic risk in the market , recommended strong and prudent risk management processes at the regulated firms with which the HLIs trade. The Committee also highlighted the importance of transparent

[5] Testimony of Richard L. Lindsey, Director Division of Market Regulation, before the House Committee on Banking and Financial Services concerning Hedge Fund Activities in the U. S. Financial Markets, October 1, 1998.

disclosure by the regulated entities dealing with HLIs and HLIs themselves on a voluntary basis, as a means to maintain market integrity.

In spite of occasional negative perception about the role of hedge funds, such perceived misdemeanors by certain hedge funds have been considered more as occasional aberrations than general industry wide behaviour. This is also corroborated by the fact that many jurisdictions are gradually opening up their markets for hedge funds to establish and market their products.

Further, for the purpose of this paper it must be emphasized here that allowing access to offshore hedge funds to invest in India through FII route will not provide any opportunity to them to build up leveraged position onshore as borrowing by FIIs are not allowed under the terms of RBIs general permission.

IV. REGULATORY ISSUE FOR ALLOWING FOREIGN HEDGE FUNDS IN INDIA

4.1 Hedge Funds in India

With the notification of SEBI (Mutual Fund) Regulations 1993, the asset management business under private sector took its root in India. In the same year SEBI, also notified Regulations and Rules governing Portfolio Managers who pursuant to a contract or arrangement with clients, advise clients or undertake the management of portfolio of securities or funds of the client. We have however, no information about any hedge funds domiciled in India. Further, on account of limited convertibility, offshore hedge funds have yet to offer their products to Indian investors within India. Recently, RBI through liberalized remittance scheme, allowed resident individuals to remit upto US $ 25,000 per year for any current or capital account transaction. The liberalized scheme will allow Indian individual investors to explore the possibility of investing in offshore financial products. Considering the existing limit being only US $ 25,000 per year, Indian market may not be attractive to hedge fund product marketing. As long as there will be restriction on capital account convertibility, foreign hedge funds, by virtue of their minimum investment limit being $ 100,000 or higher, do not seem to be excited to access investment from Indian investors in India. It may be clearly understood that the suggestions put forth in the following paragraphs are in no way aimed at allowing foreign hedge funds to mobilise investment from India by offering their products to Indian investors. Therefore regulatory issues related to investor protection have not been considered for this Report.

Some hedge funds have invested in offshore derivative instruments (PNs) issued by FIIs against underlying Indian securities. Through this route hedge funs can derive economic benefit of investing in Indian securities without directly entering the Indian market as FIIs or their sub-accounts. Through recent amendments to the FII Regulations (Regulation 15A and 20 A), the regulatory regime has been further strengthened and periodic disclosures regime has been introduced. As at the end of March, 2004, total investment by hedge funds. In the offshore derivative instruments (PNs) against Indian equity, are Rs. 8050 crores which represents about 8% total net equity investments of all FIIs. On the basis of market value, the hedge funds account for about 5% of the market value of the total assets held by the FIIs in India.

The current fiscal year (2003-2004) has seen a spectacular increase in FII activities in Indian market. Till this report is filed FIIs have already invested US $ 10 bn. during this year alone which is a record. Robust economic fundamentals, strong corporate earnings and improvement in market micro structure are driving the FII interest in India. Investors all over the world are keen to come to Indian market. From informal discussions with institutional investors including some reputed and well established hedge funds, one could gauge the extent of interest they have about Indian markets. During the discussions they have requested whether India, like other Asian emerging markets, can provide a regulatory framework that will allow them to directly invest in Indian market in a transparent manner. In this context, the following approach may be considered for allowing the well-established hedge funds to invest in Indian markets as a registered entity under the SEBI (Foreign Institutional Investors) Regulations, 1995.

4.2 Relevant Provisions of FII Regulations:

Though hedge funds are not an excluded category of foreign institutional investors under the SEBI (FII) Regulations, 1995 they are , however, by virtue of not being regulated by securities regulators in their place of incorporation or operations, cannot come as FII under the present provisions of SEBI (FII) Regulations. Regulation 6 (i) (b) of the FII Regulations requires an FII applicant to be a regulated entity in its place of incorporation or operations.

The FII Regulations allow sub-accounts sponsored by registered FIIs to invest in India. Regulation 2 (k) defines “sub-account” which “includes foreign corporates or foreign individuals and those institutions, established or incorporated outside India and those funds, or portfolios, established outside India, whether incorporated or not, on whose behalf investments are proposed to be made in India by a foreign institutional investor". Further, provisions of the regulation 13 lay down the conditions and procedure for granting registration to a sub-account of an FII. Hedge Funds of almost all variations can meet the requirements of sub-accounts if they are 'fit and proper' persons. However, based on (an internal administrative decision) if an applicant indicates in the application that it is a hedge fund, the consideration of the application is withheld. Since granting of registration to FII/sub-accounts is based on the disclosure of details and on the undertaking given by the applicant in the application form, it could be possible that a few entities who described their activities in the application form in terms other than hedge funds could have already got registration as sub- accounts. However, it must be remembered that all sub-accounts have to be sponsored by registered FIIs who are required to be regulated entities by the relevant regulators in their home countries.

4.3 Identifying Hedge Funds

As mentioned in earlier paragraphs, hedge funds do not have, any universally accepted definition. Therefore, identifying a hedge fund is the first challenge that a regulator faces. An approach for identifying hedge funds, as suggested by IOSCO is to look at the kinds of characteristics of fund management strategies employed by institutions. Hedge funds would at least exhibit some of the following characteristics:

i) borrowing and leverage restrictions, which are typically included in Mutual Fund Regulation are not applied, and many (but not all) hedge funds use high levels of leverage.

ii) significant performance fees (often in the form or percentage of profits) are paid to the manager in addition to an annual management fees.

iii) investors are typically permitted to redeem their interests periodically, e.g. quarterly, semi-annually or annually;

iv) often significant 'own' funds are invested by manager;

v) derivatives are used, often for speculative purposes, and there is an ability to short sell securities;

vi) More diverse risks or complex underlying products are involved.

The distinguishing characteristics of hedge funds are not limited to this and the list may need to adapt depending on the changing market dynamics. Further, it might be appropriate to also consider the investment strategy followed by particular funds, such as long/short exposures, leverage and / or hedging and arbitrage techniques. On the basis of these characteristics, it will be possible to identify an applicant as a hedge fund.

4.4 <u>Investment limits applicable to FIIs:</u>

Chapter II of the SEBI (Foreign Institutional Investors) Regulations, 1995 interalia list out the instruments in which an FII/sub-account can invest. The regulation does not include currency or commodities as eligible instruments for investment for the FIIs. Therefore, currency trading or investment in commodity related financial products will not be an option for any hedge funds under the present FII Regulations.

The SEBI (Foreign Institutional Investors) Regulations, 1995 also lays down scrip-wise and fund wise maximum limits a fund can invest. Further, through circular No. SMD/DC/CIR-11/02 dated February 12, 2002 and SEBI/DNAD/CIR-21/2004/03/09 dated March 9, 2004 issued by Secondary Market Department, position limits for investment by FIIs in derivatives have been advised. These limits will help diversify the foreign hedge fund investments and will help in jettisoning concentration in any specific scrip. The provisions of Chapter III (Regulation 15 (3) (a)) disallows short selling by FIIs and stipulates that all trades by FIIs are delivery based. The provision will clearly keep the hedge funds if allowed to invest as FIIs out of short selling at least in the cash segment. It is therefore, clear that existing provisions in the FII Regulations include several checks and balances which can keep our market safe from potential market abuse and manipulation.

4.5 **Additional Regulatory Concerns:**

In view of the increasing popularity among the institutions as well as their increasing interest in the Indian market, it might be time to provide a limited window to this growing segment of asset management industry within the existing framework of the SEBI (Foreign Institutional Investors) Regulations. While opening up our market one cannot be oblivious to the special concerns associated with the creative fund management strategies used by these funds. Thus, the approach adopted in formulating the following policy suggestions has been that of transparent and regulated access with abundant caution. Para 4.4 of this section has already outlined the existing provisions in the SEBI (Foreign Institutional Investors) Regulations, 1995 and the Guidelines issued by SEBI which an address the concerns related to currency speculations, short selling, scrip wise concentration in the cash market and excessive positions in the derivative segment of our market. As mentioned earlier, these types of funds raise special regulatory concerns which are necessary to be addressed with special regulatory provisions. In this context, following additional provisions have been suggested with respect to hedge funds seeking registration as FII :

1. The investment adviser to the hedge funds should be a regulated investment advisor under the relevant Investor Advisor Act or the fund is registered under Collective Investment Fund Regulations or Investment Companies Act.
2. At least 20% of the corpus of the fund should be contributed by the investors such as pension funds, university funds, charitable trusts or societies, endowments, banks and insurance companies. The presence of institutional investors in the fund is expected to ensure better governance on the part of the fund manager and fund administrators. Further, institutional investors may help fund managers to take a long term perspective of the market.
3. The fund should be a broad based fund in terms of the SEBI (Foreign Institutional Investors) Regulations, particularly in terms of the explanation to Regulation 6 (1) (d).
4. The fund manager or investment adviser must have experience of

at least 3 years of managing funds with similar investment strategy that the applicant fund has adopted. This provision is expected to allow well managed funds to access our market and at the same time, keep our markets insulated from the possible adverse effects of 'trial and errors' by uninitiated rookies.

Hedge funds as a whole are becoming an important segment of the asset management industry and gaining popularity from investors particularly from the high net worth investors, universities, charitable funds, endowments, pension funds, insurance and other institutional investors. The asset under management of the hedge funds are growing on a double digit rate. All hedge funds are not necessarily speculative funds though most of them provide an alternative investment options for the investors through innovative investment strategy.

The issues discussed and suggestions placed above are intended to widen the FII window to allow these alternatives invest pools to our securities markets in a transparent and orderly manner. In addition, the suggestions also provide for adequate safety measures to address legitimate concerns associated with these funds. The alternative investment pools if allowed to investment in Indian markets will be a source of additional liquidity and will also diversify the pool of foreign investments in Indian market.