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REGULATORY APPROACH TOWARDS HEDGE FUNDS

Under Guidance of

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"Take up one idea, make that one idea your life; think of it, dream of it, live on that idea. Let the brain, muscles, nerves, every part of your body, be full of that idea, and just leave every other idea alone. This is the way to success, and this is the way spiritual giants are produced. Others are mere talking machines".

-Swami Vivekananda

CERTIFICATE

This is to certify that this Dissertation "Regulatory Approach Towards Hedge Funds" submitted by Amit Bhaskar (ID. No. 261) for the Degree of Master of Laws of the National Law School of India University is the product of bona fide research carried out under my guidance and supervision. This Dissertation or any part thereof has not been submitted elsewhere for any other degree.

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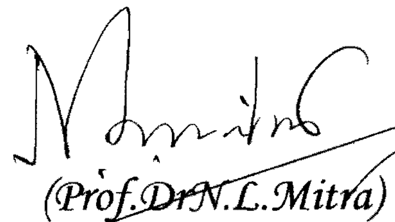

(Prof. Dr N.L. Mitra)

DECLARATION

I, Amit Bhaskar, do hereby declare that this dissertation titled, "Hedge Funds", is the outcome of research conducted by me under the expert guidance of Dr N.L. Mitra at National Law School of India University, Bangalore for the partial fulfilment of the requirements of the award of the Degree of Law.

I further declare that this work is original except for such help as duly acknowledged and has not been submitted either in part or in whole for any degree or diploma at any other University or like institution.

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I am further thankful to the Librarian and Assistant Librarian of Indian Institute of Management, Bangalore, for providing me all support in terms of enabling me having access to all the materials pertaining to my research topic.

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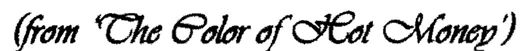
THOUGHT

"If hedge funds were a country...it would be the eight-biggest on the planet...they can sink whole economies and have the potential to crush the entire global financial system...yet they are beyond regulation....we should be very afraid.."

"The New Statesman, 21st July, 2006

"All these countries have spent 40 years trying to build up their economies and a moron like Soros comes along with a lot of money to speculate and ruin things."

-Mahathir Mohamad, Prime Minister of Malaysia, 1998



(from 'The Color of Hot Money')

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INTRODUCTION

Now a days, all over the world, regulators are in favour of regulating hedge funds in their respective financial markets considering the growing influence of it and its capacity to affect the markets adversely during turbulent times. Aggressive marketing strategies with the sole aim of making profits have brought the hedge funds to the close scrutiny of the regulators. The peculiarity of the hedge funds is that the aim of the hedge funds manager is to make profit at all times whether the market is rising or falling and hence they use all the marketing strategies to achieve their aims and hence have come under the scrutiny of the regulators whose view is that market manipulation techniques used by the hedge funds are harmful of the smooth functioning of the market and hence these instruments should be regulated so that they do not consider themselves as beyond the market.

In this research project, the researcher will start with the basic concept of hedge funds and then will go on in dealing with the various regulatory mechanisms existing in various countries of the world to regulate the hedge funds with special reference to India.

RESEARCH METHODOLOGY

AIM AND OBJECTIVE

To find out the legal framework and essential factors to be considered in regulating Hedge Funds in India in the light of existing machineries available in different jurisdictions to regulate Hedge Funds.

SCOPE AND LIMITATION

The scope of this research is to determine whether adequate legal framework exists to regulate the inflow and outflow of Hedge Funds in India and the factors which have compelled the regulators all over the world to regulate the Hedge Funds in their respective markets. An Attempt has been to understand the regulatory mechanisms existing in different parts of the world, especially European Countries, to regulate Hedge Funds and the factors which compelled them to regulate Hedge Funds especially in the light of Long Term Capital Management debacle. An Attempt has been made to discuss all the issues pertaining to regulating Hedge Funds.

RESEARCH QUESTIONS

- What is the meaning of Hedge Funds? How are they operated and what is their modus operandi?
- What is the need for regulating Hedge Funds?
- What are the regulatory and legal frameworks existing in European Countries to regulate Hedge Funds in their respective Jurisdictions?
- Is adequate legal framework exists in India to regulate Hedge Funds?
- What are the peculiar reasons and concerns for the Indian regulators to regulate Hedge Funds?
- What are the factors that need to be taking into account while regulating Hedge Funds so that dynamism and liquidity of the Indian market is not affected?

STYLE AND MODE OF WRITING

The researcher has employed a comparative and analytical mode of writing in the course of this thesis. A comparative style has been adopted to compare the regulatory mechanisms under different jurisdictions where as analytical mode has been adopted to analyse the adequacy of the legal frameworks and the factors which have led to increased regulations over the Hedge Funds.

MODE OF CITATION

All ideas which have not originated from the researcher have been duly acknowledged, as and where applicable. In pursuance of the same, the researcher has followed a uniform mode of citation throughout this research paper.

SOURCES OF DATA

The researcher has relied mainly on secondary data, which include books, articles, treatises and electronic media. Articles and books written by eminent authors have been used for better conceptual clarity and understanding of the topic.

Chapter 1

In this chapter, the researcher will deal with the basic concept of hedge funds such as what are hedge funds, how they are different form mutual funds, what is their modus operandi, how they work in markets and what are the different strategies they adopt, like leveraging and arbitraging, to make profits in the markets. Hence, in this chapter, the focus would be on understanding the basic concept of hedge funds.

1.1 CONCEPT

The term "hedge fund" is derived from the expression "to hedge one's bets", this means to limit the possibility of loss on a speculation by betting on the other side. The term "hedge fund" is no where defined in securities law and so there is no comprehensive and universal definition of the term "hedge fund". The term 'hedge fund' was first coined in 1949 to describe a private investment partnership set up by Alfred Winslow Jones[1] which 'hedged' the risk in the operation by buying what it perceived to be undervalued stocks short selling[2] what it perceived to be overvalued stocks, with the combination varying over time as Jones assessment of market conditions changed. This strategy adopted by Jones secures good returns whether the market fell or rose. The use of gearing or leverage[3] was also a crucial element in his strategy. This combination of strategic, active management positions by private partnership in financial markets is the hallmark characteristic of a hedge fund. Since then the number of hedge funds and assets under their management have expanded rapidly. All hedge funds share a basic strategy –to maximise absolute returns in all market conditions. To quote Goldman Sachs: "The term hedge fund has evolved over time to include a multitude of skill based investment strategies with a broad range of risk and return objectives. The

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[1] Alfred Winslow Jones is credited with the formation of first hedge fund in the world in the year 1949.

[2] Short selling is the sale of an asset, such as the bond, equity or foreign currency that the vendor does not own. The vendor first borrows the asset from another party, with the promise of repaying it back at some future time, and then sells it. If the price of the asset has fallen by the time the vendor is due to repay it to the lender, then he can buy it back in the market for less than he initially he sold it. The profit is the selling price less the buying price and the cost of borrowing the asset.

[3] A fund can acquire assets either by using its own capital or by using borrowed funds. Leverage refers to the use of debt to acquire assets. Leverage allows a fund to boost its assets. They add depth and liquidity to the market. But it can also make these markets more vulnerable to sharp price movements when positions shift and these vulnerabilities have the potential to adversely affect the stability of the whole financial system (President's Working Group on Financial Markets 1999).

common element among these strategies is the use of investment and risk management skills to seek positive returns regardless of market directions."

In practice, the term refers to a limited partnership, mostly domiciled in tax havens such as Cayman Islands[4], investing in equities, bonds, derivative instruments, short selling and high leverage transactions. The Webster's College Dictionary (1998) defined hedge funds as those that use "high risk speculative methods". These funds are private and largely unregulated investment pools for the rich. Typically they include any investment fund that, because of an exemption from certain regulation that otherwise apply to mutual funds, brokerage firms or investment advisors, can invest in more complex and risky investments than a public fund might. Since a hedge fund's investment activities are limited only by the contracts governing the particular fund, it can make greater use of complex investment strategies such as short selling, entering into futures, swaps and other derivative contracts and leverage. Hedge funds often seek to offset potential losses in the principal markets they invest in by hedging their investments using a variety of methods, most notably short selling. They don't have to register with any government bodies such as the Securities and Exchange Commission (SEC) in the US. Hedge fund can borrow as much as they want and unlike mutual funds, they concentrate their portfolios without any diversification.

Hedge funds are usually classified as "alternative investments" because they provide an alternative to direct investment such as equities or bonds. There are many types of hedge funds, investing in various instruments and hedging their positions. The investors in hedge funds are high net worth individuals. The objective of investing in hedge fund is to realize more profits than investing directly in equities or mutual funds. As the

[4] According to one estimate, Cayman Islands is home to 75 per cent of worlds Hedge Funds.

return is high, the risk is also very high and hence such funds are not suitable for all types of investors and are generally confined to rich investors. What makes hedge fund different from other investment instruments is their diversity. Their strategies are very wide, complex and shrouded in secrecy. Hedge funds are typically structured as a limited partnership in which the investment manager acts as the general partner while the investors are limited partners. The investment managers also known as hedge fund managers determine the investment strategy of the fund they are compensated largely on the basis of their performance. By law, these funds cannot advertise or market themselves and so they cannot be seen in newspapers and magazines or on the television. It includes a variety of investment strategies, some of which use leverage and derivatives while others are more conservative and employ little or no leverage. Many hedge fund strategies seek to reduce market risk specifically by shorting equities or through the use of derivatives. Performance of many hedge funds is not dependent on the direction of the bond or equities markets unlike mutual funds which are generally hundred percent exposed to market risk. Many hedge fund strategies, particularly arbitrage strategies, are limited as to how much capital they can successfully employ before returns diminishes. Hedge funds are also limited by the type of partners they can accept and they generally favour high net worth individuals and large institutional investors like pension plans and endowment funds and hence it is limited to few rich individuals and institutional investors.

1.2 KEY FEATURES OF HEDGE FUNDS

- Hedge funds utilize a variety of financial instruments to reduce risk, enhance returns and minimize the correlation with equity and bond markets. They are generally flexible in their investment options and strategies. They can use stocks, bonds, currencies, short selling, leverage, indexes, swaps, derivatives such as puts, calls, options, futures, etc. Since they use non-traditional investment instruments and techniques, if not handled properly, their use can create considerable risk of volatility and loss of capital and therefore these techniques and instruments are not permitted in traditional portfolios such as mutual funds. When used well, they offer cost-efficient and customized hedging and risk control.

- Hedge funds vary enormously in terms of investment returns, volatility and risk. Many, but not all, hedge funds tend to hedge against downturns in the market being traded.

- Many, but not all, hedge funds have an objective consistency of returns and capital preservation rather than magnitude of returns.

- Pension funds, endowments, insurance companies, private banks and high net worth individuals and families invest in hedge funds to minimize overall portfolio volatility and enhance returns.

- Most hedge fund managers are highly specialized and trade only within their area of expertise.

1.3 WHY HEDGE FUNDS?

1. Hedge funds have Outperformed Equity with Low Risks: Hedge funds are often considered as high risk investment strategies and many investors in the past have refrained themselves from them for fear of making losses. Managers of hedge funds have tried to explain that, in fact, this asset class can reduce the risk level of traditional portfolio and this message is becoming much more prevalent. Consultants are now recommending hedge funds for their client portfolios. In the past few years, hedge funds have outperformed equities, with much lower volatility. Worldwide, institutional investors are looking forward to invest in hedge funds because of their performance.
2. Hedge funds offer Downside Protection in Falling markets: The hedge funds improve the overall efficiency of an investment portfolio and this improvement is in both aspects-enhancement of returns and a reduction in risk levels. In the present scenario of volatile nature of the markets, hedge funds have successfully offered positive returns, while the equity indices have fallen significantly. The most unique and positive feature of hedge funds is that it provides positive returns even when market falls unlike in the case of equities.
3. Afford Managers more Freedom to Generate Alpha: The returns on hedge funds have been generally higher than for traditional equity managers for many reasons. The most talented managers are attracted towards hedge funds management because they have increased

investment freedom and they can use their talent in less constrained way. They have enough discretion and flexibility, i.e. they have the ability to sell the stocks as they don't like, as well as buying the stocks they do like. Their compensation is performance based and they are rewarded for good performance and their portfolio benefits from alpha generation (higher added value relative to the market).

4. Hedge Funds offer Significant Portfolios Benefits: The positive contribution to risk control offered by hedge funds comes from a variety of sources. They offer the ability to diversify the pure equity risk and they have low correlation with other asset classes, thus lowering the overall risk of the portfolio. Market neutral strategies can reduce volatility and absolute return strategies should provide downside protection in falling markets. Because hedge funds tend to have low correlation with traditional asset classes, they offer excellent potential for portfolio construction and diversification benefits.

1.4 VARIOUS HEDGE FUNDS STRATEGIES[5]

1.4.1 ***Aggressive Growth***: It is a primarily equity based strategy whereby manager invests in companies experiencing or expected to experience strong growth in earnings per share. The manager may consider a company's business fundamentals when investing or may invest in stocks on the basis of technical factors such as price momentum. Companies in which manager invests tend to

[5] Source: Van Hedge Fund Advisors Int.., 2003, www.vanhedge.com.

be micro, small, or mid-capitalization in size rather than mature large-capitalization companies. Managers employing this strategy utilize short selling to some degree, although a substantial long bias is common.

1.4.2 ***Distressed Securities*:** The manager invests in the debt and/or equity of companies having financial difficulty. Such companies are generally in bankruptcy reorganization or are emerging from bankruptcy or are likely to be declared bankrupt in the near future. Because of their distressed conditions, the manager can buy the securities of such companies at deeply discounted prices. The manager can make huge money if such company successfully reorganize and return to profitability. Also, the manager could realize a profit if the company is liquidated provided that the manager had bought senior debt in the company for less than its liquidation value.

1.4.3 ***Emerging Markets*:** The manager invests in securities issued by business organizations and/or governments of countries with less developed economies that have the potential for significant future growth. Examples are Brazil, China, India and Russia. Most emerging market countries are located in Latin America, Eastern Europe, Asia, or the Middle East. The strategy is defined purely by geography. The manager may invest in any asset class (e.g. equities, bonds, currencies) and may construct his portfolio on any basis (e.g. value, growth, and arbitrage).

1.4.4 ***Fund of Funds*:** The manager invest in other hedge funds rather than directly investing in securities such as stocks, bonds, etc. These underlying hedge funds may employ a variety of investment strategies or may employ

similar approaches. Because investor capital is diversified among a number of different hedge fund managers, fund of funds generally exhibit low risk than do single manager hedge funds. They are also referred as multi-manager funds.

1.4.5 ***Income*:** The manager invests primarily in yield-producing securities, such as bonds, with a focus on current income.

1.4.6 ***Macro*:** The manager constructs his portfolio based on a top down view of global economic trends, considering factors such as interest rates, economic policies, inflation, etc. Rather than considering how individual corporate securities may fare, the manager seeks to profit from changes in the value of the entire asset classes.

1.4.7 ***Market Neutral-Arbitrage*:** The manager seeks to exploit specific inefficiencies in the market by trading a carefully hedged portfolios of offsetting long and short positions. By pairing individual long position with related short positions, market level risk is greatly reduced, resulting in a portfolio that bears low correlation to the market. The manager may focus on one or several kinds of arbitrage, such as convertible arbitrage, risk arbitrage and fixed income arbitrage. The paired long and short securities are related in different ways in each of these kinds of arbitrage but in each case the manager attempts to take advantage of price discrepancies and/or projected price volatility involving the paired long and short securities.

1.4.8 ***Market Neutral-Securities*** Hedging: The manager invests similar amount of capital in securities both long and short, maintaining a portfolio with low net market exposure. Long positions are taken in securities expected to rise

in value while short positions are taken in securities expected to fall in value. These securities may be identified on various bases, such as the underlying company's fundamental values, its rate of growth or the security's pattern of price movement. Due to the portfolio's low net market exposure, performance is insulated from market volatility.

1.4.9 ***Market Timing:*** The manager attempts to predict the short-term movements of various markets (or market segments) and, based on those predictions, moves capital from one class asset to another in order to capture market gains and avoid market losses. While a variety of asset may be used, the most typical ones are mutual funds and money market funds. Market timing managers focusing on these asset classes are sometimes referred to as mutual fund switchers.

1.4.10 ***Opportunistic:*** Rather than consistently selecting securities according to the same strategy, the manager's investment approach change over time to better take advantage of current market conditions and investment opportunities. Characteristics of the portfolio, such as asset classes, market capitalization, etc are likely to vary significantly from time to time. The manager may also employ a combination of different approaches at a given time.

1.4.11 ***Several Strategies:*** The manager typically utilizes two or three specific, pre-determined investment strategies, e.g. Value, Aggressive Growth and Special Situations. Managers may choose to employ a Several Strategies approach in order to better diversify their portfolio and/or to more fully use their range of portfolio management skills and philosophies.

1.4.12 Short Selling: The manager maintains a consistent net short exposure in his portfolio, meaning that significantly more capital supports short positions than is invested in long positions (if any is invested in long position at all). Unlike long positions, which one expects to rise in value, short positions are taken in those securities the manager anticipates will decrease in value. In order to short sell, the manager borrows securities from a prime broker and immediately sells them in the market. The manager later repurchases these securities, ideally at a lower price than he sold them for, and returns them to the broker. In this way, the manager is able to profit from a fall in a security's value. Short Selling managers usually target overvalued stocks, characterized by prices that are too high given the fundamentals of the underlying companies.

1.4.13 Market Timing: The manager invests both long and short, in stocks and/or bonds which are expected to change in price over a short period of time due to an unusual event. Such events include corporate restructurings (e.g. spin-offs, acquisitions), stock buybacks, bond upgrades, and earning surprises. This strategy is also known as event-driving investing.

1.4.14 Values: A primarily equity-base4d strategy whereby the manager focuses on the price of a security relative to the intrinsic worth of the underlying businesses. The manager takes long positions in stocks that he believed are undervalued, i.e. the stock price is low given company fundamentals such as high earnings per share, good cash flow, strong management, etc. possible reasons that a stocks may sell at a perceived discount could be that the company is out of favour with investors or that its future prospects are not correctly

judged by Wall Street analysts. The manager takes short positions in stocks he believed are undervalued, i.e. the stock price is too high given the level of company's fundamentals. As the market comes to better understand the true value of these companies, the manager anticipates, the price of undervalued stocks in his portfolio will rise while the prices of overvalued stocks will fall. The manager often select stocks for which he can identify a potential upcoming event that will result in the stock price changing to more accurately reflecting the company's intrinsic worth.

1.4.15 ***<u>Sector-Specific categories</u>:*** Apart from investment strategy, hedge fund may also be categorized on the basis of the industry sectors in which they invest. While most hedge funds are diversified among several different sectors, some specialize in one sector, devoting 50% or more of their portfolio to such securities.

1.5 <u>TECHNIQUES USED IN HEDGE FUNDS</u>

1. ***<u>Short Selling</u>:*** It involves the technique of sale of borrowed securities considered overvalued in the anticipation of purchasing them later for a profit at lower prices. It is an inherently risky strategy since the most one can make is the amount received when the securities are sold short, yet the loss potential is unlimited.

2. ***<u>Hedging</u>:*** It is a defensive strategy to mitigate risk. Hedging can be likely to purchasing insurance against the likelihood of an unfavourable event. Depending upon the type of risk exposure created by the investment strategy, different types of risk must be hedged, for example currency risk, interest rate risk, political risk,

market risk, company risk. For each type of risk, there are certain hedging techniques and instruments that are appropriate. The talented manager is the one who properly analyzes risk and hedges it most efficiently.

3. ***Arbitrage:*** Arbitrage strategies attempt to exploit temporary price efficiencies or discrepancies between securities or markets. The investment manager uses historical relationship between instruments in different markets to predict future trends or movements in price. An example of risk arbitrage is the purchase of equity instruments from a company that is to be acquired by another and offsetting this with a short sale of the equity instruments of the acquiring company.

4. ***Leveraging:*** It involves borrowing money, either to increase the effective size of the portfolio, or in the form of margin purchasing of, for example, futures contracts or bonds.

1.6 HOW ARE THEY ORGANIZED?

Hedge funds are unregulated pools of money managed by an investment advisor. The hedge fund manager, who has a great deal of flexibility. In particular, hedge fund managers typically have the right to have short positions, to borrow, and to make extensive use of derivatives (from plain vanilla options to very exotic instruments). To avoid the regulations that affect mutual funds under the Investment Company Act, hedge funds must limit the number of investors who can invest and they cannot make public offerings. To bypass registration under the Securities Act of 1933, a hedge fund is restricted to having only "accredited investors consisting of institutional investors, companies, or high net worth individuals who can 'fend for themselves'". In contrast,

mutual funds generally do not have short positions, do not borrow, and make limited use of derivatives.

A hedge fund is typically a collection of funds managed by the hedge fund manager-normally through a separately organized company, the management company. It is a collection of funds because the tax status of investors differs and each fund is designed to optimize taxes for investors. A typical large hedge fund with a U.S. based management company will have an offshore fund for foreign investors and an onshore fund for U.S. investors. The onshore fund is generally a limited partnership if investors are taxed, so that gains and losses flow through to investors and there is no taxation at the fund level. The offshore fund is usually based in a tax haven, such as Bermuda. A common structure is to have the onshore fund and the offshore fund invest in a so-called master fund. The onshore and offshore funds are then called feeder funds.

In the United States, investment advisors with less than 15 clients do not have to register with the Securities and Exchange Commission under the Investment Advisers Act of 1940. The management company in the case of a hedge fund has few clients—only the funds it manages. Consequently, the management company does not have to register with the SEC under the traditional interpretation of “clients." In 2005, the SEC attempted to change this interpretation by making the hedge fund investors the "clients" of the management company, so that the hedge funds management companies would have had to register with the SEC. The courts struck down this interpretation. Many management companies register anyway, perhaps because they believe that registration gives them credibility. Further, hedge funds in which U.S. pension funds invest must have registered management companies

The incentives of hedge fund managers differ sharply from those of mutual fund managers. The compensation contract for mutual fund advisers is restricted by regulation so that the incentive compensation, if there is any, has to be symmetric—essentially, a dollar of gain has to have the opposite impact on compensation as a dollar of loss. As a result, relatively few mutual fund advisers have an incentive compensation clause in their contracts, and the compensation of mutual fund managers depends mostly on the amount of assets under management (Klton Gruber. and Blake, 2003). One of the most famous mutual funds is Fidelity's Magellan fund. The compensation to Fidelity for managing the fund is a fixed fee (0.57 percent for the year ending March 2006) plus an adjustment depending on how the fund performs relative to the Standard & Poor's 500 of up to minus or plus 0.20 percent of assets under management.

In contrast, almost all hedge fund managers have an asymmetric compensation contract that specifies that they receive a substantial fraction of the profits they generate. Alfred Jones reorganized his fund in 1952 as a limited partnership and instituted the rule that the generator managing partner would keep 20 percent of the profits generated by the fund. Typically, hedge fund managers receive a fixed compensation corresponding to 1-2 percent of the net asset value of the fund (or of the limited partners' equity) and 15-25 percent of the return of the fund above a hurdle rate (which can be the risk-free rate). The typical compensation contract of a hedge fund manager makes extremely high compensation possible if the investors experience large returns. In 2005, at least two managers had compensation in excess of $1 billion: James Simons of Renaissance Technologies earned $1.5 billion and Boone Pickens earned $1.4 billion. The 2005

Hedge Fund Compensation Report states that "the average take-home pay of the top 25 hedge fund earners in 2004 was over $250 million."

Generally, the compensation of hedge fund managers has a so-called "high water" mark—if the managers make a loss in one period, they can get the performance fee only after they have recovered that loss. The high water mark limits the risk taking of the fund. Without it, the manager gets all the upside from big bets but suffers little from the downside. With a high water mark, though, the manager may just close the fund if it makes a big loss. As long as the fund manager does not have a large investment in the fund, it is not always easy to resist the temptation to take large risks. As an example, the trader apparently responsible for the large losses at Amaranth in 2006 is reported to have earned between $80 million and $100 million there in 2005. As long as no illegal actions took place, the trader will not have to return his past compensation to the fund—in fact, he is planning to start a hedge fund of his own.

Investors in mutual funds typically can withdraw funds daily. Thus, mutual funds must have some low-earning cash on hand. It is risky for mutual funds to invest in strategies that may take time to prove profitable, because adverse developments in the short run may lead investors to withdraw their money. Hedge funds have rules that restrict the ability of investors to withdraw funds; for instance, a hedge fund might allow investors to withdraw at the end of a quarter provided that they give a 30-day notice. Depending on the fund, an investor may not be allowed to withdraw an initial investment before a period of several years. Eton Park Capital, a fund launched in 2004 by a star Goldman Sachs trader, Eric Mindich, raised S3 billion even though investors had to commit to keep their money in the fund for at least three years.

Mutual funds have to disclose a lot of information to investors. They have to report their holdings to the Securities and Exchanges Commission (SEC) and must have audited statements.[6] Hedge funds may agree contractually to disclose some types of information and to provide audited financial statements, if they decide that it helps them to recruit investors, but they are not required to do so. For instance, referring to the Long Term Capital Fund (often referred to as LTCM, which stands for Long-Term Capital Management, the company which managed the fund), Lowenstein (2001, p. 32) states: "Long Term even refused to give examples of trades, so potential investors had little idea of what they were doing." The Long Term Capital Fund, founded in 1994, was spectacularly successful until the middle of 1998 (in 1995-1997, the fund's average yearly return net o f fees was 33.4 percent). Its managing partners were star traders and academics. It had capital of $4.8 billion and assets of $120 billion at the beginning of 1998. In the aftermath of the Russian crisis in August 1998, the fund lost almost all its capital in one month. Secrecy does help hedge fund managers protect their strategies from potential imitators; on the other hand, secrecy makes it harder to assess the risk of a fund.

In the past, investors typically invested in individual hedge funds. Investors who want to invest in a hedge fund usually have to commit a large amount of money— often at least $1 million ($5 million in the case of the Eton Park fund mentioned earlier). Since individual hedge funds can be highly risky, diversification can reduce risk, but diversification across hedge funds for a single investor requires a very large amount of

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[6] Since 1978, all institutions with over $100 million must report stock holdings in excess of $200,000 or holdings of more than 10,000 shares. Hedge funds are not exempt from this requirement The requirement does not apply to derivatives and short positions. Further, institutions can ask that their positions be kept confidential for one year and hedge funds have been known to do so aggressively.

investable wealth. Further, because hedge funds are unregulated, an investor has to investigate a hedge fund thoroughly before investing in it. It is quite expensive for funds that are not well-established—$50,000 is a frequently heard price tag for due diligence for an investor who ends up investing in the fund.[7] The process starts with the investor asking questions to the fund manager. Some questions might be answered; some might not. A personal visit might follow. The investor will also check through other means whether the manager is reliable. In some cases, investors hire an investigative firm.

Many investors now invest in funds-of-hedge-funds, rather than in individual hedge funds. A fund-of-funds is a hedge fund that invests in individual hedge funds and monitors these investments, thereby providing investors a diversified portfolio of hedge funds, risk management services, and a way to share the due diligence costs with other investors. The compensation of fund-of-funds managers also has a fixed fee (typically 1 percent) and a performance fee (typically 10 percent above a hurdle rate). At the end of 2004, 30 percent or more of funds invested in hedge funds were managed by funds-of-funds.

1.7 WHAT DO HEDGE FUNDS DO?

Arbitrage takes advantage of price discrepancies between securities without taking any risk. Most hedge funds attempt to find trades that are almost arbitrage opportunities—pricing mistakes in the markets that can produce low-risk profits. Once hedge funds have identified an asset that is mispriced, they devise hedges for their position so that

[7] Due diligence in this context is an investigation or audit of the hedge fund to establish that the hedge fund is what it represents itself to be and that the risks of investing in the fund are properly understood.

the fund will benefit from the correction of die mispricing but be affected by little else. To take an example, Long-Term Capital Management specialized in identifying bonds that were mispriced. It would sell overvalued bonds short and hedge its position against interest rate risk and, if necessary, other risks. In principle, the return of the fund would depend only on the corrections in the mispricing of the bonds, not on changes in interest rates. Of course, not all positions hedge funds take are hedged, either because of high costs or because of intrinsic difficulties in hedging against some risks.

Because hedge funds seek inefficiencies in the capital markets and attempt to correct them, they can play a valuable role in financial markets by bringing security prices closer to fundamental values. However, little direct evidence exists on the extent to which hedge funds have this effect. Several hedge funds are known to account individually for several percent of the trading volume of the New York Stock Exchange. Some funds have also been accused of making money in questionable ways: for instance, by exploiting insider information or by late trading in mutual funds.

Mutual funds cannot contribute to making financial markets more efficient as effectively as hedge funds can: mutual funds are limited in their ability to hedge their positions through shore-sales and derivatives use; they are subject to diversification restrictions that constrain their ability to exploit perceived opportunities; and they must redeem shares on short notice. In contrast, derivatives and short positions are critical in most hedge fund strategies and enable hedge funds to reduce mispricings more forcefully than mutual funds. For, instance, if a mutual manager concludes that firm A is valued too richly compared to firm B which is in the same business, that manager will typically buy more of firm B and less of firm A. In contrast, a hedge fund manager

would react to a belief that firm A is overvalued compared to firm B by buying firm B and selling firm A short. With this strategy, the hedge fund portfolio will not be affected by changes in the market as a whole—or even in the industry. If the stock market drops sharply, the mutual fund would lose, but the hedge fund would not. Until 1997, the tax code made short sales extremely expensive for mutual funds, but it no longer does. As a result, the binding short-sale restriction for mutual funds is a restriction that funds put on themselves—in 2000, two-thirds of reporting mutual funds prohibited short sales (Almazan, Brown, Carlson, and Chapman, 2004).

With their focus on arbitrage opportunities, hedge funds in principle pursue absolute returns rather than returns in excess of a benchmark, such as an index of the stock or bond markets. In principle, this approach tends to make hedge funds market-neutral over time: that is, hedge funds are expected to have average performance whether equity markets have extremely good or bad performance. It is therefore not surprising that hedge funds performed well when U.S. equity markets registered sharp losses in the wake of the collapse of Internet stocks. Many investors tend to extrapolate from past returns, so it is not surprising that investors were attracted to hedge funds when they performed so well compared to stocks. Also, hedge funds appear an attractive diversification vehicle for investors who hold stocks. However, correlations of hedge funds with the broad markets have increased, so that evaluating the diversification benefits of hedge funds has become trickier {Garbaravicius and Dierick, 2005) .Some hedge funds, may have effectively become mutual funds; that is, an investor in such a fund is paying hedge fund fees for mutual fund risks and returns.

Investment in a hedge fund is a bet on the skills of the manager to identify profit opportunities. A managers' strategy may be complex and difficult to communicate. In addition, the manager has incentives not to communicate too much— otherwise investors might not need the manager. Further, it is possible for a strategy to make losses before it eventually pays off. Viewed from this perspective, it is easier for professional investors than for others to evaluate hedge fund strategies and the skill of managers. Such investors are less likely to misinterpret short-term losses as evidence of poor skills on the part of the manager. When investors do not understand these strategies, they may withdraw their funds when they make losses and force managers to liquidate their positions at a loss. Therefore, hedge funds will seek both restrictions on redemptions and investors who are knowledgeable. It is not unusual for a hedge fund to reject potential investors, which would be unheard of for a mutual fund.

Hedge fund investment strategies are classified into style categories. One way to measure the popularity of the styles is to measure the funds under management for a style relative to the sum of the funds under management. According to the Tremont Asset Flows Report (Second Quarter, 2005), the four most popular styles and their strategies are: long-short equity (31 percent of total); event-drive (20 percent); macro (10 percent); and fixed-income arbitrage (8 percent).

A long-short equity hedge fund takes both long and short positions in stocks. The fund started by Alfred Jones was a long-short fund. These funds tend to hedge their positions against market risks. For example, a hedge fund of this type might have only long positions in stocks but use options and futures contracts so that fund returns will be

unaffected by changes in the market as a whole. A typical strategy is to identify undervalued and overvalued stocks.

Event-driven hedge fund strategies attempt to take advantage of opportunities created by significant transactional events, such as spin-offs, mergers and acquisitions, reorganizations, bankruptcies, and other extraordinary corporate transactions. Event-driven trading attempts to predict the outcome of a particular transaction as well as the optimal time at which to commit capital to it.

Macro hedge fund strategies attempt to identify mispriced valuations in stock markets, interest rates, foreign exchange rates, and physical commodities and make leveraged bets on the anticipated price movements in these markets. To identity mispricing, managers tend to use a top-down global approach that concentrates on forecasting how global macroeconomic and political events affect the valuations of financial instruments.

Fixed.-income arbitrage hedge funds attempt to find arbitrage opportunities in the fixed-income markets.

Another 13 percent of the amount invested in the hedge funds is invested in multi-strategy funds. Other strategies involve emerging markets funds, funds that trade futures contracts, and convertible arbitrage funds (convertible debt is debt convertible into stock and these funds exploit mispricings in the debt relative to the stock).

The arbitrage opportunities identified by hedge funds are often small. As a partner of Long-Term Capital Management put it before the fund collapsed[8], their strategies amounted to vacuuming pennies—though others have described hedge fund strategies as picking up pennies in front of a steamroller. Many hedge funds use leverage, both to

[8] Mentioned in later part of the research work.

take advantage of more investment opportunities and to increase the return on the funds invested. To illustrate, if a hedge fund starts with equity of $100 million invested in a strategy that earns $5 million, its return on equity is 5 percent However, if the fund borrows an additional $300 million to take advantage of three similar strategies and the cost of borrowing is $2 million per $100 million, its return on equity becomes 14 percent on the original $100 million invested (the income becomes $14 million, or $5 million + 3 x $3 million). The LTCM fund had an extremely high degree of leverage—more than $20 of assets were supported by a dollar of equity capital. The typical hedge fund has much lower leverage—a dollar of equity supports two or three dollars of assets. Mutual funds do not have the same ability to use leverage without restrictions.

Chapter 2

In this chapter, the researcher will discuss the Long Term Capital Management debacle which brought the issue of regulation of hedge funds to the forefront. Since the entire issue of regulating hedge funds all over the world, especially, in the United States of America, gathered momentum with the Long Term Capital Management debacle, it would be prudent to discuss this debacle and consequent legislative and non-legislative response to it.

2.1 THE EMERGING ISSUES

If the current scenario of hedge fund is analyzed, it will be found that investors are staying away from the hedge funds. The pessimism surrounding the hedge fund is becoming global phenomenon gradually. Many institutional investors are not willing to invest in them. According to Deutsche Bank survey[9] released in January 2003, hedge fund performance versus the fund manager fees, transparency of investing strategies and risk versus returns are the still biggest issue for investors. Since the functioning and strategies adopted by hedge funds is generally shrouded in secrecy, there is lack of transparency which makes the investors less confident when it comes to investing in hedge funds. Some investors are reluctant to invest in hedge funds because of the high fees charged by the hedge fund managers which are very exorbitant as compared to fees charged by the mutual fund managers. Since the strategies are not publicly known, investors also complain that the 'beta'[10] of hedge fund portfolios seems to be manipulated. As a large portion of securities of these funds is illiquid at any given point of time, such betas misled investors. Another issue with hedge funds is that they provide little diversification values. Another important issue for investors is that hedge funds are largely unregulated and hence investors can easily be manipulated. Further, since they are not subject to disclosure norms and investors protection guidelines, risks in them are very very high; investors may not have material information at their disposal in order to make sound investment decisions in hedge funds.

There is another strong reason why investors are staying away from hedge funds. Few collapses of hedge funds in the recent past have shocked the entire world and have

[9] Deutsche Bank, Alternative Investment Review, January 2003.

[10] Beta shows The Market Risk Exposure, Higher the Beta, Higher the Risk and vice versa.

served as a classic example for understanding the risk of investing in hedge funds. One of them is Long Term Capital Management[11] (LTCM) debacle in 1998, whose team members included two Noble laureate economists, shocked the whole world[12]. More recently, the collapse of mortgage arbitrage fund, Beacon Hill (which was closed with $400 million of losses in October 2002) after revelation of portfolio has made investors aware of the risks of investing in these opaque instruments. The collapse on January 15, 2003 of Japanese hedge fund Eifuku was another remainder to the investors on the capricious world of hedge funds. After returning 76% in 2002, the $300 million fund lost 15% of its capital in the first two trading days.

2.2 LONG TERM CAPITAL MANAGEMENT DEBACLE AND RESPONSE

The entire episode of regulating hedge fund started with the Long Term Capital Management debacle which shocked the entire world. A brief study of LTCM debacle and the governmental and non-governmental response to it is very indispensable to make the study on hedge funds comprehensive.

2.2.1 BACKGROUND

LTCM is a Delaware limited partnership formed in 1994 and is based in Connecticut, Greenwich. It is the investment advisor to Long Term Capital Portfolio, LP. From its beginning LTCM was considered as unique among hedge funds because of the reputation of its principals, the size of its internal capital stake and large scale of its

[11] Hereinafter referred to as LTCM.
[12] It is discussed in greater details in later part of this article.

investment activities. LTCM's portfolio was very large and so its risk. Approximately 80 percent of LTCM's balance sheet positions were in treasury securities of the major industrial nations. However, balance sheet leverage is not an adequate measure of LTCM's market risk because it does not include off-balance sheet activities such as the use of derivatives, which LTCM used extensively to achieve leverage. As of August 31, 1998, LTCM had approximately U.S. 1.4 trillion in notional value of derivatives off-balance sheet. LTCM was able to achieve such an unusually leveraged risk posture because LTCM's creditors and counterparties failed to enforce their own risk management standards. LTCM's size and leverage, as well as the trading strategies it followed, made it vulnerable to the extraordinary financial market conditions that emerged following Russia's devaluation of the rubble and declaration of debt moratorium on August 17, 1998. The trading strategists of LTCM failed to anticipate the gravity of Russian crisis and the possible impact it could have on financial markets all around the world. However, the Russian crisis led to "flight to quality" in which investors avoided risks and sought out liquidity. As a result, risk spreads and liquidity premium rose sharply in markets around the world, confounding the risk management models employed by LTCM and other market participants. This implies that LTCM's strategy failed miserably probably because of its casual view towards Russian crisis and its impact on the world financial markets. As a result, LTCM suffered losses in different markets and its losses were more severe probably because LTCM's diversification was geographic rather than based on different strategies; thus, the simultaneous shocks to many markets confounded its expectations of relatively low correlations between market prices and revealed that its global trading strategies was

less diversified. Had its trading strategies more diversified, its actual loss would have been much less than what it was. LTCM's losses caused its principals on August 24, 1998 to launch a capital raising campaign. By September 1998, LTCM has lost over fifty percent of its equity and then on September 18, 1998, it invited U.S Federal Reserve Board officials to LTCM's offices in Greenwich, Connecticut for a presentation on its position. The Federal Reserve officials after gauging the gravity of the problems contacted LTCM's largest creditors (Goldman Sachs, Merrill Lynch and J.P Morgan) to discuss the situation. These calls ultimately led to the creation of consortium of 14 banks and securities firms that recapitalized LTCM. The Consortium acquired 90% ownership and operational control of the LTCM fund, leaving the original owners with a 10% equity stake. To acquire their stake, the consortium firms contributed U.S. $ 3.6 billion in new equity to the fund and took on the responsibility and burden of resolving LTCM's difficulties. The counterparties and creditors to LTCM also supported this move and ultimately LTCM was bailed out.

The Federal Reserve's decision to facilitate the private sector recapitalization of LTCM was based on its concern that LTCM's failure might pose systematic risk and its collapse would have great serious effects on the world markets and its abrupt and disorderly close out would pose unacceptable risks to the world economy. Further, Federal Reserve was of the view that LTCM's close out may negatively affect the market participants with no connection to LTCM and there was also fear that spread of losses among other market participants and counterparties to LTCM would result in tremendous uncertainties about how far prices would move[13]. Again at the time of

[13] LTCM estimated that its top 17 counterparties alone would suffer losses in the aggregate between U.S. 4 3 billion to U.S. $ 5 billion, with individuals firm losing as much as U.S. $ 500 million.

LTCM crisis, the world wide investors had already reached low ebb because of Russian crisis. During the months preceding LTCM's bailout, interest rate spreads had widened substantially, while equity markets around the world has suffered great decline. The level of economic uncertainty was rising while liquidity was declining. Further, many major market participants had already suffered significant trading losses and were anxious to avoid further losses. In such circumstances, a default by LTMC could have had great adverse effects on American economy. It would also have raised cost of capital to American businesses and households.

2.3 THE RESPONSE

*I*n reaction to LTCM debacle, several groups, governmental and non-governmental, conducted studies to determine the root cause of its debacle and the systemic risks associated with it and to develop and recommend safeguards against the risk posed thereby. Herein below are the brief studies of some of the groups.

2.3.1. ***The Working Group Report***[14]: The Working Group, headed by Mr Robert Rubin, US treasury Secretary, report was issued in April, 1999. The Working Group Report includes a detailed survey of the hedge fund industry, including its trading practices, credit extension practices and the disclosure and monitoring to which it is subject. The Group was of the opinion that the LTCM event and the systemic risk it presented was due to excessive leverage resulting from the failure of the LTCM's creditors to follow sound credit risk management practices. The Group found that

[14] It is also known as "Report on Hedge Fund, Leverage and the Lessons of Long Term Capital Management".

LTCM received generous credit terms in spite of existing sound credit policies because the pressure to generate profits caused deviations from such policies; some of the LTCM's creditors and counterparties were not aware of the LTCM's risk profile and did not adequately contemplate the market and liquidity risks that would have arisen had LTMC defaulted; and prosperous economic conditions also contributed to inadequate review and excessively liberal credit terms. The Group found that LTMC was able to accumulate large positions because of weak credit risk management. The working group noted that problem of excessive leverage was not limited to hedge funds, as other financial institutions, including some banks and securities firms are generally more highly leveraged than hedge funds. The Working Group did not favoured direct and strict regulation of hedge funds and expressed trust in the effectiveness of private market discipline. The Working Group made some recommendations but at the same time it concluded that the self-interest is so paramount that lessons of LTCM will fade in time. Its recommendations are: Improved transparency through enhanced disclosure to the public; Public companies to disclose their direct material exposures to significantly leveraged financial institutions and such disclosure should include analysis of how exposures are measured, a description of the quality and diversity of such exposure and be included in such companies periodic reports to the Securities and Exchange Commission; Banking, Securities and futures regulators should monitor and encourage improvements in the risk management systems of regulated

entities; Private sector suppliers of credit must improve their risk management practices and financial institutions must continuously review their risk management procedures and as a group, financial institutions should draft and publish enhanced standards for risk management, including certain important criteria for estimating potential future exposures and developing appropriate measures of leverage and risk to publish such standards; regulators should develop a more risk-sensitive approach to capital adequacy; Regulators should be granted expanded risk assessment authority for unregulated affiliates of the entities they regulate. The Working Group declined to recommend the direct regulation of unregulated hedge funds or derivatives dealers based on the concerns that such regulation would drive entities offshore, curtailing the effectiveness of such regulation, and would not be cost effective.

2.3.2 ***The Improving Counter Party Risk Management Practice Report***[15]: This report was issued in June, 1999. The CPRMPG is a group of 12 internationally active commercial and investment banks which undertook a study of comprehensive study of counterparty credit and market risk management practices in the wake of the LTCM crisis with the goal of improving such practices. The CPRMPG Report includes a comprehensive and technical review of key risk management issues and it is a comprehensive guide to strong risk management practices and this report is a substantial evidence of private sector efforts to reduce systematic risk. The few of its important recommendations are: Reporting on an informal basis

[15] Herein after referred to as CPRMPG.

by financial intermediaries with significant counterparty credit or market risk to their primary regulators of their principal risks potential systemic hazards; Implementations of significant enhancements to information sharing between counterparties, as better knowledge of one's counterparty represents the foundation upon which the other pillars of risk management rest; Undertaking a systematic evaluation of the integrated elements of market, liquidity and credit risk factors; Significantly enhancing the quality of risk information, both for the firm's senior management and Board of Directors, as well as, potentially for the regulatory authorities. The Report further sets forth: specific information financial institutions should request of hedge funds; methods of maintaining and using such information; methods for measuring market, credit and liquidity risk; standards for managing credit; guidance on international information flows; documentations policies and practices; and suggestion for regulatory reporting.

2.3.3. ***<u>The GAO Report</u>***[16]*:* The GAO report was issued in October 1999. It was based on a variety of articles, studies and surveys, including the Working Group Report and CPRMPG Report. It agreed with the finding of the Working Group Report that LTCM was able to build its leveraged positions to such a big size because the banks and securities and futures firms that were its creditors failed to enforce their own risk management standards. The GAO also looked at the failure of the financial regulators to detect and

[16] The Report is also known as "Long Term Capital Management: Regulators Need to Focus Greater Attention on Systematic Risk". It was U.S. Representative Edward Markey and U.S. Senator Byron Dorgan who requested the GAO to review LTCM's near collapse and the issued it raise.

prevent the problem from reaching the severity it did. It found that regulators too heavily relied on faith that creditors and counterparties were appropriately constraining hedge funds generally from taking on excessive leverage and risk. The report cited Federal Reserve Chairman Alan Greenspan's testimony before the Banking and Financial Services Committee just days before the LTMC bailout that "hedge funds are strongly regulated by those who lend the money". The GAO report said that the cause of the failure was the traditional focus by regulators on the risk management practices of individual firms and markets, rather than risks presented by interrelationships across each industry (i.e. banking, securities and future industries). The GAO Report concludes that regulators failed to identify lapses in risk management practices with respect to LTCM because they limited focus to problems involving the largest credit exposures of regulated firms. LTCM was not among the largest exposures of regulated firms. The GAO Report concluded that the regulatory gap combined with the failure of each regulatory agency to focus on the larger picture contributed to the agencies' failure to perceive the systemic risk that was building. It found that there was no coordination among the major regulators (the Federal Reserve, the Securities and Exchange Commission and the CFTC). It recommended coordination among all the regulatory bodies especially when there is a great degree of cross-industry risks as a result of the cross-industry activities of major firms. It concluded that the LTCM crisis showed the traditional focus of federal financial regulators on

individual institutions and markets is not adequate to identify potential systemic threats that cross such institutions and markets. It recommended that risk assessment authority of the SEC and the CFTC must be enhanced, particularly with regard to the unregulated affiliates of the regulated entities and most importantly it recommended better coordination among all the major regulators.

2.3.4. ***The International Organisation of Securities Commissions[17] Report(IOSCO) Report:*** This report is the work of an IOSCO task force that was created in response to LTCM debacle and charged with determining what measure might be advisable to reduce the systemic risk raised by the activities of Highly Leveraged Institutions[18].The IOSCO Report made recommendations regarding strengthening risk management practices at securities firms that act as counterparties to HLIs, guidance to securities regulators on scrutinizing and encouraging regulated firms to adopt sound practices, and improving the transparency of HLIs. The Report places particular emphasis on the importance of obtaining detailed and timely information from HLIs while acknowledging the burden it places on counterparties because of opacity typical of HLI operations. While giving importance to transparency, the Report said that improved risk management practices are alone not sufficient to effectively reduce and control systemic risk and that some degree of increased transparency is required. The Report

[17] Hereinafter referred to as IOSCO Report. The Report is called "Report on Hedge Funds and other Highly Leveraged Institutions".
[18] Hereinafter referred to as HLIs.

further said that some level of public disclosure from HLIs themselves is called for and the current international regulatory environment is conducive to such a change.

2.3.5 ***The Hedge Fund Group Report***[19]: This Report was issued in February, 2000. The Group was set up in response to the Working Group recommendation that a group of hedge fund should draft and publish a set of sound practices for their risk management and internal controls. The recommendation was from the perspective of hedge fund manager rather than the counterparty risk provider. The Report said that its recommendations are not to be strictly applied to all hedge funds but its recommendations are to be applied based on a fund's size, complexity, investment strategy and resources. According to Hedge Fund Group, a hedge fund manager's senior officer must take the responsibility for defining specific investment objectives and risk parameters; Manager must manage risk according to the interplay between market, credit and liquidity risk; Managers must develop periodic reporting practices with counterparties; Managers should work in close coordination and cooperation with regulators to reduce systemic risk while preserving the confidentiality of proprietary information; Managers should develop with counterparties and regulators a broad consensus on public disclosure; Managers should develop standardised transaction documentation with counterparties.

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[19] The report is a called "Report on Sound practices for hedge fund Managers".

2.3.6 ***The Basel Report:*** [20]The Report was issued in January 1999. It sets out recommended risk management practices for banks in connection with trading and derivative activities with highly leveraged institutions (HLIs). The Basel Committee highlighted the need for improvements in credit standard. The Basel Committee defined HLIs as " large financial institutions that are subject to very little or no direct regulatory oversight as well as very limited public disclosure requirements and that take on significant leverage." Hedge funds are cited as the primary, if not exclusive, examples of such institutions, although Basel Report acknowledges that many hedge funds are not highly leveraged. The Basel Committee reviewed banks' treatment of HLIs and identified weaknesses in credit risk management practices, including an over reliance on collateralisation, In-sufficient in-depth credit analysis of HLI counterparties and failures to strictly adhere to credit management standards in the face of competitive pressure. The Basel Committee recommended that banks should ensure that adequate level of risk management in place; such risk management should include an effective credit approval process which thoroughly analyses counterparty's risk profile and addresses; Bank should have proper credit risk assessment; Banks should engage in frequent and ongoing risk monitoring.

[20] The report is known as " Report on Sound Practices for Banks' Interaction With Highly leveraged Institution"

2.4 LEGISLATIVE RESPONSE

After the debacle of LTCM, two bills were introduced before congress in response to the near collapse of LTCM.

2.4.1 ***The Baker Bill***: On September, 23, 1999 Representative Richard Baker introduced a bill to enact the "Hedge fund Disclosure Act 2000" to make certain public disclosures. The Bill defines the unregulated hedge funds to any pooled investment vehicle, or any group or family of pooled investment vehicles, with aggregate total assets of U.S. $3 billion or more aggregate net assets of U.S. $1 billion or more, and to require comprehensive financial information-including a complete set of financial statements prepared in accordance with generally accepted accounting principles and measures of off-balance sheet exposure. The baker Bill requires disclosure of the financial information and measures of risk despite the findings that most hedge funds investors are highly sophisticated, that market forces, rather than government regulations, are the best tool for constraining hedge funds from engaging in excessive leverage, and that market forces are the most effective means of disciplining financial institutions that allows hedge fund. The Bill states that it is the sense of congress that there should be disclosure by all public companies of a summary of direct material exposure to significantly leveraged institutions. Apart from disclosing financial information by those HLIs that meets the threshold limit which will be disclosed to the public, the bill also provided for reporting of such other information as the Federal Reserve, the

SEC, Commodity and Futures Trade Commission (CFTC)[21] and federal banking agencies may require by regulation, although provision was made for "proprietary information concerning investment strategies and positions" to be kept confidential.

2.4.2 ***The Markey/Dorgan Bill:*** On November 19, 1999, Representative Edward J. Markey and Senator Byron Dorgan introduced bills to enact the "Derivatives Market Reforms Act 1999". The Markey/Dorgan bill is considerably more expansive than the Baker Bill in that it includes, among other things, registration and/or reporting requirements for "Derivatives Dealers". Under the Bill, "unregistered hedge fund" is defined as any pooled investment vehicle, or a group or family of pooled investment vehicles that has total assets under management of U.S. $ 1 billion or more and is exempt from registration under the U.S. Investment Company Act, 1940[22]. Unregistered hedge fund would be required to file quarterly reports with the Securities and Exchange Commission that includes the following information: a statement of financial condition, a statement of income or loss for the quarter, a statement of cash flows, a

[21] Hereinafter referred to as CFTC.

[22] Hedge funds are excepted from the definition of investment company under the Investment Company Act 1940 as amended by reason of Section 3(c)(1) and Section 3(c)(7) there under. The Investment Company Act, 1940 requires investment companies to have an independent board of directors which exercises control over investment strategies and operations. A board is independent if at least sixty percent of its members are external. Investment Companies also face certain control or prohibitions over certain types of transactions, such as those with affiliates businesses, and the extent to which they can use leverage and derivatives, all of which can have a substantial impact on their investment strategies. Mutual funds, for example, are investment companies. However, hedge funds are exempted from the operation of the Act: the rationale being that the law is involved to protect investors from exploitation, but very high worth individuals who invest in risky ventures are well placed to make their own investment choices and defend their own interests. It must here also be noted that U.S. Securities Act, 1933 also affects hedge funds in several ways; it substantially reduces disclosure requirements for them; it prohibits them from advertising directly; and it restrict investment in them to very rich. However, the hedge funds are required to provide material information to their about their securities. But there is no requirement to provide information publicly or provide detail on investment strategies or positions.

statement of changes in equity; a description of the models and methodologies that each pooled investment vehicle used to calculate asses, and evaluate market risk; other information that the SEC, in consultation with the Treasury, Federal Reserve, CFTC and other regulatory agencies, may require, including information regarding sudden changes in the pooled investment vehicle's net asset value, leverage ratio, and the total notional amount of exchange traded and over the counter derivative positions. In the Markey/Dorgan Bill threshold limit is lower as compared to the Baker Bill and hence it would be applicable to large number of hedge fund. The Markey/Dorgan Bill includes additional provisions directed at financial regulators. It extends a provision of the Market Reform Act 1990 requiring Treasury, the Federal Reserve, the SEC and CFTC to submit annual reports to congress on, among other things, their efforts to coordinate their regulatory activities to ensure the integrity and competitiveness of U.S. financial markets. The Markey/Dorgan bill also amends the SEC's risk assessment authority under the Market Reform Act to enhance the agency's ability to obtain derivatives and other financial information from unregistered affiliates of broker-dealers, and require the SEC to issue Large Trader Reporting Rules so that it can monitor the activities of hedge funds and other large traders in the equities markets.

2.5 STATUTORY REGULATIONS IN THE US

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 (Investment Act). However, Hedge Funds generally rely on one of two statutory exclusions from the definition of "Investment Company" which enables them to avoid the regulatory provisions of the Investment Act. Section 3(c)(1) of the Investment Act, 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 Act excludes from the definition of the investment company any issuer whose outstanding securities are owned exclusively by persons who at the time of acquisition of such securities are "qualified purchasers" (high net worth individual) and which is not making and does not at the time propose to make public offering of its securities. Though a hedge fund relying on this provision may accept an unlimited number of qualified purchasers for investment in the fund, but in practice, however, most funds refrain from signing up more than 499 investors in order to avoid the registration and reporting requirements of the Securities Exchange Act,1934 (Exchange Act).

The Exchange Act contains the 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 assets tests of section 12 (g) and related rules. Section 12(g) and rules 12 (g)(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 under the Exchange Act. Registration of a class of equity security subjects domestic restraints 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. To avoid registration most hedge funds have not more than 499 investors affiliated to a particular fund. The Beneficial ownership reporting rules under sections 13(d) and 13(g) of the Exchange Act generally requires that any person who beneficially owns greater than 5% of the class of equity securities, file a beneficial ownership statements (schedule 13D or 13G). 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 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 10% 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"). Upon becoming a reporting person, a person is required by section 16(a) to file an initial report with the SEC disclosing the amount of his or her beneficial ownership of all equity securities of the issuer and also any subsequent changes thereafter. Hedge

funds are also subject to the short swing profit provisions of section 16 (b) of the Exchange act.

The Investment Advisors Act, 1940s (Advisors Act) regulates the actions of investment advisers. Many hedge fund advisors, however, avoid registering with the SEC by relying on the Advisors Act de minimis exemption under section 203(b) by having fewer than 15 clients during the preceding 12 months, For the 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.

Investment advisors that are exempt from registration nevertheless are subject to the antifraud provisions of the Advisors Act. But it is pertinent to know that many hedge fund managers due to market competition do register with the commission voluntarily because the investors demand it. The SEC's attempt in December 2004 to require hedge fund managers to register under the Advisers Act failed when it was challenged in court and the SEC was asked to review the requirement (Philip Goldstein v SEC (2006).

The Employee Retirement Income Security Act (ERISA) plans are very alluring from the point of investment and some hedge fund advisors accept regulations under the ERISA in order to have an access to ERISA pension funds. An investment advisor to a hedge fund is an Employee Retirement Income Security Act (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 is deemed to be significant (25%), a benchmark that many hedge funds want to keep under. Generally, hedge fund adviser can shield ERISA plan fiduciaries from liability for its misconduct by registering as an investment adviser under the Advisers Act, and by

qualifying as an "investment manager" under ERISA. Before investing plan assets in hedge fund, however, the non-advisor ERISA plan fiduciary typically will require assurances from hedge fund advisor that it will not be liable under ERISA for any misconduct on the part of the hedge fund adviser in managing plan assets.

The Commodity Futures Trading Commission (CFTC) provides hedge fund advisors exemptions from Commodity Pool Operator (CPO) and Commodity Trading Advisors (CTA) registration. Though they are required to keep the books of record, but can avoid disclosure, periodic reporting or audit requirements that apply to a registered CPO/CTA. 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 and that sell interests to highly sophisticated pool participants. Investment advisors to Hedge funds that operate in reliance upon Section 3(c)(7) of the Investment Act may be able to rely upon one of these CFTC exemptions. Like the Advisors Act's de minimis exemption CEA also provides a similar de minimis exemption from CTA registration.

Sections 352 of the USA Patriot Act require every "financial institution" to establishan anti-money laundering program that meets certain minimum requirements, especially related to 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.

Chapter 3

In this chapter, the researcher will focus on various regulatory mechanisms available in some of the European Countries to regulate hedge funds in their respective jurisdictions. Here, writer will focus on legal, regulatory, and tax issues in various European Jurisdictions.

3.1 *INTRODUCTION*

The rules on private placements of unregulated offshore funds, including hedge funds, are not, unlike those for retail funds sold under the UCITS passport, consistent across Europe. Each jurisdiction has its own rules on the numbers of potential investors who may be approached, the manner in which a solicitation may be made and the nature of investor who may be allowed to invest. In addition, the taxation of investors in these funds varies in extent and application.

This chapter explores the different legal, regulatory and taxation regimes in six of the major European jurisdictions: France, Germany, Italy, the Netherlands, Spain and Switzerland. It is a collaboration of the member firms of the Landwell network of law firms on legal and regulatory issues and Pricewaterhouse Coopers on taxation matters, respectively as to the legal and regulatory issues and taxation. For the purposes of this article, a hedge fund is "a fund established for institutional and high net worth investors in an offshore jurisdiction as an open-end fund and which uses the services of a prime broker, investing both long and/or short, including on a leveraged basis, in anything, e.g. shares (both listed and unlisted), debt securities, currencies, commodities and derivatives".

3.2 *LEGAL AND REGULATORY ISSUES*

3.2.1. FRANCE-

3.2.1.1 Defining Private Placements

The provisions governing private placements in France have changed since 1998. Private placements involve the issuance or the sale of financial instruments (as defined

in the French Finance Act 1996) to "Qualified Investors" (*investisseurs qualifies*) or to a limited circle of investors (*cercle restreint d'investisseurs*), provided that these investors act on their own account. A "Qualified Investor" is a legal entity capable of understanding the risk related to transactions in financial instruments. Qualified Investors are, in particular, credit institutions, financial companies, UCITS, investment companies, venture capital companies, commercial companies with a consolidated balance sheet or single balance sheet for the last financial year greater than 1 billion FF, and companies owned to at least 99 per cent by a Qualified Investor.

A limited circle of investors are constituted by persons who are not Qualified Investors and who have personal relationships (either professional or familial) with the directors or managers of the issuer. If the number of investors in this category is less than 100, the transaction is deemed to constitute a private placement.

3.2.1.2 ***Approval By The French Ministry Of Economy And Finance***

Decree number 89-938 dated 29 December, 1989 regulating financial relationships with foreign countries requires the prior approval by the French Ministry of Economy and Finance (MEF) for the placement in France of:

- Securities issued by a non-OECD resident; or
- UCITS which are not registered in an E.U. Member State.

Therefore before a private placement can be made to the persons described above, the MEF's approval must be sought. The following general conditions must be met to obtain MEF's approval:

- Security: the fund must implement a risk- spreading policy.

- Transparency: the French regulatory authorities will assess the information given to the potential investors concerning the fund's regulations and management policy.
- Reciprocity: the French regulatory authorities will assess the extent of the control process carried out by the regulatory authorities in the fund's jurisdiction.

Where a reciprocity treaty meeting these three requirements, and entered into by the *Commission des Operations de Bourse* (COB) and the local regulatory authority has been entered into, the chances of obtaining the MEF's approval increase. Under French regulations, the solicitation of subscribers in France by an investment services provider acting for the account of the issuer of financial instruments, e.g. a hedge fund, is considered to be a placement activity.

3.2.1.3 ***Filing With The Cob***

(a) The "passive" marketing of offshore UCITS in France does not require any filing with the (COB).

"Passive" marketing covers the subscription of shares in the fund upon the request of an investor who has neither received any advertisement nor been solicited to subscribe to such shares. An investor wishing to make a claim against the fund or its distributor would have to prove to the French regulatory authorities that the subscription to the Fund's shares were the result of active solicitation, e.g. .advertising, road shows and mailing.

(b) "Active" marketing of offshore UCITS in France requires prior filing with the COB. Any marketing which is not "passive" marketing (per the above) requires a prior filing with the COB.

3.2.1.4 __Taxation__

There are no specific tax regulations applicable to offshore hedge funds since they are not qualifying E.U. UCITS. A French individual investor in an offshore hedge fund is taxed at his personal income tax rate only on income received from a distribution by the fund of its revenue, or at the capital gains tax rate, currently 26 per cent, upon disposal of his interest in the offshore fund. Moreover, section 123 of the French Tax Code may be applicable when the investors hold directly or indirectly at least 10 per cent of the voting or financial rights of the fund should the fund benefit from a favourable tax regime. In that case, French individual investors are taxed on the income of the fund (determined in accordance with French taxation rules) in proportion of their financial rights with a minimum lump sum payment based on the net assets, should the fund not be located in a tax treaty country.

Institutions, i.e. corporate bodies subject to French corporation tax are only taxed when the fund distributes its revenues. The mark to market rule at year-end applies if the fund is subject to the principle of division of risk and the liquidity principle is satisfied, i.e. the ability to redeem an interest in the fund on any day at the demand of the unit holder. However, as with individuals, French corporations owning more than 10 per cent of funds (per the above) may be taxed on their part of the accumulated profit of the fund at its year end.

3.2.2 GERMANY

3.2.2.1 *Hedge Funds and Fund Categories.*

The German regulations on foreign funds do not define a "hedge fund". Instead, the regulations refer to criteria such as the investment objective in order to determine the rules applicable to such funds.

Foreign funds are classified into two categories:

(a) Funds which invest in commodities or derivatives which are not derivatives of securities. These funds are not covered by German fund regulations and may therefore be marketed without any specific restrictions in accordance with general marketing provisions. If the interest offered in the fund is a security, such as units or shares, a standard prospectus would be required. This prospectus has to comply with applicable regulations, but does not need to be approved by any public body.

(b)All other funds, for example, hedge funds investing in securities. This category is covered by German foreign fund legislation and is subject to a variety of specific rules and restrictions.

3.2.2.2 Impact Of The Legal Form Of Funds And Listing

In contrast to the above, the legal form of the hedge fund does not have a substantial regulatory impact in terms of the marketing of foreign funds, In Germany;,hedge funds are treated as foreign funds irrespective of whether they are structured as partnerships, trusts or corporations and whether they are open-ended or closed-ended. However, the marketing of securities such as fund units or fund shares would trigger the obligation to

prepare a sales prospectus, whereas this is not required for an interest in a partnership. A listing does not affect the regulatory treatment of foreign funds.

*3.2.2.3 **Public Offers And Private Placements***

A public offer includes any offer to acquire an interest in a hedge fund which is made to an unlimited number of potential investors regardless of whether they are institutions or private individuals. Therefore, any advertisement or information given over the press, radio or television is considered a public offer. If, however, an investment is marketed to a selected range of individuals or entities, the offering would be regarded as a private placement under German law, provided that the potential investors are known to the distributor. This would be the case for example, if German banks are approached by the central distributor of the foreign hedge fund and the banks then offer the fund to some of their existing clients. The selected range of clients described above may be contacted by any direct marketing tool like mailing, telephone calls or a personal visit.

To date, there are no clear-cut rules how a solicitation over the Internet should be treated in this context. Clearly, any information which is either flagged or otherwise specifically addressed to German investors would qualify as a public offer. Moreover, any indication that there are German distributors would exceed the scope of a private placement. On the other hand, foreign funds may market their shares via a global web site which is accessible in Germany. With respect to a private placement of foreign hedge funds, no registration with a German authority is required. In the case that the participation in the fund is a security, however, a prospectus may be required.

*3.2.2.4 **Restrictions On Public Offerings***

As mentioned above, there are no restrictions on the public offering of an investment in funds investing in commodities or derivatives. A participation in funds which, inter alia, invest in securities may only be marketed to the public if the hedge fund is registered with the relevant German supervisory authority (*Bundesaufsichtsamt fur das Kreditwesen*). In the course of the registration, the supervisory authority will check thoroughly whether the foreign fund compares to a German fund vehicle as this is the basic prerequisite for a registration. Hedge funds will probably fail this test as their investment objective usually involves investments which do not conform with the tight restrictions under German law. Moreover, in practice, registration will in any case be denied to offshore funds based in jurisdictions such as Bermuda or the Cayman Islands. The view of the German authorities is that these jurisdictions do not provide investor protection equivalent to domestic requirements. In consequence, standard foreign hedge funds are therefore not eligible to be publicly marketed in Germany.

*3.2.2.5 **General Restrictions On Certain Types Of Marketing***

When marketing hedge funds to German clients, some minor general constraints have to be observed if the potential investor is contacted via telephone or a personal visit. If contact was not solicited by the investor, subscription of a hedge fund interest made on the basis of .the telephone call or personal visit may be revoked by the investor within a certain time frame.

3.2.2.6 Distribution Channels

Foreign funds are marketed by banks and a wide range of dependent or independent financial intermediaries. As the hedge funds will usually not be registered in Germany, these distributors require a financial institution licence from the supervisory body mentioned above.

3.2.2.7 Taxation

The taxation of income from a hedge fund depends on whether it qualifies as an investment fund, which is a question of whether it operates under the principle of risk spreading and what type of instruments it invests in. If the hedge fund qualifies as an investment fund and has an appointed tax representative, all income from the fund, including realised capital gains, is taxable in the hands of the investors in the calendar or financial year in which it accrues. Income accrues either upon distribution or at the fund's year end if no distributions were made during the year. These rules apply to individual as well as to corporate investors. If the hedge fund does not have a tax representative, income will be taxed on a standardised and estimated basis. The fund itself is not liable to tax.

A hedge fund which is not regarded as an investment fund, i.e. a fund for which the primary purpose is not to spread the risk, is subject to general tax rules. How investors are taxed depends on the legal structure of the fund, for example, a partnership or a corporation. Investors are taxable on their share of profits accrued in a partnership or dividends received from a corporate vehicle. Further, the percentage of German shareholdings or stakes in the hedge fund may be important, as it might trigger certain

controlled foreign company issues. Under certain conditions part of the individual investors' income may not be subject to German tax.

3.2.3 ITALY

3.2.3.1 General Rules And Consents:

Under the Italian Financial Consolidation Act, an offering of non-E.U. UCITS funds in Italy must be authorised by the Bank of Italy and the *Commissione Nazionale per le Societa e la Borsa* ("CONSOB") shall be informed thereof, provided that the funds are operated in a manner which is consistent with the operation of Italian funds. The Bank of Italy has not so far enacted regulations specifying how this authorisation shall be obtained. Therefore, a different regime, under the Italian Financial Consolidation Act, applies whereby the fund offering needs authorisation from the Ministry of Treasury on the prior notification of the Bank of Italy and CONSOB, the Italian banking and financial supervisory authorities. A non-UCITS fund may start to market its units two months after submitting the notification to the Ministry of Treasury, unless the latter refuses to authorise marketing within that period. The Bank of Italy and CONSOB can investigate a hedge fund's activities carried out in Italy through its Italian placing agents.

3.2.3.2 Fund Interests Acquired For Managers' Portfolios:

CONSOB has stated that an authorised discretionary portfolio manager may purchase interests in foreign offshore funds for the account of a client where the Treasury authorisation referred to above has not been given. Thus, institutional investors (banks

and SIMs) will in these circumstances be able to acquire interests in collective investment vehicles which cannot be offered in Italy for the benefit of their clients. This is because the Italian Financial Consolidation Act regulates "offerings" but not those deemed to be made in the context of discretionary portfolio management which does not involve solicitation of the relevant manager's client. However, CONSOB has also pointed out that terms and conditions regulating asset management activities carried out by institutional investors for the benefit of their clients shall not be used to avoid compliance with the law governing the marketing of units of foreign investment vehicles.

*3.2.3.3 **Protection Of Investors:***

In the event of purchases of interests in foreign investment vehicles not authorised in Italy, the following principles, inter alia, regarding the protection of investors shall be observed:

(a) Financial brokers must be sufficiently informed about the interests (e.g. the nature, risks and structure of the investment) to ensure that managed assets are adequately protected.

(b) The operation of the offshore fund must comply with CONSOB regulations. In particular, the fund must allow the investor to withdraw from the investment forthwith, or to have his assets transferred or withdrawn without any penalty to be paid.

(c) Transactions where a potential conflict of interest may arise require the prior approval, in writing or by phone, from the investor.

(d) Offshore funds must be among-a category of investments permitted to be made for the investor.

(e) A fund manager may not invest more than 10 per cent of the portfolio in the interests of one offshore fund as total offshore fund interests must not exceed 25 per cent of a portfolio, except in the case of institutional investors' portfolios.

(f) A discretionary management contract must specify a relevant objective benchmark against which the manager's performance can be measured. This does not apply to contracts entered into with institutional investors.

3.2.3.4 Taxation:

This section summarises the tax regime of proceeds deriving from non-E.U. investment funds collected by residents of Italy for tax purposes.

3.2.3.5 Individual Investors:

Proceeds arising from the disposal or the redemption of shares and from distributions of dividends in the hands of individual investors must be disclosed in the investor's annual income tax return and form part of his taxable income subject to personal income tax (IRPEF). This applies at gradual rates by bracket of income from 19 per cent up to 46 per cent with, tax credit entitlement for withholding taxes suffered abroad. If an Italian intermediary is responsible for the payment of the proceeds, withholding tax at a rate of 12.5 per cent is levied on account of total tax liability. As proceeds arising from Italian funds are subject to substitute tax at a rate of 12.5 per cent levied at the fund level with no reporting obligation for the investors, and as proceeds arising from E.U. investment

funds falling within the scope of the UCITS Directive collected by individuals are subject to taxation at a rate of 12.5 per cent (usually by means of definitive withholding levied by Italian intermediaries with no reporting obligation), the tax regime provided for non-E.U. investment funds is less favourable in terms of taxation and of reporting obligations.

3.2.3.6 Corporate And Commercial Entities:

Proceeds arising from the disposal or the redemption of shares and from dividend distributions to corporate investors or to commercial entities have to be disclosed in the annual income tax return and are included in the business income subject to ordinary taxation with tax credit entitlement for withholding tax suffered abroad. In the case of industrial and commercial companies, proceeds are subject to corporate income tax (IRPEG) which applies at a rate of 37 per cent. If the investor is a financial institution, a bank or an insurance company, proceeds may also be subject to regional tax (IRAP) which, for fiscal year 2000, applies at a rate of 5.4 per cent. If an Italian intermediary is responsible for the payment of the proceeds, withholding tax at a rate of 12.5 per cent is levied on account of total tax liability.

It is worth noting that proceeds deriving from Italian investment funds collected by company investors are subject to ordinary taxation with an entitlement to a tax credit of 15 per cent of the proceeds. As regards foreign funds, the tax treatment of proceeds arising from non-E.U. investment funds is equal to the one provided for E.U. investment funds falling within the scope of the UCITS Directive since in both cases proceeds are subject to ordinary taxation.

*3.2.3.7 **Italian Pension Funds And Investment Funds:***

Specific regulatory and tax provisions apply in the case of investment in funds not falling within the scope of the UCITS Directive made by Italian pension funds and investment funds.

3.2.4 NETHERLANDS

In the Netherlands, the marketing of hedge funds is not subject to specific rules other than those applicable to investment funds in general. With regard to regulatory and tax constraints, The Netherlands is generally not an attractive country for setting up a hedge fund.

*3.2.4.1 **Scope Of The Act On The Supervision Of Investment Institutions:***

The Act on the Supervision of Investment Institutions (*Wet toezicht beleggingsinstellingen)* (the "Act") provides the basis for the supervision of investment institutions in the Netherlands. Pursuant to the Act it is prohibited to solicit or obtain, in or from the Netherlands, moneys or other goods, beyond a restricted circle, in exchange for units of an unauthorised investment institution or to offer units of such an investment institution. Pursuant to the exemption regulation of October 9, 1990 (*Regehng van 9 Okiober 1990 tot uitvoering van artikel 14 van de Wet toezicht beleggirigsirtstellingen*) (the "Regulation"), that prohibition is not applicable if the investment institution offers such units to "professional (markets) parties". According to the explanatory notes to the Regulation, "professional market parties" are considered

to be institutions such as credit institutions, brokers and institutional investors. The Regulation itself does not provide criteria for what is considered to be a "professional market party".

If investors in "hedge funds" are considered to be "professional market parties" in accordance with the Regulation or within a restricted circle, the fund does not fall within the scope of the Act. This means that the hedge fund does not need to obtain a licence from the Dutch Central Bank (*De Nederlandsche Bank N.V.)* ("DCB") and does not fall within the supervision of DCB. The rules of the Act relating to, inter alia, the preparation of a prospectus, advertising and marketing are not applicable.

A hedge fund which is subject to the Act or an investment fund in general, may be structured in different ways, i.e. as an investment company or unit trust. In the case of a unit trust the provisions of the Act apply to the management company, which is required as to obtain a licence from the DCB.

Dutch Hedge Funds And Foreign Hedge Funds Active In The Netherland:

Under the Act investment and borrowing restrictions are imposed on undertakings for collective investment in transferable securities (UCITS) only and not on hedge funds. The restrictions are in line with the UCITS Directive (E.E.C.85/611) and provide that no more than 15 per cent may be hedged. For Dutch investment institutions which do not qualify as E.U. UCITS, Dutch tax laws may impose restrictions on investment and borrowing as well. Considering the aforegoing it is unlikely that the Netherlands is attractive as a home country for an international hedge fund. Foreign hedge funds may be marketed in the Netherlands directly to professional market parties. If the hedge

funds are not marketed within a group of professionals in the Netherlands, the fund needs to obtain a licence from DCB unless the fund qualifies as an UCITS and subsequently is properly notified at DCB.

3.2.4.3 Taxation:

Dutch Individual Investors:

Dividends and interest received by a Dutch resident individual are subject to the standard personal income tax rates (progressive rate up to 60 per cent). Any withholding tax incurred may be credited against personal income tax liability. Capital gains arising from the sale of shares are, in general, not subject to income tax. Capital losses are not deductible. Capital gains may become taxable in case of the sale of a so-called substantial interest. Dutch individuals who invest in a foreign investment fund will have to include in their personal taxable income deemed income from the foreign fund to the extent that the foreign fund has not distributed such income. This deemed income is calculated as a percentage of the value of the interests in the fund at the beginning of the calendar year. The applicable percentage, 4.8 or 6 per cent, depends on the natures of the investment of the hedge fund. The deemed dividend may be reduced by individual investors by filing a counterproof. This means that the Dutch investor, or the fund on behalf of the investors, calculates the income which could have been distributed by the investment fund. The income in this respect includes the current income of the fund such as dividends and interest. Capital gains may be included in a re-investment reserve. Capital gains realised by hedge funds can, under certain circumstances, be reclassified in current income. In this way, Dutch investors in foreign

investment funds can, in principle, achieve the same tax burden as Dutch investors in Dutch qualifying investment institutions.

It should be noted that a new tax reform is proposed which will radically change the current personal income tax system. The new legislation will come into force on January 1, 2001. Based on this new proposed legislation all portfolio investments, local and foreign, will be considered to generate a deemed income of 4 per cent of the value of the interests in the fund at the beginning of the calendar year. The deemed income will be taxed at a special rate of 30 per cent.

Dutch Corporate Investors:

Investment income, including capital gains, received from investment funds is included in the taxable income of corporations and is subject to corporate income tax at the standard rates (the first NLG 50,000 of taxable income at 30 per cent, the excess at 35 per cent). Withholding taxes levied are creditable against the corporate income tax liability of the corporate investor.

Dutch (Exempt) Corporate Investors:

Certain institutional investors (such as pension funds, charities and family foundations) are fully exempt from tax on income from foreign investment funds and capital gains on the disposal or redemption of shares in foreign investment funds. Consequently, they cannot claim foreign tax credits with respect to income from foreign investment funds. Under certain tax treaties, for example the tax treaty concluded with the U.S., they qualify for a full refund of withholding tax.

3.2.5 SPAIN

3.2.5.1 Public Offers And Private Placements:

In Spanish law there is neither a general definition of "public offering" of securities, nor established rules which distinguish between a public offering and a private placement. Nonetheless, Article 3 of Royal Decree 291/1992 of March 27, 1992 on Public Issues and Offers of Securities (the "1992 Decree") does lay down certain qualitative criteria to determine when a public offering of new or existing securities should be deemed to exist.

Public offerings are deemed to be the following:

(a) Offerings of securities which are equal in nature to other securities already issued by the same Spanish issuer which are admitted to quotation on a stock exchange, an official secondary market or an unorganised secondary market established in Spanish Territory.

(b) Those in which the issuer, the offeror or a person acting on his behalf offers securities in Spain and carries out the relevant advertising in Spanish territory through news and communications media usually aimed at the general public or through restricted or individual media.

These criteria apply "to all negotiable securities mentioned in "Article 2.1 of the-1992 Decree, which include shares and units in investment funds. If these criteria are deemed to be met, the offering will be subject to compliance with the following requirements: prior notification to the Spanish Securities and Exchange Commission (CNMV), prior registration of the documents attesting to the resolution to make the issue, the characteristics of the securities and the rights and obligations of the investors,

verification and registration of audit reports and the annual accounts and the prospectus.

The specific rules regulating collective investment schemes establish certain requirements concerning their setting up and the information requirements to be fulfilled in order to protect investors, which prevail over the general regulations laid down in Royal Decree 291/1992. Nevertheless, Royal Decree 291/1992 is also applicable to non-UCITS and funds set up outside the European Union through the reference made in Additional Provision 2 of Royal Decree 1393/1990 of November 2, 1990 which approved the regulations governing collective investment schemes.

*3.2.5.2 **The Need For CNMV Approval:***

To determine whether an offering in Spain of shares and units in a non-UCITS fund (i.e. collective investment schemes which are not subject to the criteria established under the E.U. Directive 35/611), or funds set up outside the E.U. should be authorised by the CNMV, it must be determined beforehand whether marketing (*comercializacion*) activity takes place in Spain. In this respect, CNMV's view is that marketing takes place in Spain when:

(a) The interests in the fund are offered in Spain through advertising activities;

(b) An entity takes part actively, as opposed to sporadically, in the acquisition by the public of interests in the fund; or

(c) Most of the fund's assets are owned by investors resident in Spain or when most of the shareholders or unit holders made their acquisition in Spanish territory.

In view of the very broad meaning which the CNMV affords to the term "marketing", the offer, sale or issue in Spain of shares or a unit in non-UCITS or funds incorporated outside the E.U. is not possible without prior authorisation from and registration with the CNMV. This authorisation must be sought irrespective of the types of person for whom the placement is intended (whether individual investors, professional investors or institutional investors).

3.2.5.3 ***Requirements Applicable To A Hedge Fund In Order To Be Authorised:***

In practice, the CNMV has not authorised any hedge funds to date, and has only registered non-UCITS aimed at institutional investors. This difficulty probably derives to a large extent from the complexity of complying with the requirements laid down by the CNMV when applying for authorisation, and the high level of discretionary authority which the Spanish regulator reserves for itself in such cases. This difficulty is even greater when the fund marketing is aimed at the general public, since a report must be submitted evidencing that in its country of origin the fund offers a level of investor protection which is at least as high as that provided for under Spanish legislation. This confers a lot of scope for interpretation by the CNMV. In this respect, the structure of the fund can be of key importance, since if there is no equivalent fund authorised in Spain it is very likely that authorisation will be withheld. At present, Spanish law does not envisage any investment vehicle with structural characteristics similar to those that would be demanded of a hedge fund in accordance with the criteria that are accepted on an international level. The CNMV also demands a favourable report from the authorities in the fund's jurisdiction concerning the fund's activities.

In contrast, when marketing efforts are directed at "institutional investors" (as defined below), these requirements are understood to be met when, pursuant to the CNMV's criteria, the regulations of the fund's jurisdiction offer a reasonable level of protection bearing in mind the type of sophisticated or institutional investors being targeted. In these cases prior clearance and registration of the prospectus, annual accounts and audit report of the fund are not required.

Under the 1992 Decree, institutional investors are defined as pension funds, collective investment schemes, insurance companies, credit institutions, securities companies and any other institution which on a regular basis and professionally invests in negotiable securities. Portfolio management companies are regarded as institutional investors, whether acting on their own or another's behalf, when they operate by virtue of a discretionary management mandate, provided that the volume acquired by each portfolio is at least 25 million Ptas, approximately Euros 150,000.

3.2.5.4 Advertising:

Advertising is understood to be any kind of communication aimed at investors with the purpose of directly or indirectly promoting the subscription or acquisition of shares or units. Telephone calls, door-to-door sales, personal letters, e-mail or any other telephonic/electronic means are regarded as advertising activities when they form part of a campaign for the spreading, marketing or promotion of fund's shares or units. In this respect, the CNMV opts for a broad definition of advertising activities which includes media directed to the public, provided groups of persons are targeted. Circular 7/1998 of May 6, 1998, on Advertising with respect to Collective Investment Schemes,

defines advertising activities broadly as any means of communication aimed at investors or potential investors performed by a person or entity through mass media, with the intention of promoting directly or indirectly the acquisition or subscription of interests in collective investment schemes, irrespective of their country of origin. Moreover, any advertising activity concerning a collective investment scheme must comply with the provisions of the General Advertising Act: Law 34/1988 of November 11, 1988. These guidelines are further developed in the General Code of Advertising Conduct of collective investment schemes and pension funds which are members of INVERCO (a Spanish collective investment organisation) as a system of self-regulation. Any type of advertising concerning the offer or securities or investment services made in Spain or aimed at investors' resident in Spain is restricted to authorised intermediaries and registered securities.

3.2.5.4 ***Promotion On The Internet:***

Concerning marketing over the Internet, the 1992 Decree establishes that an offer is directed at investors resident in Spain when the issuer or offering party or anyone acting on its behalf offers securities or provides residents in Spain with sufficient information needed to appreciate the characteristics of the issue or offer and to accept it. In this respect, the CNMV considers that some of the factors that should be taken into account to determine when an offering of securities or a supervised activity is performed through the Internet in Spanish territory are-as follows:

a) Being written in one of Spain's official languages (Spanish, Basque, Catalan, Galician);

(b) Additional use of other communication media in Spain;

(c) Personal mailing—by electronic or physical means—of the information or marketing proposals in the knowledge that the potential investors reside in Spain;

(d) Volume and nature of the promotional activities and contacts carried out in Spain, particularly if directed at investors resident in Spain; and

(e) Omission of warning notices that clearly indicate that the issues or offers or services proposed are not available for investors resident in Spain, or that they are only available to investors resident in the countries listed in the notice.

3.2.5.4 __Taxation:__

Spanish law establishes a special tax regime applicable to funds established or registered in Spain with the CNMV. Basically this regime considers that the transfer or redemption of units will be taxable as a capital gain or loss for individual investors. Distributions made by the fund are taxed as dividends in the personal/corporate income tax of the Spanish unit-holder. Nevertheless, in practice, the CNMV has not authorised the marketing in Spain of any hedge funds to date, and has only registered non-UCITS (other than hedge funds) aimed at institutional investors. Due to this fact, and considering that a hedge fund has not been registered by the CNMV, the tax regime would depend on the legal status of the fund.

3.2.5.5. Hedge Funds Without Legal Personality:

In principle, the tax regime for investors, either individuals or corporates, would be the "income attribution" regime whereby income of the fund is deemed to be that of the Spanish holder.

3.2.5.6 Corporate Hedge Funds:

These would be subject to the same tax treatment as funds registered in Spain.

3.2.5.7 Hedge Funds Incorporated In Tax Havens:

Holders of interests in the fund would have to include each year in their taxable income a "deemed distribution" equal to the annual increase in the value of the participation, even if that participation has not been disposed of during the year. It would be assumed, unless there is proof to the contrary, that this "deemed payment" would be 15 per cent of the acquisition value of the interest in the fund.

3.2.6 SWITZERLAND

The marketing of shares/units or interests in investment funds in Switzerland is governed by the Federal Investment Funds Act (the "IFA") which came into force on January 1, 1995, supplemented by two implementing ordinances issued respectively by the Federal Counsel and by the Federal Banking Commission (the "FBC"). In addition, the FBC issued seven directives on June 1, 1999 applicable to Swiss and foreign investment funds. The IFA differentiates between Swiss and foreign investment funds,

and hedge funds, as discussed below, can be either as a Swiss or a foreign investment fund.

3.2.6.1 Swiss Structures:

Swiss Investment Fund (Contractual Structure)—According to the IFA, "an investment fund consists of a pool of assets raised from investors as a result of a public solicitation for the purpose of collective investment; it is managed by a fund management company for the account of the investors, generally on the principle of risk diversification." The definition of a Swiss investment Fund according to the IFA is limited to a contractual structure. Other Swiss investment structures like companies limited by shares or investment foundations are not subject to the IFA.

In 1996 the FBC, which acts also as supervisory authority for investment funds, ruled that, in principle, it is possible to establish a Swiss investment fund acting as a fund of funds investing in foreign hedge funds. Such a fund has to be classified as an "other fund with specific risks". In 1997 the FBC authorised, for the first time, the establishment of a fund of funds structure investing in foreign hedge funds that would not themselves be authorised for distribution in Switzerland. However, the FBC required additional information to be inserted in that prospectus, namely a complete description of the investment strategy as well as the foreseen composition of the portfolio, the investment limits imposed by the fund management company as well as the selection procedure and the controls put in place by the fund in order to select the different hedge funds. In addition, the prospectus must contain information regarding

the professional qualifications of the fund management company as well as the investment advisors. Finally, the various hedge funds in which the fund of funds is going to invest have to be described in detail and in such a way that the investor can receive information on the investment strategy, past experience and the legal and organisational structure as well as the name of the auditors of each hedge fund. In this respect, the fund management company must let each investor have a complete set of documentation regarding the hedge funds in which the fund of funds has invested. In addition, the FBC required that the risk factors would have to be disclosed to the investors and imposed some additional reporting duties.

Swiss Investment Company—Until recently, funds of funds investing in foreign hedge funds publicly offered were structured as so-called investment companies, i.e. Swiss companies limited by shares quoted on the stock exchange. Such structures do not fall within the scope of the IFA, and consequently, such investment structures are not subject to the supervision of the FBC. However, they have to comply with the regulations issued by the Swiss Stock Exchange (SWX), in particular the regulations applicable to quoted investment companies.

3.2.6.2 Foreign Investment Funds:

Definition—The IFA defines foreign investment funds in a variety of ways and the definition is sufficiently wide to cover unit trusts, open-ended investment companies,. SICAVs and mutual funds. The IFA distinguishes the following categories of foreign investment funds:

(a) Pools of assets created pursuant to a collective investment contract, or other type of contract with the same effect, and managed by a management company whose registered office and administrative headquarters are outside Switzerland;

(b) Companies whose registered office and administrative headquarters are outside Switzerland and whose objective is collective investment, provided that an investor has the right to require the company itself or a company associated with it to redeem his shares; and

(c) Any other foreign pools of assets or foreign companies which are subject to supervision in their home country as investment funds (to the extent that interests in them are marketed or distributed in Switzerland).

Under the IFA, any person who offers or distributes shares/units in foreign funds on a professional basis in or from Switzerland must be licensed to that effect by the FBC. The authorisation is subject to various conditions, including that the foreign investment fund must be subject in the jurisdiction in which it is established to supervision aimed at protecting investors. In addition, the organisation and the investment policy must be comparable to the requirements of the IFA regarding investor protection. For the time being, the FBC considers that only certain states, including the E.U. member states, USA, Guernsey and Jersey, offer supervision comparable to Swiss supervision. Therefore, as most of the jurisdictions where offshore hedge funds are established do not fulfil the above mentioned conditions, foreign hedge funds usually do not obtain authorisation to be offered or distributed on a professional basis in Switzerland.

The situation is different in the event of a fund of funds investing in hedge funds. Indeed, the FBC has recently licensed in the category of "other funds with specific

risks" a Luxembourg fund of funds investing in hedge funds, registered under Part II of the Luxembourg Investment Fund Act. Consequently, provided the additional requirements imposed by the FBC are met, it is not excluded for a fund of hedge funds organised under the laws of a recognised jurisdiction to be licensed in Switzerland.

3.2.6.3 ***Marketing Activities In Switzerland Without Licence:***

As mentioned above, marketing activities in Switzerland are subject to a licence requirement if:

(a) an "offering or distribution" of shares/units of foreign funds takes place in or from Switzerland; and

(b) such "offering or distribution" is made "on a professional basis".

It is important to note in this connection that the FBC considers the concept of "offering or distribution on a professional basis" to be broader than the concepts of "public offer" and "public solicitation" as understood under previous legislation. Accordingly, as a rule, any form of "advertising" of a foreign fund will be subject to a licence requirement. No private placement exemption, as understood in other jurisdictions, is available in respect of the offering or distribution of foreign funds in Switzerland. A. complete amendment of the implementing ordinance issued by the Federal Council is pending. The present version of the draft provides, in particular, that offerings or distributions of foreign investment funds in or from Switzerland which are directed to private investors will be made easier and in particular, no licence will be required anymore for the distribution to less than 20 private investors.

The first element of "offering or distribution" is broadly construed by the FBC, which considers that any form of promotion of shares/units in a foreign investment fund in Switzerland or directed at investors or potential investors in Switzerland will be subject to a licence requirement, unless the institutional investors' exemption is available. A foreign fund or its selling agent will not, according to the FBC, be subject to a licence requirement if it limits its marketing activities to sending a prospectus to, or meeting with, Swiss banks or asset managers which are not themselves potential investors, provided that no public offer is made.

In the absence of a definition of the phrase "on a professional basis" in the legislation, the FBC issued guidelines in 1996 outlining what it regards as cases typically requiring or not requiring licences as the case may be. Summarising these guidelines, Swiss banks and financial institutions will not be considered to be offering or distributing shares/ units in a foreign investment fund "on a professional basis" so long as the following conditions are met:

(a) The customer on his own initiative issues a purchase or subscription order for shares/units in a foreign investment fund without any recommendation to that effect from the Swiss bank or asset manager ; or

(b) Shares/units are placed by the Swiss bank or asset manager in customers' discretionary accounts which it manages, provided that shares/units of the same fund are not systematically acquired for those accounts; and

(c) The Swiss bank or asset manager places in customers discretionary accounts the funds he is the originator of and whose shares/units are exclusively distributed to his managed clients.

In no event should a formal distribution agreement should exist between the Swiss bank or financial institution and the fund. The criteria described above relate only to the position of Swiss banks and asset managers. They do not deal with the circumstances in which a foreign investment fund or its selling agent will or will not be considered to be marketing or distributing shares/units in the fund in Switzerland on a professional basis. The FBC has thus far consistently refused to indicate which (potential) investors can be contacted without a licence, even in terms of the institutional investor's exemption.

3.2.6.4 Institutional Investors Exemptions:

An amendment to the IFA provides for an exemption for certain marketing activities to institutional investors. The amendment allows offerings or distributions of foreign investment funds in or from Switzerland without a licence to the extent that such offerings or distributions are directed exclusively to investors whose assets are managed professionally (e.g. banks, insurance companies, pension funds, etc.) and that no public offer is made. The FBC has indicated that the purpose of this exemption is to allow offerings or distribution, road shows, etc., addressed to a limited number of potential institutional investors. This exemption is also applicable to foreign hedge funds.

The offering or distribution on a professional basis of shares/units in a foreign hedge fund in or from Switzerland requires an authorisation to be delivered by the FBC. Such an authorisation will not be delivered to a foreign hedge fund established in an offshore jurisdiction, which does not offer supervision comparable to Swiss supervision.

However, an authorisation can be delivered to a foreign fund of hedge funds established in a recognised jurisdiction. Swiss law does not provide for clear rules regarding the private placement of units of a foreign hedge fund.

The following marketing/sales activities may be carried out in or from Switzerland without an authorisation:

(a) Offerings, road shows, group seminars or presentations addressed to a limited number of investors whose assets are managed professionally for example banks, insurance companies, pension funds, etc., provided that no public offer is made.

(b) Sending a prospectus to, or meeting with, banks or financial institutions which are not themselves potential investors (in other words, if they are not subscribing for their own account, but solely for the account of their customers), provided that no public offer is made. In such cases, marketing or distribution of interests in foreign funds would be the responsibility of the banks or financial institutions, which may be required to obtain a licence. This would, for example, apply in cases of systematic placement of interests in the fund in customers' discretionary accounts managed by the Swiss bank or asset manager.

3.2.6.5 Taxation:

Switzerland has one federal and 26 distinct cantonal tax laws. As a rule, foreign hedge funds are treated for tax purposes according to their legal structure. However, the tax authorities may ignore a corporate (non-transparent) fund structure, if its characteristics resemble those of a transparent Swiss fund. Although legally a corporation, the fund will then be treated like a transparent fund. Such treatment is likely to apply to foreign

open-ended funds with corporate structures. The cantons are not required to follow this federal tax treatmént, yet most do.

3.2.6.6. Particular Issues: Imputation Of Income/Capital Gains Securities Transfer Tax:

For both private and corporate investors, as a principle, interest and dividend components are taxable when distributed, whether the fund is transparent or non-transparent. However, if the fund is an accumulating fund and transparent for tax purposes, then income accumulated by the fund also becomes immediately taxable in the hand of the private investor. Such imputation does not apply to corporate investors. For the private investor capital gain components broken out separately are not taxable, provided that the interests in the fund are held as private (and not as business) property and the private investor is not deemed to be a professional securities dealer. Equally, capital loss components are not tax deductible by the private investor. With the corporate investor, capital gain components are taxed as ordinary business income and capital losses are tax deductible.

The issuance and transfer of interests in a fund are subject to securities turnover tax of 0.3 per cent of the trade value if one of the parties involved is a Swiss securities dealer. The foreign fund manager's portion (0.15 per cent) is not due on issuance of fund shares/ units if the foreign fund manager is comparable to a Swiss fund manager. Equally, securities transfer tax should normally not be levied on the subscription or transfer of partnership shares/units. In addition, there is no turnover tax on a sale or redemption of shares/ units.

3.2.6.7 ***Redemption Of Fund Shares/Units: Private Investors Beware:***

In cantons which do not follow the federal tax treatment for the private investor, the tax consequences of redemption of interests in a fund would be severe. The difference between the redemption price and the nominal value would represent taxable income for the private investor. This may lead to a taxation of the whole redemption proceeds, regardless of the actual profit of the private investor, as the nominal value of fund interests is typically minimal. Therefore redemption of fund interests has to be avoided at all cost and only a sale of fund interests to a third party represents a feasible exit for the private investor in those cantons. Such treatment is not applicable to corporate investors. However, in the cantons which do not follow the federal tax treatment a redemption of fund interests would be beneficial to the corporate investor, as any gain calculated as the difference between the book value and the redemption price of fund share would be eligible for participation relief, provided that the investment in the fund exceeds the equivalent of CHF 2 million.

Chapter 4

In this chapter, the researcher will focus on the Participatory Notes-the entry route for hedge funds in India. Since, the primary purpose of this research paper is to discuss the issue of hedge funds regulation in India, it would be prudent to devote one entire chapter on Participatory Notes through which hedge funds invest in Indian markets. Since the issue of Participatory Notes is very controversial considering the disliking of regulatory bodies and since it is through these notes major investments are done in the Indian markets by the hedge funds, an entire chapter has been devoted on Participatory Notes.

4.1 INTRODUCTION

In the recent past, a lot of coverage has been given to participatory notes and they have become a matter of concern for regulatory bodies in India. They have always generated lot of debate and controversy in the financial markets circle. The participatory notes were responsible for largest fall witnessed ever in Indian Stock markets. Participatory notes have been in news for all the wrong reasons and now and then Indian regulators i.e. SEBI and RBI are seen issuing notices or warnings to all the parties associated with these instruments. In fact the capital regulators dislike for them is so much that they have proposed a ban on participatory notes in India to protect the Indian capital markets from the market manipulators and for ensuring greater transparency of the capital markets. For all these reasons, participatory notes are sometimes referred to as Problematic notes. In this paper the writer will analyze the different issues and controversy behind the participatory notes.

4.2 CONCEPT

Before introducing the concept of participatory notes, it is important to know the concept of Foreign Institutional Investors (FII). According to SEBI (FII) Regulations, 1995, FII means an institution established or incorporated outside India which proposes to make investment in India in securities. Regulation 7A provides that a FII and its key personnel shall observe high standards of integrity, fairness and professionalism in all dealings in the Indian securities markets with intermediaries, regulatory and other Government authorities. FII need to register themselves with SEBI and once they are registered they have to comply with the regulatory notifications of SEBI and RBI

especially the disclosure norms and regulations relating to foreign exchange. Registered FII invest through sub-accounts on behalf of foreign corporate, foreign individuals, and institution, funds or portfolios established or incorporated outside India.FII may issue, deal in or hold off shore derivative instruments such as Participatory notes, Equity Linked Notes or any other instruments which derive their values from underlying Indian securities which are listed or proposed to be listed on any stock exchange in India. Participatory notes are derivative instruments issued by investor bankers abroad for their clients-investors to buy shares from Indian stock markets through foreign institutional investors. They are instruments used by the foreign funds or investors who are not registered with SEBI but are interested in making investment in Indian securities markets. They are generally off shore derivative instruments. Participatory notes are like contract notes or are simple derivative instruments. The special features about the participatory notes are that they are largely unregulated instruments and regulatory bodies in India do not exercise any regulatory jurisdiction over them and so they are not required to adhere to disclosure and other norms which are generally applicable to other market players. . Another special feature of Participatory Notes is that the beneficial ownership or the identity of the owner is not known unlike in the case of FII since these are freely transferable and trading of these instruments makes it all the more difficult to know the identity of the owner of these instruments and this the most important reason for high popularity of the Participatory Notes. Their anonymity and secrecy enables large hedge funds to carry out their operations without disclosing their identity. Then, some of the entity route their investment through participatory notes to take advantage of the tax laws of certain preferred countries. The modus

operandi is that the FIIs buy stocks and securities on behalf of the overseas investors in the domestic capital markets: the unregistered investors place their order with the FIIs and registered FIIs execute that order and uses its internal account to settle the trade. In the entire process, registered FIIs act like an exchange and they keep the investor's name anonymous. Though this is balance of convenience between them but ultimately the nature of money, source of money and the identity of the owner remains in the dark. All FIIs are required to be registered with SEBI but the holder or owner of Participatory notes are not required to register with SEBI. That is the reason why capital market regulators dislike participatory notes.

4.3 INFLUENCE OF FIIs IN INDIAN MARKET

FIIs are very important source of investment in Indian Capital markets. If we look at the data of past few years of investments in the Indian Securities market, we can see that whenever the market booms the reason behind this boom is the investments made by FIIs. Similarly, as and when these FIIs withdraw their money from the market, the markets fall down drastically. They are the major contributors to the stock markets. They are very active while trading in the Indian Securities market. The past boom in the stock markets in 2001-02, 2003-04, and 2005-06 have been attributed to the FIIs. But still FIIs are looked with a word of caution and a sense of worry for market regulators. The bottom line is that FIIs are blessing in disguise for the Indian financial system. The problem with foreign entities is that they want to enter every emerging market and want to come out with resources in both of their hands. .Whenever, investment climate in the country is not good, they will indulge in capital flights and within overnight withdraw

their money from the markets thus making the conditions in the market worst. They have a very strong influence in Indian markets and Governments and regulators cannot take the risk of taking them lightly. Their strong presence in the Indian markets has cautioned the government to address the issue of participatory notes very carefully because otherwise they may adversely affect the FIIs inflow into India: the prime reason being is that those FIIs that don't wish to register with SEBI or fails to get registration or are ineligible to get registration make entries in the Indian capital markets through the participatory notes and the other reason being is that FIIs earns huge rent while facilitating investment of participatory notes holders like unregistered FIIs, hedge fund, university endowments, etc in the Indian Capital markets. The influence of Participatory Notes in Indian Capital markets can be gauged from the simple fact that, according to one estimate, 51% of FII investment till August, 2007 were via Participatory Notes and that is equal to 3, 53,484 crores.

4.4 THE CONCERNS

There are several reasons that have made the issue of participatory notes hotly debatable in India. Firstly, investors who are investing money in the market deserve access to details from FIIs on inflow of funds. This will help them find out how much a registered FII has invested or holds in the country. This will also helps investors in gauging the investment climate of the country as accurately as possible. But this is not possible in the case of participatory notes which constitute the major chunk of FIIs inflow into India. Another cause of concern is that many times accounted wealth of rich Indians veiled under the pretext of foreign institutional investment is used to invest in

these participatory notes and it is generally alleged that such monies are tainted and linked with illegal activities such as smuggling and drug-trafficking and most dangerously the terrorist organizations also invest monies in the Indian capital markets through the participatory notes since the identity of the holders is not disclosed. This matter becomes all the more important that India is one of the prominent country suffering from militancy and terrorism for the last few years and all the more importantly India's financial capital is infected by mafias and underworld dons for whom it is very lucrative to invest money in Indian capital markets which are used not only to fund terrorist organizations and make them financially stronger but are also used in promoting drugs-trafficking, smuggling and all other kind of illicit and anti-national activities. Even experts are of the view that money laundering is taking place through large extent in the Indian capital markets through the use of participatory notes. Moreover, such participatory notes are the best instruments available for corrupt politicians and businessmen to convert their black money into white money by routing the money through foreign institutional investors. Hence, participatory notes are associated with all kinds of benami transactions which are not allowed in Indian capital markets and market regulator SEBI applies strict and comprehensive disclosure norms for protecting investors' interest. The sensitivity of the matter can be gauged from the fact that recently National Security Advisor M K Narayanan had cited instances of terrorist outfits manipulating stock markets to raise funds for their operations. The stock exchange in Mumbai has reported fictitious or notional companies engaged in trading only confirm the Narayana's worst fears. Further, the intelligence agencies have, time and again, pointed towards the financing of the terrorist outfits and

organizations through the stock markets. The reason for showing interest towards the Indian financial markets is obvious. Indian markets being one of the energetic and promising economies of the world is an attractive target of investment, the investors from different part of the world want to enter this market and want to depart with both hands filled with huge profits. There is no denying in the fact that monies earned through the stock markets will be used to fund and finance the terrorist activities which is a great threat to the stability of our country as well as the stability of the whole world and hard earned income of the retails investors are being used for terrorist activities.

Apart from this, another cause of concern is that Indian financial markets can be manipulated by few unidentified corporations or persons through the use of participatory notes and they can make the market more volatile by their conducts and manipulate it as per their wishes. These participatory notes are like capital flights and these notes could be quite volatile in nature and may adversely affect the stability of the Indian capital markets .Their influence in Indian capital markets can be gauged by simple illustrations. On the 16th of October, 2007, SEBI proposed curbs on participatory notes which accounted for roughly 50% of FII investment in 2007. SEBI was not happy with participatory notes because it is not possible to know who owns such instruments and such notes might therefore cause volatility in the Indian markets. When the market opened on the following day (October 17, 2007), within a minute of opening trade, the sensex crashed by 1744 points or about 9% of its value- the biggest intra-day fall in Indian securities markets in absolute terms. This led to automatic suspension of trading for one hour. Finance Minister P. Chidambaram issued clarifications in the meantime that the government was not against FIIs and was not

immediately banning participatory notes. Not only the SEBI but RBI is also not happy with the participatory notes and it has time and again expressed concern over the secrecy about its ownership and source of fund.SEBI is not very much happy about the participatory notes and is of the view that non-residents Indians may be using participatory notes route and round tripping investment into India. In view of the above apprehensions, there was a major clampdown of the participatory notes in October, 2007. There is general apprehension among the regulatory bodies that the participatory notes have become convenient route for foreign investors to take up exposure to Indian securities without taking the trouble of registering with the market regulators. There are number of investors who want to take this route of participatory notes and the reasons may be that they don't want to disclose their identity or to avail of tax benefits or they are not eligible to invest in Indian capital markets and regulator may not grant registration. For example, hedge funds are not granted registration as they are not regulated in their own country. In such cases, the registered FII act as an exchange since it executes trade and uses its internal account to settle this.

Another Contentious issue regarding the participatory notes is tax issues. The income tax department has proposed to tax participatory notes holders. The FII invests in Indian securities and issue participatory notes to its beneficial owners. On redemption/maturity, the FII passes on the gains to the investors. Since FII holds securities, it may be asked to pay tax in India on any gain derived from such transactions. However, FII registered in a tax favourable jurisdiction, for example Mauritius, are not taxable in India in view of the double avoidance tax treaty between

India and Mauritius. Since, FII discloses the gains in its return of income and validly claims the exemption, the contention of the FII is that such gains should be considered as reported to the tax authorities in India and hence should not be considered again in the hands of the overseas investors (participatory notes holders). However, in some of the merger and acquisition deals, the tax authorities have taken the view that eve3n if transaction has taken place outside India between the two overseas investors, tax is payable in India as it amounts to transfer of controlling interest of an underlying asset situated in India. Apparently, applying the same analogy, tax authorities have started to examine whether participatory notes can be taxable in India and whether FII should withhold tax while passing on the gains to participatory notes holders. The tax authorities are aware of the fact that tax implications of gains made on participatory notes trades would have to be carefully considered in the light of Indian domestic law and tax treaty which India has with the country of residence of participatory notes holders. The implication could vary significantly depending upon the exact structure and cash flow of each participatory note transaction and one really cannot apply one general principles of taxation to all the participatory notes transactions. For example a funded transaction would stand on a different footing as compared to a non-funded one. Similarly, participatory notes may be an uncovered one i.e. the issuer may not always hold underlying Indian securities. Such cases would have to be viewed differently as compared to the covered participatory notes. Also, where an issuer FII actually sold the underlying securities is very different from where it does not sell its securities in order to pay the participatory notes holder. Since, the approach adopted by the tax authorities

would have a long term impact on India's ability to attract foreign capital, the tax authorities should go slow on this issue.

Another concern among some experts is that the investment made through participatory Notes creates a mirage that the market is booming, but the reality is that they are destructive for the market. The market always has the fear in the mind that as and when FIIs will go back the market will again be at odds. The Government is also under the pressure that FIIs will take their money back and cannot take any policy decisions comfortably, as every time there is an apprehension in the mind that whether or not a particular policy will be appreciated by the FIIs and adverse consequences that may flow there from.

4.5 THE OTHER SIDE

Some of the experts are of the opinion that regulating and restricting participatory notes in the name of increasing transparency may be counter productive. They are of the view that when the flow of foreign capital into India is caused by a global rather than a local phenomenon, can the solution lies in blocking a few channels? India now has a gigantic capital account: if all else fails, over invoicing and under invoicing can be used to move capital across the border on a gigantic scale. They are of the opinion that if the entry conditions in Indian markets were made easier, instead of money coming through Participatory notes; it would come through registered bodies. Vast pools of foreign money are in action in the New York Stock Exchanges, or the London Stock Exchanges, etc. But this foreign money does not flow through participatory notes in those countries, because the market is easily accessible to the foreign investors. This

has neither weakened regulation nor led to market manipulation, do they contend. The way to better regulation is to make the Indian market directly accessible. They argue that participatory note route has fallout in terms of high rents earned by FIIs registered in Indian markets. SEBI and RBI rules have made entry for foreign entities, including cumbersome and expensive. When investors come through those already registered in the markets they pay them. When we allow entry only to a few, by making it difficult for other to invest, we make the incumbent more powerful. The way to increasing competition, increasing liquidity in the market and making it more difficult to manipulate markets is through making those markets accessible to all, not by restricting entry. If the market is made more accessible, then instead of a handful of FIIs making decision to buy or sell, the decision will be taken by thousand of investors scattered all over the world. The government job is to save capitalism from capitalists and remove the rent earned by a few privileged FIIs. The policy of making entry into Indian markets difficult favours the incumbents FII. It creates a new business opportunities for those already registered in the Indian markets. They argue that it is in the India's interest to have a level playing field between all the investors in the world, and not to concentrate the financial capital of global investors into a handful of FIIs. Giving so much privilege to FIIs strengthen them while hurting small investors. It reduces liquidity and makes regulation more difficult.

4.6 REGULATORS' REACTION AND RESPONSE

The SEBI is considering steps to include disclosure of information about the terms, nature and contracting parties to the participatory notes issued by FIIs. SEBI has

stipulated that the names and locations of those to whom the offshore instruments are issued should be submitted along with the identity and type of investors such as hedge fund, corporate, pension funds and individuals. It has also asked for information regarding quantity and value of the offshore instrument and the underlying Indian securities. The SEBI has also issued Know Your Client (KYC) guidelines which includes that FIIs must know all the requisite details about their clients and be able to furnish the same, as and when demanded by the regulator, to which there should be strict compliance, failing which they should suffer the wrath of the regulator. The SEBI has decided to tighten disclosure norms in the light of the Joint Parliamentary Committee (JPC) report on stock markets that surfaced in 2001. While investigating into the last stock market manipulation, SEBI had come across certain cases of participatory notes issued by FIIs. In order to increase transparency, SEBI had in October 2001 issued circular to all FIIs and their custodians advising the FIIs to report as and when any derivative instruments with Indian underlying securities are issued/renewed/redeemed by them either on their own account or on behalf of sub-accounts registered under them. Accordingly, FIIs are sending reports from time to time whenever they are issuing participatory notes. What is required is that disclosures in the reports submitted by FIIs are to be enhanced and should be made more comprehensive. The JPC in its report suggested that failure on the part of FIIs to report about details of participatory notes should be viewed seriously and should entail stringent punitive actions. The committee has said that it should be ensured that this instrument is not misused in any way to manipulate the Indian securities markets. The JPC report observed that some of the Indian promoters had purchased shares of their own

companies through participatory notes issued by sub-accounts of FIIs and this mechanism enables holders to hide their identities and enable them to practise "Insider Trading" which is prohibited under the Indian law. Further, in order to negative any adverse implication on the FIIs inflow into India, SEBI has decided to encourage participatory notes to register themselves as FII and for that purpose registration process would be made faster and more streamlined. SEBI has clarified that the real aim is to not to discourage the FII flow into India but to make the market more transparent for the healthy development of Indian capital markets and to curb money laundering activities and to prevent the capital markets from being acting as the financial hub for terrorist outfits. In order to exercise control over such Notes, SEBI has come out with the draft proposals in the October, 2007 and has suggested that the Participatory Notes issued against derivatives should wind up in the next 18 months, adding that there should be an unwinding of Participatory Notes issued by sub-accounts in 18 months. It has suggested an incremental rate of 5% for issue of P-Notes for FIIs with less than 40% of assets in P-Notes and regarding issue of P-Notes by FIIs with assets of more than 40% in P-Notes, on redemption/cancellation. The Finance Ministry has reacted to it by saying that this is an attempt to control leveraging flexibility of Participatory Notes.

The RBI is also deeply concerned with the matter and it shares the same view and concern of SEBI on the entire matter. RBI is of the view that foreign entities should not be allowed to enter the Indian market through the route of Participatory notes and if overseas investors are willing to take exposure into Indian markets, it must be

mandatory for them to get registered themselves as FIIs so that they can comply with the regulatory requirements of the regulators. The RBI stance is valid because when UBS securities scam took place, SEBI took one long year to find out who the real beneficiaries were and in the process circumvented the whole world without any success. The Fact of the UBS securities scam will explain the disliking of regulators for Participatory notes. On 17th May 2004, FII's made a sale of about Rs. 188.35 crores in the stock market. This immediately sent shivers into the market and investors especially the small investors upon seeing this sale binge started panic selling their shares too. Like any self-fulfilling prophecy, the stock market plummeted. The Sensex fell by 567.74 points, NIFTY fell by 196.90 points & the Intra-day Sensex fell by 842 points. The estimated loss in the market was about Rupees One Lakh Crores. The stock market had to be closed three times that day and when it reopened the next day it again saw some fall. Upon investigations by SEBI it was found that UBS got its order to sell on its sub account by Swiss Finance Corporation Limited, which was based in Mauritius. This acted on the orders of UBS AG London, which got its orders from its clients including Caxton international, which is a hedge fund based in the British Virgin Islands. This one hedge fund alone had issued sales orders of about Rs. 99 crores. SEBI further investigated only to find NRI names at the root of this long chain.

It took SEBI almost one full year to get to the bottom of the chain and that too without being able to hold any one person or entity responsible. It meanwhile had stopped UBS from market transactions since UBS was not cooperating in sharing much of the information. This case is a good pointer as how P Note channel is an open invitation to

irregular investors. That is why SEBI guidelines to the FII and brokerage houses include KYC or "Know Your Client". Meaning, the FII should be able to provide information on who are the ultimate investor and beneficiary of the trade to facilitate SEBI to monitor the market closely for unsettling flows but this is rarely followed in its full dimension. .It must be remembered that SEBI is a part of International Organisation of Securities Commissions (IOSOC) and has signed information-sharing agreements with leading regulators but there was no support from them during the investigation of UBS scam. In UBS case, the letter of request for information sharing being sent by SEBI Chairman did not gave any desired result to the regulator. The regulator found itself helpless in such circumstances and so the only option left to them is to ban such notes. The RBI has clarified in its press note that they do not have anything against the participatory notes but their only concern is that this instrument helps in concealing the original beneficiary of the instruments and leads to multi-layering which makes it more difficult to find out the beneficiary. RBI has reiterated its stance, time and again, that issuance of Participatory notes should not be permitted. It is of the opinion that by not allowing the suspicious fund in the market, image of the market can be enhanced which will ultimately leads to healthy flows in the economy. Further, RBI is of the opinion that money coming through the route of FII is hot money which can become cold at any point of time. More than 40% of FIIs at any given instance comprise of money through Participatory notes. RBI feels that even if FIIs take 20% of the total invested money out of India, it might lead to financial crisis or destabilize the economy. The Lahiri Committee (June 2004), which was set up to recommend measures on FII inflows, describes Participatory notes as akin to contract

notes issued against an underlying security usually to investors that are not otherwise eligible to invest in India The Lahiri Committee (on `Encouraging FII flows and checking the vulnerability of capital markets to speculative flows') had debated the issue of Participatory notes in detail. While taking note of the possibility of misuse of the instrument, the Lahiri panel had favoured the continuation Participatory notes with the rider that "SEBI should have full powers to obtain information regarding the final holder/beneficiaries or of any holder at any point of time in case of any investigation or surveillance action." However, RBI was not happy with the recommendation: in a dissent note; the RBI representative on the panel said the central bank "reiterated that the issuance of Participatory notes should not be permitted." The member had pointed out that the main concern of the RBI was that "the nature of the beneficial ownership or the identity of the investor will not be known, unlike in the case of FIIs registered with a financial regulator." The Lahiri Committee was expected to throw some light on Participatory Notes and the way to make them a more acceptable and a secure instrument but the report was found wanting on this issue. The report failed to deal comprehensively with the issue of Participatory notes and failed to throw light on the entire matter from the different angles. Again, one important dimension to the entire matter is that Ministry of Finance feels that Participatory Notes are a major source of much needed foreign inflow in India and cannot be banned. Hence, there is no unanimity between the Government and regulator on the banning of Participatory Notes. The RBI has called for one more committee to examine the whole matter comprehensively.

4.7 CONCLUDING REMARKS

Although FIIs have contributed to the Indian economy, in more ways than once, but still they have not been able to earn the respect for them as they should be. The concerns of the regulators are not without reasons. In fact their concerns are very genuine and in the larger interest of the Indian markets. The feeling of the regulators that Participatory Notes can be used to destabilize the market and can be a strong source of funding for terrorist outfits is very true. The Indian financial markets can become mecca for money launderers, smugglers, drug traffickers and for anti-national elements if the route of participatory notes remains largely unregulated. Further, it can be used to destabilize our economy and to create artificial crisis in our market considering the fact that Participatory Notes constitutes major chunk of FIIs inflow into India. Moreover, it can be used as an instrument to evade taxes, promote benami transactions, running parallel economy and most importantly act as an attractive source of investment for mafias and underworld. Under the present situation, the investment pattern of Participatory Notes does not satisfy the criteria of fair play. The Government has to give serious thought to the entire matter as it is closely related with our financial markets development as well with our national security and peace. The writers will suggest that Government of India should appoint high level committee to go through the issues deeply and analyze it from the entire angle. There is no denying in the fact that present system of Participatory Notes investment gives the scope for benami transaction and at the same time grossly overlooks the disclosure guidelines of SEBI the aim of which is the symmetry of information between the market participants and ultimately the protection of interest of investors. The present investment pattern of

interest of our financial markets. The SEBI, RBI, and Ministry of Finance must work in close coordination with each other to achieve this end and must work in close collaboration with International Organisation of Securities Commission (IOSOC) on information sharing agreement. The prime factor which the Government of India should give top priority is that in no case and under no circumstance Indian financial markets should become financial hub for terrorists and mafias because we are the worst sufferers of terrorism and in order to break them mentally and psychologically it is important to break them financially. The RBI is perfectly right on its stand that the integrity of Indian markets must be maintained at any cost.

Chapter 5

In this chapter, the researcher will discuss the regulatory framework in India to regulate the hedge funds in the light of legal regulation available in United States of America.

5.1 REGULATING THE HEDGE FUNDS

The most clamorous reasons cited by the votaries of regulating the Hedge Fund industry is the incredible growth of hedge funds and the increased influence and power that hedge funds are having on the financial markets. The industry is attacked for being secretive, engaged in risky behaviour and capable of unduly influencing global economies and corporate activities. An increase in fraud cases involving hedge fund advisers, juxtaposing with an increase in exposure of unsophisticated small investors to the risks of hedge fund investing has enticed the policymakers and regulators to bring the hedge fund industry under greater scrutiny. Hedge Funds were largely held responsible for the South East Asian Economic crises in the late 1990s, the failure of the Long Term Capital Management Fund in the US in 1990s and its subsequent $ 3.5 billion bailout by the Federal Reserve Bank to prevent the cascading collapse of global financial markets; and the current surge of the Bombay Stock Exchange sensex, which even surprised the Indian Finance Minister as to comprehend the reasons for such a surge, creates an argument that some form of regulation should be encouraged for hedge Funds.

There have been studies into the possibility of direct regulation undertaken over the past number of years by such bodies as the Basel committee on banking supervision, the International Organization of Securities Commissioners and probably most significantly, the US president's working group on financial markets. However, no major regulatory body has advocated direct hedge fund regulation.

5.2 SELF REGULATIONS:

Even though there is no statutory obligation to make a public disclosure, hedge funds provide their potential investor with a private placement memorandum that discloses information about the overview and investment strategies of the hedge fund. The memorandum also provides the adviser with the maximum flexibility in selecting, shifting and modifying its strategies and arms him with broad discretion in valuing hedge fund's assets. Hedge Fund investors generally receive some ongoing performance information, risk analysis and portfolio profiles from their hedge fund advisors. Most hedge funds retain an auditor to conduct an independent audit which if certified is prepared using generally accepted accounting principles (GAAP). Market competition has also led to a growing demand by the investors for business-unit level SAS 70 assessment (Statement on Auditing Standards No.70 Service Organizations,) by reputed firms. The hedge fund industry's main trade group in the US, Managed Funds Association, has laid down certain professional the guidelines in a publication called "Sound Practices for Hedge Fund Managers". It contains guidance about anti-money laundering policies, determining net asset value, risk monitoring and also a model "due diligence" questionnaire to enable the investors to question hedge fund managers. Also though the much talked about performance fee figure is generally 20%, yet the common practice is that there is a "high water mark" that is often applied to its calculation.

This means that the manager does not receive performance fees unless the value of the fund exceeds the highest net asset value it has previously achieved. This measure is intended to link the manager's interests more closely to those of investors and to reduce

the incentive for managers to seek volatile trades. It is pertinent to keep in mind that these are more of market competitive regulations than statutory regulations.

5.3 HEDGE FUNDS REGULATIONS IN INDIA

A lot of debate is going on in India as to whether hedge funds should be regulated or not. The Indian regulators, Securities and Exchange Board of India (SEBI)[23] and Reserve Bank of India (RBI)[24] have expressed concern, time and again, about the unregulated nature of the hedge funds and its possible adverse effect on the Indian Markets. The main concerns of the regulators are the lack of transparency and the secretive nature of such funds. The real identity of the beneficial owners of such funds are not known and there is apprehension among the regulators that money from illegal sources such as drug trafficking, terrorist organizations, unaccounted and illegal wealth of rich individuals are bring invested in India through participatory notes[25], the route which is followed by the hedge funds. Moreover, the market manipulation tactics including leveraging and short selling resorted to by the hedge funds is also a matter of concern for the regulators. It is said that 1997 Asian Crisis that shocked the entire Asian

[23] Hereinafter referred to as SEBI
[24] Hereinafter referred to as RBI
[25] The participatory notes are off shore derivative instruments which are issued by the registered FIIs in India to unregistered FIIs such as hedge funds to invest in Indian markets without getting themselves registered as FII or their sub-accounts. Since those hedge funds which are not regulated in their own country are not allowed to get themselves registered as FIIs in India, they generally follow the route of participatory notes which serves useful purposes for them. The advantage of using participatory notes is that the real identity of the beneficial owners is not known, they are not subject to disclosure norms and regulations of the regulators, they can invest money and derive economic benefits from the markets without disclosing their identity and without getting themselves regulated by the regulators which helps them because they, by their very nature, derive their advantages by being an unregulated entities. This also shows their reluctance to get registered as FIIs and comes under the regulatory net of the regulators. They always prefer participatory notes route to make entry into and exit from the Indian markets. Almost all top FIIs, including Merrill Lynch, Morgan Stanley, Credit Lyonnais, Citigroup and Goldman Sachs who are registered in India issue participatory notes.

region in particular was due to the sudden withdrawal of the huge amount of money by the hedge funds from the Asian markets. Further, since hedge funds are not required to follow the strict and comprehensive disclosure norms unlike in the case of mutual funds, the investor protection is also a matter of concern for the regulators. The regulators are also worried that these hedge funds are in the nature of hot money[26] and they resort to capital flight tactics and leaves the market when the market is sliding downward hence further deteriorating the market conditions. The hedge funds which are unregulated entities in their country of incorporation cannot invest in India directly because they are not allowed to be registered as FII because of their unregulated nature and hence such hedge funds invest in India through participatory notes given to them by the registered Foreign Institutional Investors[27]. One important reason for hedge funds not getting registered in India as FII is that once registered they have to comply with the regulations of Indian Regulators (SEBI and RBI) which they think will adversely affect their flexibility and their strategies. Given the influence of hedge funds in the Indian markets, the SEBI has also recognized its contribution in bringing foreign investment in Indian markets and has rejected the view that it has any hostility towards the hedge funds and the only issue for the regulators is the transparency of such funds.

[26]The money in bank balances or liquid securities which is liable to rapid removal to other countries if the holder suspects that the currency will depreciate is called hot money.An inflow of hot money may make a country's balance of payments situation look satisfactory, but also makes it subject to sudden deterioration.

[27] Hereinafter referred to as FII

5.6 SEBI DRAFT REGULATIONS ON HEDGE FUNDS[28]

In its draft regulations for hedge funds in the year 2004, SEBI has said that it intended to widen the FII window to allow these alternative investment pools access to Indian markets in a transparent and orderly manner. It acknowledged that the alternative investment pools if allowed to invest in Indian markets will be a source of additional liquidity and will also diversify the pool of foreign investments in the Indian market.

The SEBI, in its draft regulation, has laid down some guidelines for hedge funds seeking registration as FII. These are-

- With respect to the US based hedge funds, the investment advisor to the hedge funds should be a regulated investment advisor under the relevant Investment Advisor Act of USA or the fund is registered under Collective Investment Fund Regulations or Investment Companies Act of USA.
- 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 SEBI said that the present of institutional investors in the fund is expected to ensure better governance on the part of the fund manager and fund administrators and the institutional investors may help fund manager to take a long term perspective of the market.
- The Fund should be a broad based fund in terms of the SEBI (Foreign Institutional Investors) Regulations, 1995. It means that hedge funds should invest in a basket of 30-40 stocks (approximately). This stipulation arises because hedge funds, which seek absolute returns, usually invest in a few stocks

[28] SEBI came out with the draft regulations on Hedge Fund on 24 May, 2004.

that catch their fancy. The SEBI (FII) Regulations, 1995 require a more broad-based investment philosophy.

- The fund manager or investment adviser must have experienced of at least three years of managing funds with similar investment strategy that the applicant fund has adopted. The SEBI said that this provision is expected to allow well managed funds to access the markets and at the same time, keep the markets insulated from the possible adverse effects of 'trial and errors' by uninitiated rookies.

With the notification of SEBI (Mutual Fund) Regulation 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, advice clients or undertake the management of portfolio of securities or funds of the client. There are no hedge funds domiciled in India and they are not allowed to raise funds from the domestic market. Further, on account of limited convertibility, offshore hedge funds have yet to offer their products to Indian investors within India. The RBI through liberalized remittance scheme has allowed resident individuals to remit up to US $ 25,000 per year for any account or for capital account transaction. This liberalized scheme will allow individual investors to explore the possibility of investing in offshore financial products.

The current fiscal year has seen a spectacular growth in FII investment activities and they account for nearly 30% of FII inflows into the Indian market. Robust economic fundamentals, strong corporate earnings and improvement in market micro structure are driving the FII interest in India. With such fundamentals, hedge funds have evinced

keen interests and would like to directly invest in Indian markets as a registered entity under the SEBI (Foreign Institutional Investors) Regulations, 1995 (FII Regulations). Hedge funds typically invested in the offshore derivatives instruments (Participatory Notes (PNs)) issued by FII against the underlying Indian securities. Through this route the hedge funds could derive economic benefits of investing in Indian securities without directly entering the Indian market as FIIs or their sub-accounts. As of October 07 there were more than 1,100 registered foreign investors and 3,447 registered 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. The provision 15 (3) (a) of the FII Regulations relates to the prohibition on short selling of securities by FIIs. It allows that FIIs may transact business only on the basis of taking and giving deliveries of securities bought and sold, and cannot engage in short-selling securities. Further regulation 6(1)(b) of FII Regulations, provides that the hedge fund have to be registered with the statutory regulatory authority in their place of incorporation. Most Hedge funds would fail to meet this criterion because they are not registered with any regulatory authority, nor are the managers registered with regulatory authorities.

In October '07 SEBI has mandated that in the spot market, FII will not be allowed to issue P-notes that were more than 40 per cent of their assets under custody and those FII over the threshold will have to freeze their holdings. FIIs that have issued P-notes below the limit may increase issuances at an incremental rate of 5 per cent of their

assets under custody, he said. Also the reference date for calculating such assets will be September 30, which is the latest date for which data is available.

The FII Regulations allow sub accounts sponsored by registered FIIs to invest in India. Regulations 2 (k) defines "sub-account" which "includes foreign corporate 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 regulation 13 lay down the conditions and the procedure for granting registration to a sub-account of an FII. But the October '07 SEBI mandated new guidelines, under which FII currently registered in India will not be allowed to issue new derivatives from sub-accounts based in tax havens such as Mauritius.

However in practice if an applicant indicates in the application that it is a Hedge Fund, the consideration of the application is generally withheld. Since granting of registration to FII/sub-accounts is based on the disclosure of the details and on the undertaking given by the applicant in the application form; it could be possible that the 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 is mandatory that the sub accounts have to be sponsored by registered FIIs who are required to be regulated entities by relevant regulators in their home countries.

Chapter II of the SEBI (Foreign Institutional Investors) Regulations, 1995 inter alia lists 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 FII.

Therefore, currency trading or investment in commodity related financial products will not be an option for any hedge fund under the present FII Regulations.

The FII Regulations also lays down scrip-wise and fund wise maximum limits a fund can invest. Further, through circular dated February 12, 2002 and March 9, 2004 issued in the Secondary Market Department, position limits for investment by FII in derivatives have been advised. These limits will help diversify the foreign hedge fund investments and further help in jettisoning concentration in any specific scrip. The government wants to keep the hedge funds out of short selling at least in the cash segment and thus provisions of chapter III (Regulation 15 (3) (a)) disallows short selling by FII and stipulates that all trades by FII be delivery based.

The Money Laundering Act, 2003, is an endorsement of various international conventions to which India is signatory. It adequately empowers the state authorities to declare laundering of monies a criminal offence. Working out modalities of disclosure by financial institutions regarding reportable transactions, confiscation of the proceeds of crime, declaring money laundering as an extraditable offence and promoting international cooperation in investigation of money laundering is the main aim of the act. It also provides for reciprocal arrangement for assistance in certain matters and procedure for attachment and confiscation of property to facilitate transfer of funds involved in money laundering kept outside the country and extradition of the accused person from abroad.

CONCLUSION

Hedge Funds as a whole are becoming a prominent segment of the asset management industry and gaining popularity from investors particularly from high net worth investors, universities, charitable funds, endowments, pension funds, insurance and other institutional investors. Most hedge fund managers are embracing the new sources of capital from institutional investors, who are, by their very nature, highly regulated and their investments scrutinized. They encourage the hedge funds to improve their internal controls to meet the Alpha requirements. The assets under management of the hedge funds are growing on a double digit rate and it is estimated that worldwide the Hedge Fund industry is nearly $3 trillion dollars. This has created a lot of disquietude for financial regulators as Hedge funds are able to influence markets in a more radical manner than they would do so when they first started. In India the issues are intended to widen the FII inflow and to allow these alternatives investment pools to our securities market in a transparent and orderly manner. In addition, the suggestions also provide for adequate safety measures to address legitimate concerns associated with these funds. Most industry people are of the view that regulation is welcome and good but only if it does not impinge on innovation, competitiveness and the industry's ability to evolve. It's all about educating the investors and ensuring they know what they are getting into.

Hedge Funds bring liquidity to capital markets, and also make capital markets more efficient because they scour the financial landscape for inefficiencies, and then use expertise to structure the optimal investment to take advantage of the opportunity. They

have been instrumental in transforming the investment landscape, making it much broader than equities, bonds and property. Hedge funds have acted as a beachhead in new investment strategies, including middle market lending, asset-backed lending, credit derivatives, reinsurance, and carbon credits. The greater challenge for the regulators is as to how to increase compliance and protect investors without making hedge fund managers relocate to unregulated jurisdictions.

It is no doubt that the hedge funds need some regulation all over the world because of their capacity to influence any markets given the huge size of their investments and aggressive manipulative tactics adopted by them. If it remains totally unregulated, it can cause irreparable damage to the market because of its aggressive market manipulative tactics and strategies and also because of the possibility of systemic losses that are often borne by the financial markets they invest in. But such regulations should not defeat the basic strategies which hedge funds follow because in such cases it will loose its identity as indulging in complex financial transactions and taking high risk are the basic features of the hedge funds and it must be seen that their basic strategies such as short selling, leveraging, arbitrage and hedging are not adversely affected due to any such regulations at national and international level. The regulators have to be very cautious while regulating such funds because the very purpose of hedge funds, that is, to maximize returns at all time would be defeated in case any blind approach is followed. Like everything in life, hedge funds can also be misused and hence their should be some regulation as well as some guidelines for investor protection. But regulating it in such a manner so as to defeat the real character and identity of the hedge funds does not sound good and prudent. After all they infuse liquidity into the market,

provide an alternative investment strategies to the special classes of investors having higher level of risk appetite, greatly enhance the efficiency of the market, provides huge foreign investment in markets especially in Asian markets and helps in its growth and development, attract heavy investments and provides very high return and most importantly provides high level of liquidity in the market at the time of market slowdown and thus prevents market from being illiquid in some situations. They also contribute to the dynamism of the markets all over the world and hence their contribution to the global financial markets cannot be ignored or minimised by branding them as something illegal or unethical. In the same breath, they should not be blame for all the crises and havoc in the markets that takes place. It must also be remembered that the hedge funds are out of the reach of national regulators because of their international nature and character and because of their tendency to invest in various markets across the world and hence any such regulation must be at the international level through International Organisation of Securities Commission which should come out with the comprehensive guidelines and regulatory norms which hedge funds should follow so that national regulators have uniformity in regulatory approach as far as hedge funds are concerned.

In India, despite lot of hue and cry, regulators have not yet come out with the clear and comprehensive guidelines and norms to deal with the various issues that haunt regulators regarding the hedge funds. The concerns of the regulators are not without reasons because they want transparency and integrity to be the main features of Indian financial markets but merely expressing concerns now and then will not solve the problem. It is the high time for the regulators to take the matter seriously and take

appropriate and comprehensive steps in this direction. The writer will suggest the Government of India to appoint high level committee to deeply examine and analyze all the issues, aspects and concerns relating to hedge funds such as their conditions for registration as FII, disclosure norms-what kind of information and to what extent and the assurance for the confidentiality of such information because there is a possibility of misusing such information by other market players if such informations are made public especially when hedge funds maintain secrecy about their investment strategies which is one of their features, taxation issues, transparency, source of funding, how to prevent ill-gotten money from being invested in Indian markets through the use of participatory notes route, etc.

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