STRATEGIES FOR HOST-COUNTRY REGULATION OF HEDGE FUNDS: LESSONS FROM INDIA'S APPROACH

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Umakanth Varottil*

Faculty of Law
National University of Singapore
469G Bukit Timah Road
Singapore 259776

Email: v.umakanth@nus.edu.sg

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* Graduate Student Tutor and PhD Candidate, Faculty of Law, National University of Singapore; LL.M, New York University School of Law, B.A., LL.B (Hons.), National Law School of India University. This is a revised version of a paper presented at the 5th Asian Law Institute Conference held in Singapore in May 2008. I would like to thank Sumana Nagendran for generously sharing helpful background research materials with me, and Ipsita Dutta, Tan Lay Hong and Hans Tjio for their comments on a previous draft of this article. Errors or omissions remain mine alone.

STRATEGIES FOR HOST-COUNTRY REGULATION OF HEDGE FUNDS: LESSONS FROM INDIA'S APPROACH

Hedge funds tend to employ aggressive investment strategies, and they highly leverage their funds. While hedge funds enhance liquidity and efficiency in financial markets, they also engage in complex financial transactions that may result in systemic losses that are often borne by the financial markets they invest in.

In this context, the role of regulation of hedge funds in host-countries that receive their investment assumes importance. The Indian securities regulator, the Securities and Exchange Board of India ('SEBI') has employed various regulatory strategies to regulate hedge fund investments. These include the prohibition strategy, disclosure strategy, restriction strategy and the registration strategy. Using the example of SEBI's measures in the Indian context, the article examines the dynamics involved in regulating the offshore hedge fund industry, discusses the advantages and drawbacks of each regulatory strategy and sets out certain guiding principles for regulating offshore hedge fund investments.

I. INTRODUCTION

Hedge funds are collective investment pools that are privately constituted in order to invest in various types of securities (Gibson, 2000: 683). Such pools are used for investments by institutional investors and wealthy individuals, and they are not widely available to the public. What distinguishes hedge funds from other investors is that they tend to employ aggressive (and often risky) investment strategies, and that they highly leverage their funds (Eichengreen and Mathieson, 1999).[1] They also structure themselves in such manner as to avoid stringent regulation, thereby making their management and strategies opaque.

Hedge funds have become fairly prominent in the global financial markets. Over the last decade, they have grown exponentially, both in terms of their number and amounts invested.[2] Due to its size, the hedge fund industry is in a position to play a beneficial role in the development of the financial markets. It can infuse liquidity, promote the integrity of the financial markets by engaging in various types of trading that enhance efficiency of the markets and act as 'shock absorbers' by stabilising the markets during a crisis, all of which promote capital formation and business enterprise (Paredes, 2007: 1).

There is also another side to the hedge fund industry. Hedge funds are largely unregulated and hence shrouded in secrecy; they indulge in risky investment strategies in massive volumes supported by excessive leveraging. Due to this, their activities may not only cause losses to their investors or other entities with which they deal, but the spiralling effect could extend to the entire financial markets thereby exposing them to 'systemic risk' (Paredes, 2007: 2, Schwarcz, 2008).[3] Further, during declining market conditions, hedge funds may pull out of markets on a large scale thereby causing a steeper fall that can adversely affect the wider investing community.[4]

That brings me to the role of regulation in the hedge fund industry. Due to the benefits that hedge funds deliver to the financial markets, their activities cannot be prohibited altogether. At the same time, owing to the risks they carry, it may be imprudent to allow them to operate without checks and balances. Hence, the regulation of hedge funds assumes importance in terms of maintaining a balance between healthy development of financial markets on the one hand and the prevention of systemic risk due to aggressive investment strategies on the other.

While countries have been implementing variations of market regulation or government intervention, recent efforts to regulate the hedge fund industry in India demonstrate certain difficulties that are characteristic of this industry and its regulation. The objective of this article is to analyse the measures of the Indian securities regulator in reining in the hedge fund industry. It examines the Indian regulations in the context of the advantages and risks that hedge fund investments carry with them to the economies they invest in. Using the example of the regulations implemented by India's securities regulator, the Securities and Exchange Board of India ('SEBI'), this article explores the dynamics involved in regulating the hedge fund industry by analysing the strategies that were adopted by SEBI to rein in the hedge fund industry and the response of the industry to each such strategy.[5]

II. THE DYNAMICS OF HEDGE FUND REGULATION

A. Hedge Funds: Their Unique Traits

Hedge funds are traditionally described as such because of their unique design and strategy to hedge combined long[6] and short[7] positions in equities to appreciate the value of the portfolio of securities during any stage of the market cycle (Gibson, 2000: 683; Verret, 2007: 799). Hedge funds also invest heavily in the derivatives segment of the capital markets, including in futures, options and over-the-counter derivatives; they invest in currencies as well.

Hedge funds possess several other unique traits. *First*, hedge funds charge high performance fees. Such fees are linked to a ‘high water mark’, whereby they are conditional upon the hedge fund returns being above a set threshold (after recouping any accumulated losses) (Ali, 2003; Stultz, 2007: 178-79). Such performance incentives may drive managers to employ aggressive strategies with a short-term outlook to surpass the threshold and earn the fees rather than take a long-term view purely with the investors’ interests in mind (Stultz, 2007: 178).

Second, hedge funds follow a flexible investment strategy. Not only do they invest in a varied set of financial instruments that includes equities, bonds, derivatives, currencies, commodities and other financial assets, they are also not bound by any restrictions on specific investments. For instance, hedge funds are usually not restricted from investing in any particular class of assets beyond prescribed limits, so as to prevent concentration of investments in single companies or specific industry sectors and the associated financial risk. Such a wide canvass enables hedge fund managers to engage in aggressive investment strategies without prudential limits.

B. Hedge Funds: Their Investment Strategies; Systemic Risk

At a more specific level, hedge funds follow various investment strategies seeking either absolute returns or relative returns. These include the long/short strategy, the market neutral strategy, the event-driven strategy, the sectoral strategy and the global macro strategy (Fung & Hsieh, 1999: 318-22; Wynkoop, 2008: 3100-01). In addition, hedge funds do not merely invest in plain-vanilla debt or equity securities. They also invest in complex derivative instruments, and also engage in transactions such as options, repos and short-selling (Stultz, 2007: 180-82; Wynkoop, 2008: 3100-01). Furthermore, hedge funds heavily employ the instrument of leverage. This enables them to infuse a small amount of capital to make investments, and then use those investments as margin to borrow monies that are used to make further investments, and this cycle is repeated over and over again such that the borrowed monies of hedge funds vastly exceed the capital raised by them.[8] While leverage enables hedge funds to make exceedingly high profits when their bets are successful, they can cause the downfall of hedge funds when market movements negatively affect their portfolio. Excessive leverage causes these impacts to balloon beyond direct counterparties, and causes fractures to segments of the financial markets, or sometimes the markets as a whole.[9]

When an economy has a large exposure to over-leveraged hedge funds, there is a greater risk that the hedge funds' investments may be liquidated in a difficult situation, thereby bringing the price of the investments down substantially in a distress sale of such investments. A systemic situation that affects many such leveraged entities can have disastrous consequences as hedge funds may cause a mass distress sale of the investments in order to obtain liquidity, and such consequences across financial markets can potentially cause a regional or global financial crisis owing to contagion effects (Shore, 2005: 576; Wynkoop, 2008: 3107). As the investment strategies of hedge funds are extremely complex, and since leverage carries with it a potential to cause market risk, hedge funds bear the potential to cause systemic risk.[10]

C. Hedge Funds: Their Investor-Side Regulation

The nature of regulation of hedge funds in jurisdictions where they are domiciled (which is mostly designed to address investor-side concerns) has a direct correlation with the nature and content of regulation by economies in which such hedge funds invest. Generally speaking, greater investor-side regulation by countries where hedge funds are domiciled mitigates the risks from hedge fund activities in host countries where they invest.

There is a broad spectrum available in terms of types of investor-side regulation of hedge funds. At one end of the spectrum lies market regulation where players are left to design their own rules and protections to prevent financial crises without any significant governmental intervention. In jurisdictions that follow this approach, regulation of the hedge fund industry through government intervention continues to be comparatively light.[11] At the opposite end of the spectrum lies stringent government regulation of hedge fund activity. Under this approach, local regulators in jurisdictions step in to regulate hedge funds as well as their managers by specifying restrictions on the marketing and sales of hedge fund products.[12]

This broad array of perspectives on investor-side regulation of hedge funds demonstrates the lack of uniformity with which hedge funds are regulated in their domiciliary jurisdictions. While some countries' governments tightly regulate hedge funds, most other jurisdictions leave it to the market to regulate itself. Light investor-side regulation, which is a key attraction to hedge funds results in lack of transparency in the strategies and operations of hedge funds. The availability of secrecy is considered to be an advantage to hedge fund players, and this is a key reason for players to incorporate in jurisdictions that show leniency towards disclosure requirements (Chew, 1999: 87). It must be noted, however, that in the aftermath of the global financial crisis and due to allegations that hedge funds were involved in precipitating the crisis, there have been calls (both international and domestic) for tighter regulation and registration of market players with regulatory authorities even in countries that have hitherto displayed a benevolent attitude towards hedge funds.[13]

In concluding this Part, we see that hedge funds have certain unique traits (high performance fees and flexible investment strategies), they indulge in complex types of trading and investments and they are generally lightly regulated in their domiciliary jurisdictions thereby making their strategies and activities opaque to the outside world. These features of hedge funds necessitate a considered and thorough strategy for regulation by host countries where they make investments, as their activities are likely to have a deep and long-lasting impact on the economies of host countries. With this background, I proceed in the following Part to examine the Indian regulatory regime dealing with offshore hedge funds before analysing the various regulatory strategies adopted by SEBI.

III. REGULATION OF OFFSHORE HEDGE FUNDS IN INDIA

At the outset, it would be appropriate to provide a broad understanding of the magnitude of hedge fund investments in India and their impact on stock market performance. Hedge fund investments constitute a significant portion of foreign portfolio investments into India over the last decade. It is difficult to estimate hedge fund inflows into India with a great deal of accuracy as they are not monitored separately by the regulatory authorities, but it is possible to identify some general trends using suitable proxies. As we shall see later in this Part, hedge fund investments have not been allowed directly into India, and hence hedge funds have availed of indirect routes such as offshore derivatives (more specially known as participatory notes) to take positions on Indian stocks. The level of investments into Indian through the use of participatory notes serves as a useful indicator to determine the amount of hedge fund investments.

Hedge fund inflow numbers (represented by participatory notes) have generally been tracked since 2003. One study notes that of the total foreign investment of Rupees

900 billion in the Indian stock markets around 2003-2004, nearly 25% (Rupees 240 billion) is accounted for by issuance of participatory notes (Maniyar & Kashimpuria, 2004). More recently, an estimate by SEBI shows that the notional value of participatory notes outstanding has multiplied ten times between March 2004 and August 2007 – from Rupees 318 billion to Rupees 3.53 trillion (which is approximately 50% of the total foreign portfolio investment into India) (SEBI, 2007: 2). In U.S. dollar terms, this growth translates into $ 8.1 billion in March 2004 to $ 89.8 billion in August 2007 (Timmons, 2007). It is evident that not only has there been a dramatic increase in hedge fund investments into India in absolute terms, but its proportion relative to overall foreign portfolio investment into Indian stock exchanges has grown to half, having doubled from 25% to 50% during the period under review.

Since it constitutes a significant portion of Indian stock market investment, the hedge fund industry's movements in and out of Indian markets are likely to affect stock market performance. Although there appears to be no systematic empirical study that tracks the correlation between hedge fund activity and stock market performance, there is sufficient anecdotal evidence that signals a strong relationship. Based on market sources and action by regulators, it has been suggested that sell-offs by hedge funds holding participatory notes in May 2004 and May/June 2006 may have caused the sharp decline in the Indian stock market indices of the Stock Exchange, Mumbai and the National Stock Exchange (Singh, 2007: 4-5).[14] More recently, the global financial crisis has adversely affected hedge fund investments and owing to redemption pressures from their investors, hedge funds are being compelled to liquidate their investments in several countries, including India, thereby pulling down stock prices (Bhalla, 2009; Lokeswarri, 2008).

In this context, the Indian securities regulator, SEBI, has followed a chequered pattern of regulating offshore hedge funds. A process that began with a complete prohibition on recognition of hedge funds has subsequently led to SEBI's view of registering hedge funds as foreign institutional investors ('FIIs') so as to enhance transparency in their operation in India's financial markets. The various policy approaches that SEBI has had to steer through and the resultant position that currently prevails place emphasis on some salient issues that SEBI has had to grapple with as the Indian securities regulator.

A. FII Regime: The Prohibition Strategy

Foreign portfolio investors invest in the Indian stock markets through the regime created by SEBI under the SEBI (Foreign Institutional Investors) Regulations, 1995 ('FII Regulations'). Foreign entities that satisfy certain prescribed qualifications may register themselves with SEBI as FIIs.[15] While considering an application for registration of an entity as an FII, SEBI examines an applicant's track record, professional competence, financial soundness and, most importantly, whether the applicant is regulated by an appropriate foreign regulatory authority (regs 6(1)(a),(b) of the FII Regulations). Entities that are unregulated in the domicile of their incorporation have been viewed unfavourably by SEBI. Although the FII Regulations themselves do not explicitly refer to registration (or otherwise) of hedge funds as FIIs, in the initial years after the promulgation of the FII Regulations, SEBI adopted an internal administrative decision whereby if an applicant indicated in its application that it is a hedge fund, then SEBI would withhold consideration of the application (SEBI, 2004c: 38). Hence, in practice, SEBI's view towards hedge funds was to distance itself from this class of investors, with the rationale being to disallow unregulated offshore entities from accessing the Indian capital markets.

B. Response to the Prohibition Strategy; Exportation of Indian Capital Markets

A logical consequence to SEBI's stance would have been to prevent hedge funds and other unregulated investment pools from investing into India. But, that was not to be. The offshore entities began accessing the Indian stock markets through indirect methods using derivative instruments and other complex structures that cloaked the identity of these investors. These structures provided avenues to hedge funds to continue to participate in the Indian stock markets without submitting to the regulatory regime of the Indian regulators.

Hedge funds began accessing the Indian capital markets using offshore derivative instruments (‘ODIs’).[16] ODIs are instruments that “derive their value from an underlying financial instrument such as an equity share” (Sampathkumar, 2007). They are issued offshore by FIIs to various investors (including hedge funds), on the strength of underlying equity, derivatives or other securities issued by Indian companies that are held by the FIIs. ODIs are typically taken up by unregulated entities that are either otherwise ineligible to invest in the Indian capital markets or that are desirous of keeping their identity outside the purview of the Indian regulators. Being derivative instruments, the ODIs confer an interest on the hedge funds holding them to receive economic returns from the FIIs that mirror the returns that the FIIs obtain from the underlying Indian securities. For instance, dividends or other economic returns received by the FIIs on the underlying securities are paid out to the hedge funds as returns on the ODIs. Similarly, the returns to the FIIs on sale of those securities are in turn passed on to the hedge funds.

Such indirect structures have been found by hedge funds to be an extremely advantageous method of investing into India. They are able to obtain returns on the Indian stock markets without actually investing in them, as the ODIs are purely offshore instruments that are traded and settled outside India. These instruments allow hedge funds to enter and exit the Indian markets without registering with the Indian securities regulator. The key advantage to hedge funds in this structure is the fact that they can not only continue to operate unregulated in their domiciliary jurisdiction (where that is possible, depending on the specific local regulations), but also maintain complete opacity with respect to the Indian securities regulator as SEBI is unable to discern the identity of the ODI investors (Kane, 2007).

The emergence of an instrument in the nature of an ODI is symptomatic of the constant attempt by players in the financial markets to skirt regulation so as to maintain anonymity of their activities and to remain outside the sphere of regulation. Although this phenomenon is generally present in financial markets regulation, it is even more characteristic of hedge funds and other unregulated investment pools.

C. Sunshine as a Disinfectant: The Disclosure Strategy

Until the year 2001, the ODI market was almost entirely unregulated. Consequently, hedge funds and other unregulated investment pools enjoyed a free hand in entering and exiting Indian capital markets without directly investing in the underlying Indian securities. However, with the growing need to regulate an offshore market in such derivative instruments, SEBI in 2001 decided to adopt a new strategy to regulate hedge funds and other investors participating in the Indian markets through ODIs. The fulcrum of this approach lies in the element of transparency. In a measure designed to bring ODI investments out in the open so that requisite information about such investments is available to regulators, SEBI ushered in disclosure requirements. SEBI issued a circular calling upon FIIs to report the issuance, renewal, cancellation and redemption of ODIs with SEBI in a prescribed format (SEBI, 2001).[17] This measure was intended to enable SEBI to track the beneficial ownership of interest in Indian securities held by offshore investors.

While the disclosure strategy enhanced the availability of information in the markets regarding hedge fund trading through ODIs, it failed to address some of the other concerns. Most importantly, hedge funds were able to continue to be unregulated in their domiciliary jurisdiction and still avoid any registration with SEBI as a host-country regulator. The disclosure strategy only enhanced hedge funds' obligations in terms of having to disclose their ODI holdings to the FIIs (that in turn had an obligation to disclose such information to SEBI). No other disclosure or transparency measures were required in terms of the hedge funds' own structures and investment strategies. Hence the disclosure strategy does not appear to have had a significant restrictive impact on the operation of hedge funds through investments in India, which only grew exponentially during the period.

D. Domiciliary Regulation: The Restriction Strategy

Seemingly due to the shortcomings of a pure disclosure-based approach, SEBI in 2004 adopted a somewhat different strategy, which was restrictive in nature. This was in addition to the disclosure strategy which continued as well. The primary prong of this restrictive strategy was to prescribe that ODIs may be issued by FIIs only to entities that were regulated in their domiciliary jurisdiction. This would ensure that unregulated entities are not conferred the privilege of participating in the Indian capital markets, and that all entities that hold ODIs will be subject to the supervision of a regulator that oversees their activities and operations. This was meant to lend credibility to hedge funds and other investment pools that are allowed to participate in the Indian capital markets.

Consequently, the FII Regulations were amended in January 2004 to introduce reg 15A, which provides that an FII may issue, deal in or hold ODIs only in favour of those entities which are regulated by any relevant regulatory authority in the countries of their incorporation (SEBI, 2004a). This restricted the availability of the ODI market only to regulated entities. However, the list of regulated entities that could invest in ODIs issued by FIIs provided sufficient flexibility to hedge funds and other similar investors to invest in the Indian markets. This list was not limited to entities 'registered' with capital markets or other financial regulators in the countries of domicile, but included any corporate entity that has filed its constitutional documents with a registrar of companies or other comparable regulatory agency (SEBI, 2004b). Due to the wide range of entities that are covered within the meaning of 'regulated entities', there was no serious threat to the hedge fund industry, whose ODI investments into India continued to grow even after adoption of such a restrictive strategy.

The fact that a combination of the restrictive strategy and the disclosure strategy has not deterred hedge funds from operating in large-scale transactions is borne out by the mass sales of investments by FIIs (including UBS Securities Asia Limited) on 17

May 2004 that triggered a sharp drop in the stock prices on the Indian stock markets (Outlook, 2005). SEBI initiated action against UBS for its inability to provide information regarding ODI holders on whose behalf massive divestments were made (*UBS Securities Asia*, 2005a). However, SEBI's initiatives were unsuccessful as the Securities Appellate Tribunal, the appellate body that hears appeals from SEBI, found that the FII Regulations were unclear as to the information required to be provided by FIIs in relation to the ODIs, and that such information lacks precise definition (*UBS Securities Asia*, 2005b).

This clearly demonstrates the difficulties that prevail in regulation of offshore hedge funds. Since hedge funds use derivative instruments to invest, and since these instruments are issued outside India using complex structures, it is usually problematic for Indian regulators to pinpoint with precision the types of information that need to be disclosed. On the other hand, any general description of disclosure required may not suffice either (as *UBS Securities Asia*, 2005b shows). Hence, regulators are left with the onerous task of calibrating the disclosures such that they are specific enough to withstand judicial scrutiny, but at the same time are flexible enough to capture various practices across offshore jurisdictions.

For the reasons discussed here, SEBI's combined prescription of a disclosure strategy coupled with a restrictive strategy (that involves limiting the issuance of ODIs to regulated entities only) has not been entirely successful in containing the Indian markets from the effects of massive trading by hedge funds and other investment pools (Pinto, 2007; Singh, 2007: 3). This also resulted in a clarion call being sounded by various regulators and policymaking bodies for either banning ODIs altogether or for containing their effect.

E. Quantitative Measures: The Registration Strategy

In October 2007, SEBI initiated prominent changes to strengthen the regime governing hedge funds by adopting a two-pronged approach (SEBI, 2007). It noted that the number of FIIs that issued ODIs increased significantly, thereby signalling an explosive growth of ODIs in absolute terms and as a percentage of total FII assets in India (SEBI, 2007: 2). In order to check this growth, the following steps were taken. *First*, SEBI announced the imposition of quantitative restrictions on the issuance of ODIs by FIIs to investors offshore in respect of underlying securities in the cash market (by prescribing an upper limit of 40% of assets of the FIIs) and entirely prohibited the issuance of ODIs where the underlying securities are derivatives. These measures were required to be implemented within a period of 18 months from the date of announcement. *Second*, SEBI instead encouraged hedge funds and other similar investors to register themselves with SEBI as FIIs or sub-accounts rather than to continue to participate in the Indian stock markets through indirect routes such as ODI, thereby calling on hedge funds to come in through the "front door".[18]

It was expected that hedge fund investing, which hitherto remained offshore, would come onshore into India by way of FII registrations (Singh, 2007).[19] Further, there was likely to be a churn in investments held through ODIs, especially in the derivatives segments, over 18 months following the announcement[20] as the derivative positions are required to be wound down gradually during that period (Singh, 2007).

However, even before the dust settled on these new set of regulations imposed in 2007, in a recent move announced on 6 October 2008, SEBI decided to reverse its earlier position and removed restrictions relating to the issue of ODIs by FIIs. It is believed that this reversal was necessitated due to the perceived flight of foreign capital from Indian markets owing to stringent regulations, which was exacerbated by recent credit crisis (Singh, 2008; Sundaresan, 2008).

In initiating this reversal of policy, SEBI seems to have been overcome by the fear of scaring hedge fund investors away from the Indian markets thereby bringing the stock prices down in a manner as to hurt the Indian domestic investors, including individual investors, who are likely to lose in a stock market crash. Keeping in mind such economic compulsions, the Indian regulator has been forced not to adopt the straightforward regulatory strategy of banning ODIs. This is characteristic of financial sector regulation where "the regulator constantly battles against over-regulation which may dampen market activity, and under-regulation which puts a market at risk of disruption and manipulation" (Chew, 1999: 82). SEBI's attempt has been to tread that fine line by regulating hedge funds without making the regime so onerous that they do not participate in the Indian stock markets thereby affecting liquidity and foreign exchange flows.

While SEBI has indeed followed a chequered approach towards regulating offshore hedge funds, these entities have nevertheless thrived in the Indian markets that have witnessed relative prosperity over the last few years. Each time there has been a regulatory pronouncement, the hedge fund industry has navigated through regulation without being impeded by any regulatory efforts. In the wake of increased regulatory efforts, the hedge fund industry's participation in the Indian markets has only grown rather than shrunk.

IV. REFLECTING UPON VARIOUS REGULATORY STRATEGIES

I now discuss each of the strategies adopted by SEBI in regulating hedge funds and examine how the industry responded to each of the strategies, thereby highlighting some of the benefits and drawbacks of each strategy. I then discuss another strategy that was not adopted by SEBI, but one that is fairly prominent in hedge fund regulation the world over. That is the strategy of market regulation or self-regulation, where the market players lay down norms to regulate themselves without governmental intervention by the host countries.

A. Prohibition Strategy

This strategy, which was initially adopted by SEBI, required that hedge funds be prohibited altogether from registering themselves as FIIs thereby denying them access to the Indian markets. While this approach, on the face of it, appears to be quite a stern measure to contain risks from hedge fund investing, it failed on one count. The industry swiftly reacted to this approach by participating indirectly into the Indian stock markets through FIIs (registered with SEBI) by investing in ODIs. This brought about exportation of the Indian capital markets. The hedge fund industry's reaction demonstrates its malleability in being able to tweak its investment structures and approaches to comply with applicable host-country regulation. Apart from that, it also shows the hedge fund industry's mobility and its ability to engage in restructuring with relative ease.

B. Disclosure Strategy

The disclosure strategy provides a fine balance between regulation so as to prevent misuse and manipulation of the markets and at the same time grants sufficient flexibility to hedge funds to carry out their investments in a manner that makes their activities profitable to their investors. Disclosure is generally the harbinger of financial market regulation. The advantage of this strategy is that it brings the operation of hedge funds out into the open and removes the veil of secrecy that normally surrounds these entities and their operations.

However, there are drawbacks in a pure disclosure strategy. *First*, disclosures are incapable of precise definition, especially when the entities whose information is required are not only unregulated, but are also incorporated in jurisdictions that do not impose stringent information requirements. It would be a gargantuan exercise for host-country regulators to devise precise disclosure requirements regarding entities that are incorporated in other jurisdictions (that follow information requirements dissimilar to that of the host-country). Where such disclosure requirements lack precision, FIIs and hedge funds are easily able to retreat on their obligations with impunity.[21] Further, it is not sufficient if disclosures merely relate to the identity of the hedge funds or their holdings of securities in a host country. The disclosures must also cover sufficient background information about the hedge funds, including the identity of the sponsors and managers, as well as their broad strategies (Gibson, 2000: 710). Such information would assist host-country regulators in guarding against systemic risk by enabling regulators to determine whether hedge fund trading has the potential to affect the markets in any significant way (Gibson, 2000: 711). *Second*, the disclosure strategy alone is likely to fail in regulating offshore entities due to their extra-territorial nature. It will be problematic for host-country regulators to implement disclosure obligations on offshore hedge funds (that indirectly invest in the Indian stock markets) when they are not within the purview of SEBI's jurisdiction. Hence, while SEBI may possess jurisdiction over the FII, it cannot directly enforce disclosure obligations against offshore hedge funds (that invest through ODIs), and this imposes severe limitations on the ability of the Indian securities regulator to implement the disclosure strategy with reference to purely offshore entities.

C. Restriction Strategy

This strategy permits hedge funds to invest in the host-country markets only if they are regulated in the countries of their domicile. In other words, it restricts the types of entities that can invest in the stock markets. This strategy has also been followed in India since 2004 wherein ODIs can be issued only to 'regulated entities'. This effectively involves the host country piggybacking on the regulation of the country of domicile. Therefore, host countries rely on the fact that since the hedge funds are regulated in their country of domicile, they will be subject to at least minimal requirements such as satisfying qualification requirements for establishment, submission of information and other cautionary matters that may guard investors against fraud and misuse of their funds.

Such domiciliary regulation would lend credibility to the hedge funds, upon which host-country regulator would ride. The advantage of this strategy is that it allows hedge funds to submit themselves only to a single regulatory authority (ie in their country of domicile) and avoid being subject to multiple-regulation.

On the negative side, the restrictive strategy would work only if the regulatory requirements in the country of domicile (by which hedge funds are regulated) and the host-countries (where they make investments) are nearly identical or fairly streamlined. If the regulatory perspectives and compliance requirements vary significantly, then regulation of hedge funds by one country does not signal their credibility in other jurisdictions. This is particularly true when hedge funds are domiciled in tax havens and other lightly-regulated jurisdictions, which is in fact the case with a large percentage of hedge funds that are currently operating in the global markets (IFSL, 2008). In this case, there is bound to be a wide chasm between the actual domiciliary regulation (mostly light) and the expectations of host countries (generally strong and detailed), and this is likely to cause severe regulatory mismatch.[22] When the regulatory concerns of domiciliary jurisdictions and host-countries are disparate, the rationale of host-country regulators relying on domiciliary regulation leaves matters to grave doubt, thereby questioning reliance of regulators on the restrictive strategy.

D. Registration Strategy

This strategy involves host-country regulators requiring all financial investors to register with them in case they wish to invest in the financial markets. SEBI has followed this approach by welcoming hedge funds to register with itself as an FII and thereby permitting them to invest in the financial markets, both in the cash and derivative segments. This strategy is advantageous in that it achieves several regulatory objectives. *First*, by registration, it ensures that the hedge funds are subject to the supervision and authority of the host-country regulator. Issues of extraterritoriality are automatically eliminated. *Second*, registration strategy embraces elements of disclosure as well, since registration would require the hedge funds to disclose information regarding their activities to the regulators. Hence, this strategy would confer strong interventional powers to governmental authorities to step in and act as a check on the activities of hedge funds during times of crises (or even to forestall one).

Registration also confers another oblique advantage to hedge funds. It enhances their credibility with investors. Large institutional investors such as pension funds, mutual funds and insurance companies tend to invest in funds that follow proper investment practices and whose managers are entities with a credible track record. Registration of hedge funds with host-country regulators will boost the credibility and reputation of the hedge funds thereby increasing their ability to attract high quality investors. Hence, even though registration may impose additional compliance requirements on hedge funds, the reputation incentives it offers may lure hedge funds towards registration rather than to allow them to stay away from regulation.

On the other hand, excessive regulatory interference in the activities of hedge funds would force them to migrate to other jurisdictions that impose lighter regulation.[23] Hence, the obligations that accompany registration must not be so onerous as to stifle the flexibility that hedge funds seek by their very nature. Regulators will therefore have to tread a fine line while framing the compliance requirements that are tied to registration.

E. Market Regulation Strategy

This strategy is one that allows hedge funds to freely operate in host-country markets without any governmental intervention. Here, it is left to the market players to regulate one another and thereby avoid any crisis. The exercise of market discipline by hedge funds as well as their counterparties would help contain the effect of any systemic risk arising out of complex trading strategies as well as leverage (Gibson, 2000: 706). The advantage of market regulation is that it is dynamic and flexible in nature, and can modify itself to suit constantly changing market circumstances (Verret, 2007: 818). For example, in this approach, counterparties that trade with hedge funds (either as lenders, derivative counterparties or otherwise) will exercise prudent judgment while dealing with hedge funds, and that itself operates as a check in relation to the activities of hedge funds (Gibson, 2000: 706). This approach can be buttressed by the involvement of self-regulatory bodies that oversee the regulation. The self regulatory authorities[24] could lay down norms to be complied with by their members, and any failure to comply could result in sanctions, including removal from membership of the peer body. Until recently, there were significant efforts for the hedge fund industry to be governed by market regulation and self-regulation rather than governmental intervention (PWG Agreement, 2007), mostly due to the flexibility it provides to the operation of the hedge fund industry.

It may be noted that market regulation and self-regulation, if at all feasible, are possibly useful tools in advanced economies that can boast of developed capital markets dominated by sophisticated and experienced players. It may, however, be noted that recent events and the ongoing financial crisis that emanated in the US have questioned the success of market regulation even in advanced economies such as the US Both internationally and in several developed economies, there is a perceptible shift in regulatory stance away from the market and self-regulation approach towards a government-regulation and registration approach. In that sense, the financial crisis may mark a decline (at least momentarily and marginally, if not more permanently) of the market regulation strategy.

In emerging economies (such as India), the chances of success of market regulation is even lesser due to the relative lack of sophistication of the financial markets. If at all there is a case for introducing market regulation and self-regulation in certain areas, it should be in addition to (and not instead of) governmental intervention. In other words, there may be areas where government can cede some of its regulatory territory in favour of self-regulatory authorities without withdrawing from the regulatory scene entirely. The self-regulatory mechanism has to sit on top of, and be commensurable with, a basic government regulatory framework. In such a model, the government would lay down certain basic rules of the game regarding host-country issues involving hedge funds, and then leave it to self-regulatory bodies to determine and implement the detailed norms and conditions so as to enhance enforcement measures.

F. Is there an Optimal Strategy?

That naturally leads me to the question as to which strategy a host-country regulator should follow. It appears that there is no single strategy that might be optimal in all circumstances, or even in the context of a specific host-country market. But, it is certainly possible to set out some guiding principles.

Given any host-country jurisdiction, the registration strategy would function effectively in protecting its financial markets from systemic risk arising out of hedge fund investments. The registration strategy would require offshore hedge funds to submit to the host-country jurisdiction. Constant supervision and control of hedge fund activity by host-country regulators would keep such activity under check.[25] Further, the registration strategy carries with it all the benefits that accompany the disclosure strategy. Care must be taken to ensure that the registration process is streamlined, timely and cost-effective. The registration strategy would be most suitable to emerging economies where not only are market institutions and players less sophisticated, but the state plays a significant role in economic activity.[26]

However, developed host-country jurisdictions may perhaps command a wider menu of options. In conjunction with the registration strategy, they can also adopt the market regulation strategy. Developed economies generally have relatively sophisticated players (such as banks and financial institutions) who are better placed to protect themselves from systemic risk. Hence, the exercise of better market discipline by hedge funds and other entities they deal with will help guard against systemic risk (Gibson, 2000: 682). However, market players will not be in a position to regulate themselves effectively if the market is beset by problems arising due to information asymmetry. This issue has been brought to the fore with the financial crisis. Market participants (such as counterparties of hedge funds) cannot protect themselves unless they have adequate information about the financial position, trading position, risk management practices, market strategy and exposure of the hedge funds they deal with (Gibson, 2000: 710). To that extent, market regulation *per se* is inadequate. Market regulation needs to be buttressed by disclosure requirements that are imposed on hedge funds. Here, governmental regulation needs to be introduced for the purpose of registering hedge funds and mandating disclosures to be made by them. Hence, even in the case of developed economies, this article advocates a combination of the registration strategy (which requires hedge funds to register with regulatory authorities and satisfy certain threshold requirements) and the market strategy through self-regulation (which keeps the detailed activities of hedge funds under check). In that sense, market regulation cannot stand on its own, but can only be in addition to the registration strategy.

V. CONCLUSION

Hedge funds are an evolving category of financial investors whose ability to invest large sums of monies in financial markets (in emerging economies, in particular) and also to exit such markets makes them a crucial part of financial sector regulation in host countries in which they invest. While hedge funds, owing to their enormous size, bring several advantages to host-country markets, they also carry significant risks and bear the potential to cause systemic loss in markets where they invest.

As for regulation, there has so far been no uniform approach on the part of host-countries to regulate their investments. As we have seen from India's approach alone, there are several strategies available to regulate the operations of hedge funds. But, the key lies in the regulators being able to arrive at the right combination of strategies so as to encourage hedge funds to invest in their markets, but at the same time to ensure that their activities do not lead to any financial crises or disruptions in the host-country markets. Hitherto, the approach of securities regulators, including that of India, has been to periodically review the regulatory position and take immediate steps to remedy any situation. While that approach tends to operate in the short-term to stave off any crisis or regulatory situations that emerge, it does not help deal with a comprehensive long-term strategy in regulating hedge funds that sets out a plan that is clear to the regulators, the hedge funds themselves and also all other parties that are involved in the financial markets.

The conceit of this article is that regulators in host-countries that receive hedge fund investments should devise a comprehensive long-term plan after taking into account the various regulatory strategies available. This analysis sets out a framework and provides a menu of options available to the host-country regulators to pick and choose from each strategy so as to create the winning strategy that serves the purpose of the host-country and its financial markets. Any such strategy ought to be one that encourages the growth of hedge funds and financial innovation by guarding against systemic risks and financial crises. The Indian approach reveals several shortcomings in the regulatory strategy, but it indeed provides lessons for its own regulator, SEBI, and perhaps for regulators in other host-country jurisdictions to learn from that experience.

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[1] Leverage is the practice of borrowing funds in order to make investments. Firms that engage in leveraging thus have high debt-to-equity ratios.

[2] It has been reported that there were over 11,000 hedge funds at end-2007 with assets under management totalling around $2.25 trillion. IFSL, 2008: 1.

[3] For a detailed discussion of the concept of 'systemic risk', see Schwarcz, 2008.

[4] History bears testimony to the havoc that hedge funds and other unregulated investment pools can cause to the financial markets. The first widely publicised hedge fund collapse relates to the Long-Term Capital Management ('LTCM'), whose enormous size (built up through excessive leveraging) required banking regulators and counterparties to participate in a bail-out operation in 1998 to the tune of US$ 3.6 billion to avoid financial shock in the markets, see Gibson, 2000: 682; Gastik, 2001: 591-94. Hedge funds are seen to have played a significant role in exacerbating the Asian markets crisis of 1997-98, see Shore, 2005: 563. More recently, hedge funds are also involved in the situation emanating from the subprime crisis due to their large-scale investments in collateralised debt obligations backed by subprime housing mortgages, see Partnoy, 2007, and the collapse of Bear Stearns, a leading broking firm, was triggered by the failure of two of its hedge funds in mid-2007, see Browning, 2007.

[5] This article focuses on regulation of investments by hedge funds from the perspective of economies that are the recipients of these investments. Such countries are referred to as the 'host countries'. In that sense, it places special emphasis on the impact of investments by offshore hedge funds in the host-country markets such as India. This article is not intended to cover the manner in which hedge funds are regulated in jurisdictions where they are domiciled (with such countries being referred to as 'domiciliary jurisdictions'), except to the extent they have interplay with host-country regulation.

[6] A long position is one where an investor purchases a security, commodity or other asset with the expectation that such asset will appreciate in value and that the investor can make a profit upon sale of such asset. See, Beelaerts, 2003: 163.

[7] A short position is the opposite of a long position. In a short position, the investor borrows shares from another person that actually owns the shares (a lender) and then sells them in the stock market. The investor retains the proceeds of the sale. This transaction is effected when the investor expects the market price to fall. The loan in respect of the shares is squared off subsequently when the borrower buys further shares in the market and returns those to the lender. Beelaerts, 2003: 164.

[8] Several methods are employed for leveraging, beginning with simple borrowings against securities to complex derivative and collateralised repo transactions that achieve the same objectives. See Arditti, 1996: 186-88.

[9] The LTCM debacle is a classic example of such a systemic loss caused due to over-leveraging by a hedge fund that required regulators and other counterparties to participate in a large and complicated bail-out process. Gibson, 2000: 682. Apart from that, leverage also allows hedge funds to engage in speculative transactions, and this risk manifests itself strongly in derivatives trading. See Chew, 1999: 85-89.

[10] Wynkoop, 2008: 3106 (observing that hedge funds also contribute to systemic risk, and that fund activity that impacts "the ability of financial intermediaries or financial markets to efficiently provide credit" creates risks to the entire financial system). See also, Davidoff, 2008: 181 (providing examples of systemic risk that "include increased market volatility as a consequence of hedge fund market trading, adverse market fluctuations due to hedge fund … over-leverage, and the extreme case of fund collapse with adverse effects on the national or global financial system.")

[11] Jurisdictions like the U.S. largely follow the market regulation approach towards hedge funds. See PWG Agreement. For an analysis of the relevant provisions of law that are applicable in the US for regulation of hedge funds and similar investment vehicles, see, Paredes, 2007: 4; Gibson, 2000: 688-99; Verret, 2007: 807. Other countries that impose light governmental regulation and rely largely on

market regulation are offshore jurisdictions (typically tax havens) such as Cayman Islands, British Virgin Islands and Bermuda.

[12] Examples of jurisdictions that follow this approach are the UK and other European countries. In the UK, such regulation is effected through the Financial Services Authority (FSA). See IFSL, 2008: 7-8. In addition to U.K., both Hong Kong and Singapore are reputed to regulate hedge funds quite extensively. See Shore, 2005: 584.

[13] Some of the efforts internationally include: (i) recommendations of the G-30 for registration and regulation of managers of leveraged investment pools, see Group of 30, 2009: 9; (ii) declaration of the G-20 to "extend regulation and oversight to all systemically important financial institutions, instruments and markets", which will "include, for the first time, systemically important hedge funds", see G20, 2009; and (iii) detailed recommendations of IOSCO for global regulation of hedge funds, see IOSCO, 2009. Some of the efforts domestically in the US include the introduction of various bills for consideration such as the Hedge Fund Transparency Act of 2009 and the Hedge Fund Adviser Registration Act of 2009, both of which have been referred to the Financial Services Committee, see Hedge Fund Law Report, 2009.

[14] One such investigation initiated by SEBI relates to *UBS Securities Asia* (2005a), discussed in Part IIID of this article.

[15] Regulation 6(1)(d) of the FII Regulations sets out the categories of persons that may be registered as FIIs. These include a pension fund, mutual fund, investment trust, insurance company, multilateral organisation, asset management company, investment manager, university, endowments, sovereign wealth funds and the like.

[16] These offshore derivative instruments are issued in the form of, and are known as, participatory notes, equity-linked notes, capped return notes, and participating return notes. See, SEBI 2001. The most common instrument among those is the participatory note.

[17] The disclosure requirements were further streamlined by SEBI, 2003a. Further, the FII Regulations were amended to introduce reg 20A that requires FIIs to disclose information regarding ODIs. See, SEBI 2003b.

[18] This expression has been attributed to Mr. M. Damodaran, then Chairman of SEBI. See David, 2007.

[19] Several hedge funds (including some leading ones) have begun to register themselves as FIIs. These include Renaissance Technologies, Old Lane and DE Shaw. See Abraham, 2008.

[20] SEBI appears to have carefully provided for a time-frame to allow for winding down positions as any short time-frame would have resulted in massive liquidation of positions thereby possibly allowing the markets to spiral downwards due to the selling pressure from FIIs that issued ODIs in order to comply with the new restrictions.

[21] The difficulties involved in defining information requirements was played out in *UBS Securities Asia* (2005b), where SEBI was unsuccessful in requiring the UBS FII to provide the information SEBI had requested.

[22] Furthermore, domiciliary regulation is essentially steered by investor-side concerns, such as protecting the interest of the investors in the hedge fund in terms of securities regulation. However, host-country regulation and its objectives are vastly different. The concerns of host-countries are primarily to ensure a healthy financial market and a smooth flow of funds in and out of it without any adverse impact on other investors.

[23] This issue gains greater importance in the context of regulatory competition among host nations. Where regulations in relation to hedge funds are onerous, these entities tend to reincorporate or reinvest in other jurisdictions that are friendlier to their operations. Consequently, there is competition among nations to attract hedge funds by providing easier access to hedge funds without stringent compliance requirements. The danger here is that such competition is likely to result in a 'race to the bottom' than in a 'race to the top', an aspect which is of crucial importance to regulators while framing

the optimal regulatory strategy. 'Race to the bottom' is where countries or states compete to form the most liberal regulatory regime to attract market players. 'Race to the top' is where countries or states compete to develop superior competency through efficient and effective regulatory regimes. See Verret, 2007: 824.

[24] For example, the National Association of Securities Dealers (NASD) is a self-regulatory body in relation to stock intermediaries. See Verret, 2007: 818.

[25] Registration may also provide host-country regulators with the ability to impose quantitative restrictions such as limits on the amount of leverage allowed and minimum capital adequacy required. However, at the outset, it may not be necessary for host-country regulators to impose such quantitative restrictions as they may be unnecessary and inefficient in addressing systemic losses. Rather, this may lead to overregulation that may cause hedge funds to migrate to other jurisdictions. See Gibson, 2000: 706. However, in case systemic risk in fact manifests, and if circumstances so require, regulators may retain the ability to use regulatory tools such as quantitative restrictions, but not otherwise.

[26] In developing and emerging economies, the state continues to play a greater role in regulating financial market activity, often by imposing mandatory standards and bright-line rules. There is usually a governmental body that oversees securities and financial markets, with a perceived reluctance on relying on market-based systems for regulation. See Steinberg, 1996: 720.

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