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Government of India
Ministry of Finance
Department of Economic Affairs
Capital Markets Division
India

BY E-MAIL
am.bajaj@nic.in; Shefali.dhingra@nic.in

Dear Sirs

REPORT OF THE WORKING GROUP ON FOREIGN INVESTMENT IN INDIA

ISDA and its members welcome the report of the Working Group on Foreign Investment in India ("**Working Group**") and believe that the implementation of the key recommendations in the report will greatly help promote foreign investment in India. To derive the maximum benefits from the report, we believe that it is important that a specific time-line be agreed for implementing those recommendations of the report that are accepted by the Government.

I. Legal Process

1. We support the enshrinement of due process and rule of law in the application of the relevant laws and regulations. This is perhaps even more important in the area of foreign investment than in other areas as foreigners with no prior exposure to India could otherwise form a mistaken perception of an unlevel playing field or arbitrariness. We agree that the inclusion of the following recommendations will go a long way towards ensuring that this does not happen:

   (a) Allow judicial review of all regulatory orders (including denial of registrations and licenses) by an independent tribunal, require written grounds of decision by the tribunal and publish the tribunal's decisions.
   (b) Institutionalize a public consultation process before introducing material new policies or changes to policies.
   (c) Issue statements of regulatory intent or purpose where appropriate.
   (d) Institutionalize a framework for access to regulators to clarify the interpretation or application of existing policies. Where appropriate, such clarifications should be published.

(e) Enhance the public information systems to provide immediate access in a comprehensive and organized manner to current laws and regulations (together with a history of changes), regulatory statements of intent and clarifications, and decisions of the tribunal.

(f) Ensure that law departments are involved throughout the process of policy formulation and not just brought in at the end to draft or vet the policy.

II. Qualified Foreign Investor

1. We support the recommendation to introduce a Qualified Foreign Investor ("**QFI**") scheme and to abolish the Foreign Institutional Investor ("**FII**"), Foreign Venture Capital Fund ("**FVCI**") and Non-Resident Indian ("**NRI**") schemes. We agree that the current complex web of multiple schemes with their overlapping and sometimes contradictory requirements not only deters foreign investments but also provides arbitrage opportunities. We agree that the benefits that will flow from implementing a simplified investment framework will far outweigh the loss of the limited discrete benefits attached to the FVCI and NRI schemes. We also support the recommendation to extend the QFI scheme to foreign investors who are natural persons.

2. Clearly, management of capital flows, foreign exchange control, anti-money laundering and countering financing of terrorism, tax evasion, and enforcement of rules against market manipulation and insider trading are all legitimate concerns that have to be addressed. We agree that, instead of the present "blended" approach, the better approach is to come up with the optimal measures to address each of these concerns after consultation with the relevant enforcement authorities. We also agree that while capital flows management and foreign exchange controls obviously depend on the nationality of the investor, organized crime and terrorism, tax evasion and market manipulation and insider trading should be addressed in a nationality-neutral manner.

3. We support the proposed framework of a qualified depository participant ("**DP**") who will have to meet certain requirements and be registered with, and regulated by, the Securities and Exchange Board of India ("**SEBI**"). We agree with the approach that the DP will be held legally responsible for enforcing OECD-standard Know-Your-Customer ("**KYC**") requirements. In line with the Working Group's recommendations on legal process, we hope that SEBI will conduct a public consultation before issuing the rules regarding DPs. We submit that it will be timely to conduct a holistic review of the KYC requirements with a view towards streamlining such requirements and removing areas of overlap or inconsistencies in the requirements imposed by different regulators.

4. We agree with using a 10% threshold to demarcate foreign portfolio investment from foreign direct investment. It would also help if the position with regard to the treatment of investments by partially foreign-owned Indian entities could be clarified (particularly as the Reserve Bank of India ("**RBI**") and SEBI do take different views as to whether these should be treated as foreign or domestic investments).

III Equity and outflows

We agree that further work should be done in regard to the regulatory framework that should be put in place to protect consumers when foreign offerors market their offshore products onshore. However, in settling this framework, it is important to avoid duplication and overlapping of regulatory requirements.

IV Debt

1. We agree that more needs to be done to incentivize the issuance of rupee-denominated corporate debt. The current regime encourages "original sin", that is, the issuance of foreign currency-denominated corporate debt, which creates currency mismatches and exchange rate risk. Immediate steps that should be taken include replacing the numeric caps with percentage caps and applying the QFI scheme to foreign investment in the debt markets. Steps should also be taken to fully implement the outstanding recommendations of the past Committee reports. If these measures are taken, foreign firms may be encouraged to make the investments needed to build onshore debt market practices and to transfer their know-how and technology.

2. With regard to the Working Group's recommendations in regard to protecting consumers investing in foreign debt, we make the same comment as under paragraph III above.

V Derivatives

1. We agree that capital flows management should not focus on derivatives, given that derivatives trading has minimal balance of payments implications.

2. We submit that there is a need for both exchange-traded derivatives and over-the-counter ("**OTC**") derivatives and that there should not be a policy preference for one over the other. In order to be exchange-traded, contracts must be standardized and thus, participants who use exchange-traded derivatives will not be able to perfectly match their underlying need or purpose. In contrast, OTC derivatives are bilaterally negotiated and customized to suit the specific needs of an end-user. In the Indian context, there is an additional reason for OTC derivatives over exchange-traded derivatives. RBI, for prudential and policy reasons (for example, exchange control), requires an end-user to have an underlying risk to hedge and speculation is not permitted. The banks who offer the OTC derivatives are held responsible by RBI for verifying this. If end-users are allowed to engage in exchange-traded derivatives, it will not be possible to enforce this requirement. In addition, the stated rationale for favoring the exchange-traded market, that is, transparency, no longer holds given the global impetus for OTC derivatives trading to be reported to trade repositories. We would also add that transparency is a complex topic and should not be an end in itself, but rather, a means to an end. In this connection, we would refer you to ISDA's Research Note, Issue Number 1,

2009 entitled *Transparency and over-the-counter derivatives: The role of transaction transparency*[1].

3. We agree that position limits should not discriminate between foreign and domestic participants as enforcement measures directed against market manipulation should be nationality-neutral.

4. We agree that there will be less incentive for investors to invest through offshore derivative instruments or participatory notes if direct portfolio investment is made easier. However, as noted by the Working Group, there will nevertheless remain a market for such instruments. Such instruments will be the preferred means of access for certain types of investors (or certain types of investments) based on various considerations such as lower transaction costs and recordkeeping overheads, or operational convenience or because the issuer provides access to markets in different countries and the investor prefers the convenience of dealing with one party across multiple markets, or because they allow leveraging by the investor (particularly on a global portfolio basis). We also agree that there is little correlation between the amount of such instruments and the inflows into and outflows from the Indian securities market as hedging and risk management tools have advanced well beyond simple delta one products. Thus, capital flows management should not be the driver behind measures related to such instruments. Neither should concerns related to organized crime, terrorism and tax evasion for as pointed out by the Working Group, the issuers of such instruments are large-sized reputable financial institutions who are subject to regulations dealing with such concerns. The Working Group has noted that SEBI should have the final right to demand details about the end investor in cases of needed investigations. We presume that such investigations by SEBI will be in relation to market manipulation and insider trading. While we agree in principle with this, it will be helpful to market participants and will also encourage the implementation of a common standard of best practices if SEBI could give more explicit guidance as to what types of instruments it would be concerned with and its expectations of the measures that should be put in place by the QFI in order to meet SEBI's requirements.

5. We agree with the recommendation that investments (including margin payments) of up to the US$200,000 limit under the Liberalized Remittance Scheme by Indian residents be exempt from further regulation. With regard to the Working Group's recommendations in regard to protecting consumers making such investments, we make the same comment as under paragraph III above. In particular, any consumer protection guidelines should take into account the fact that RBI already imposes obligations on the Indian banks (including Indian branches of foreign banks) to conduct suitability and appropriateness checks before selling such offshore derivatives products to customers.

[1] http://www.isda.org/researchnotes/pdf/ISDA-Research-Notes1.pdf

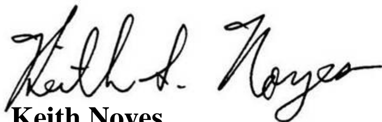
V. Tax

We support the recommendation that in-depth studies be conducted on the implications of moving from the current source-based taxation system to a residence-based system. We would also request that such studies include a review of stamp duty.

ISDA would be happy to clarify any points raised in this letter. Please do not hesitate to contact Mr Keith Noyes (knoyes@isda.org, +852-2200-5909) or Ms Jacqueline Low (jlow@isda.org, +65 6538 3879) of ISDA.

Yours faithfully,

For the International Swaps and Derivatives Association, Inc.



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