THE ASSOCIATION OF GLOBAL CUSTODIANS

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14 April 2008

Shri C.B. Bhave,
Chairman, SEBI,
Plot No.C4-A,'G' Block,
Bandra Kurla Complex, Bandra(East),
Mumbai 400051

Re: New Margin Requirements for Foreign Institutional Investors

Dear Sir:

We write on behalf of the members of the Association of Global Custodians (the "Association")[1] with regard to new margin requirements that are scheduled to be imposed, effective 21 April, on foreign institutional investors ("FII") participating in the equity market in India. Below for your consideration are members' comments concerning various complications that the new requirements, as currently proposed, will present to global custodians and global cross-border investors. Also below is a brief summary of the impact we believe the new requirements inadvertently may have on FII investment in Indian markets. Based on our comments, we respectfully encourage the Securities and Exchange Board of India ("SEBI") to restructure, delay or eliminate the margin requirements as they would apply to FII's.

Background to our Comments.

Association members act on behalf of many, if not most, of the FII's that invest in Indian markets. We estimate that Association members, as global custodians, hold in

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1 The Association is an informal group of eight global custodian banks that provide securities safekeeping services and related asset-servicing functions to cross-border institutional investors, including pension funds, insurance companies and investment companies. Through their intermediary activities, Association members play a critical role in enabling the flow of investment capital from market to market globally, including facilitating investments in Indian securities. The Association members are listed on the letterhead above.

excess of US$100 Billion for FII's in Indian markets.[2] FII's -- including those investing in India -- typically buy and hold their positions as serious and sizeable cross-border investors; they do not actively trade in-and-out of positions. Their investment pattern and the size of their commitments add important quality and liquidity to local markets globally, including in India; and as global experience confirms, the FII investment profile and discipline mean that FII settlement defaults do not occur.

Supplementally -- from a systemic point of view -- FII settlement responsibilities are carefully monitored and controlled by the custodial agents that act on behalf of FII's -- global custodians and local sub-custodians. Custodians are heavily regulated and examined; they exercise a high degree of care in carrying out their custody activities; and, as noted below, they employ an elaborate series of credit and risk controls to manage and secure client settlements.

Given the FII investment/settlement pattern and the custodial controls noted, we believe that collecting margin from FII's is not necessary to reduce actual credit or settlement risks. Additionally, given members' experience with institutional investor profiles, we believe that the costs and risks imposed by the new margin requirements may limit continued commitment of FII capital to Indian markets. A perception of costly and burdensome procedures -- and any resulting increase in investment risk -- may make FII's hesitant to continue to invest actively in India. That hesitance could adversely impact local market depth and liquidity.

One reason for an FII perception that the new requirements entail new costs and special risks is that FII's do not face comparable margin requirements in other global or regional markets. In other major markets, FII's execute their trades (directly or indirectly) through exchange members – typically, international or domestic brokers -- who in turn provide margins on the net value of their trades to the Exchange or Clearinghouse. In those markets, the systemic risk to which the securities clearing and settlement systems are exposed is the risk of default of any member of the Exchange or CCP; and it is for that reason that exchange members are required to meet stringent capital adequacy requirements and to post collateral on their net obligations. In contrast, settlements of FII obligations through local custodians typically occur on a delivery-versus-payment basis, which provides inherent protection against settlement default risk, making FII margin unnecessary.

[2] It is estimated that Association members collectively hold in custody approximately $US 55 Trillion for global investors world-wide.

We recognize that the Indian market has unique structures, and that investors are viewed as potential sources of clearing risk given the brokers' limited role. We believe it important, however, to also recognize that not all investors employ professional custodians to facilitate safe, risk-managed settlement (i.e., not all investors are comparable). FII's fund their investments in advance. Requiring them to also post exchange-level margin on trades, particularly on a gross basis, is costly and operationally problematic and will not appreciably enhance systemic risk management.

Specific Comments.

A. Aspects of the margin requirements, as currently proposed, present the particular problems outlined below.

- Some estimates suggest that FII's will need to keep significant funds on hand to cover their margin levels -- potentially enough cash to cover margin requirements at both the broker and custodian. These un-invested cash positions reduce investable capital, impair net asset values, and further increase the cost of investing in India, potentially making alternative markets with lower administrative/carrying costs more attractive by comparison.

- Unlike retail investors, who typically can borrow funds locally to pay margins, each FII will need to estimate its margin needs and then purchase sufficient INR to cover their margin (over and above the foreign exchange ("FX") required to cover the principal amount of the trade). This added burden will introduce new and unwanted FX risk and FX spread costs for the FII, which may create regulatory consequences for some FII's.

- The processing limitations around late-day payments will complicate custodians' ability to process margin payments called for on the evening of T+1 on behalf of FII's. In turn, this could complicate record keeping and ultimately lead the Exchange (which recognizes the custodian and not the underlying FII) to apply funds as margin for one FII that should be available for release to another FII. That action could indirectly involve funding of an FII by a custodian in ways that may not be consistent with regulatory requirements applicable to custodians in other markets.

- Significantly, custodians process settlement confirmations for FII's only when securities are available and funding confirmations by the FII are in place and reconciled. The T+2 settlement cycle and the rules guiding settlement further

limit the opportunity for failed FII trades. Therefore, margining of FII's for purposes of mitigating settlement risk will not achieve a risk-limiting objective but instead will be cost-ineffective given the administrative costs, FX risks, and processing risk that FII's and their settlement agents will encounter with the new procedures.

B. Should SEBI decline to eliminate the new margin requirement as it would apply to FII's, the Association makes the following suggestions for changes in the requirement that would likely reduce the adverse impact on FII's and the Indian market.

- Temporarily delay implementation until (1) all rules, practices and procedures are clarified, published, and understood by investors and custodians and (2) market participants, investors, money managers, and global custodians can put in place systems and procedures to address the new requirements reliably. Since comparable requirements do not exist in any other market, the absence of operational guidelines, procedures and systems today leaves little time between now and the 21 April deadline for the careful work necessary. A delay may be essential to make compliance feasible and to promote sound risk-management.

- Consider adopting a flat percentage of traded value as a margin rate -- perhaps revised monthly or quarterly -- to facilitate estimation and funding of margin requirements and to avert regulatory/compliance risk.

- Consider permitting netting of the margin collected against the total pay-in amount so that FII's pay only the outstanding difference at settlement.

- Consider relaxing the rule such that margins are only collected on short sale transactions by FII's.

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We appreciate the opportunity to provide you with the Association's views and suggestions. We look forward to providing additional commentary during further consultation periods. If you have questions or would like additional information, please contact the undersigned.

Sincerely yours,

Dan W. Schneider
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Counsel to the Association

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