



Growing role of hedge funds in India: An overview

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Abstract

There is no exact law for Hedge Fund in India. Generally, it is recognized as Alternative investment fund by Securities and Exchange Board of India (SEBI), to make huge amount of money by investing a small portion of funds with minimum risk availability. The term Hedge Funds represent into: firstly, the word 'Hedge' which means 'Protection against risk' and secondly 'Funds' which means Pool of funds. Thus, it is a pool of fund of funds which includes the pension funds, university funds, pension funds etc. with the guarantee or protection against risks. It is also known as richest funds due to its nature and species. In India, the SEBI passed a SEBI (Alternative Investment Funds) Regulations in 2012 to regulate these funds. As per this regulation, the SEBI identified these funds in Category III. To fiscal growth of hedge fund industry, the SEBI amended it in so many times such as 2015, 2017, 2023 & recently in April, 2024 ^[1]. In Present epoch, Hedge fund is becoming an important segment of the asset management industry and gaining popularity from the high net worth investors specially in term of endowments and other institutional investors. Presently, some of the major investments are Motilal Oswal's offshore hedge fund, Munoth Hedge Fund, Quant First Alternative Investment Trust, IIFL Opportunities Fund, India Zen Fund, etc ^[2]. Further, the SEBI also denoted the adjudication method is Arbitration in light of protection for investors.

Keywords: Hedge, Alternative Investment Funds, Arbitration, SEBI.

Introduction

The term 'Hedge fund' is not defined by the Investment & Securities Laws. There is neither an industry wide definition nor a universal meaning for it. Generally, it includes fund of funds, pool of funds, private investment partnerships etc. that may invest & trade in many different markets, strategies and instruments such as securities, non -securities and derivatives etc. Hedge fund represents a large and growing industry that offers investors an opportunity to diversify and to earn competitive returns with low to moderate volatility. It can provide benefits to financial markets by contributing to market efficiency & enhancing liquidity. Although it is a nascent concept in India but it has been started by Albert Wilson Jones in 1949 ^[3]. During that period of time, the managers of that funds were using incentive fees, short selling, and leverage strategies to manage the investment. The hedge funds advisors were engaging in traditional or equity strategies. They often assume risks by serving as ready counter parties to entities that wish to hedge risks. Over time, hedge funds began to diversify their investment portfolios to include other financial instruments and engage in a wider variety of investment strategies likes- leverage, short selling, put and option etc.

Hedge fund can also serve as an important risk management tool for investors by providing valuable portfolio diversification. Sometimes it perceived to be speculative and volatile. However, apart from these types of funds there is no other fund exhibit such characteristics. Realizing the growing importance of hedge funds, several emerging market regulators have opened their markets to offshore hedge funds by providing authorization as registered foreign investors. As per regulation 15(1)(a) of SEBI (Alternative Investment Funds) Regulations 2012 ^[4], the RBI authorized to invest in securities of companies incorporate in India

through Foreign Investments. The said trade is regulated by the Foreign Exchange Management Act (FEMA).

Meaning and Definitions of hedge fund

The term "hedge fund" refers to an investment instrument with pooled funds that is managed to outperform average market returns. The Word Hedge Funds comprises with two terms, first on is the 'Hedge' which means no risk or without reassurance secondly, 'Funds' which means pool of funds. So, Hedge funds denote the pool of funds which provides the hundred percent returns without any market risks.

According to Thomas Schneeweis & Richard Spurgin, "A Hedge fund is an investment structure for managing a private, loosely regulated investment pool that can invest in both physical securities as well as derivative markets on a leveraged basis" ^[5].

According to SEBI (Alternative Investment Funds) Regulations 2012, Regulation 2(1) (I) ^[6]

"Hedge fund" means an alternative investment fund which employs diverse or complex trading strategies and invests and trades in securities having diverse risks or complex products including listed and unlisted derivatives.

Characteristics of Hedge funds

- The larger investment fund or pool of funds with hedging.
- Flexible mandates permitting use of shorting and listed/unlisted derivatives.
- Attractive market returns using with Skill-Based Strategies.
- Valuable portfolio diversification.

- Use a wide variety of trading strategies.
- Contributing to market efficiency & enhancing liquidity.
- Pay performance fees to their managers

Strategies of Hedge Fund

- **Global Macro:** It is a hedge fund strategy that bases its holdings primarily on political forecasts of various countries or the macroeconomic principles that have high impact on the economies of those countries. The professionals of this strategy have taken a short or long position in market as per SEBI guidelines [7]. Advantages & Challenges: Diversification, flexibility and adaptability, Global Mkt Exposure, Volatility and Uncertainty in Global Markets, and Due Diligence etc.
- **Event – Driven:** In this strategy the managers of hedge funds are trying to take advantage of temporary stock mispricing which occur on the basics of corporate events such as merger, demerger, acquisitions, bankruptcy, takeovers etc. It is most often used by the managers on or before/ after any major corporate events. The Managers must be expert to analyze the effects of those events. Advantages & Challenges: Distinctive investment planning, Spin off investment, Distressed debt investment, Predictability of events, Identification of valuable events etc [8].
- **Arbitrage Trading Strategy:** The Objective of this trading strategy is to make a profit from the differences in prices between securities or markets, without taking on significant directional risk. Arbitrage means to buy a security from one market on lower price and further sell it to another market on higher price. In this strategy the manger should be advance in technology and must be aware with the varying of market prices. Advantages & Challenges: More complicated variations, Better price discovery, Liquidity risk & High costs and to increase the Minimal Profits etc.
- **Relative Value:** In this strategy of hedge funds, the manger aims to profit from price differences between related securities. Generally, the managers emphasize only one market and make a point of employing hedging in the most profitable way. They don't corner themselves into a long or short bias. It is a popular investment strategy in the hedge fund industry.

Advantages & Challenges: Systematic approach, data-driven insights, Improved risk return profile, lowering portfolio volatility etc.

Procedure of Hedge Fund

After the recommendation of Malegam Committee, the SEBI notified the hedge funds in category III of SEBI (Alternative Investment Funds) Regulations 2012. The SEBI denotes the procedure for registration of hedge funds, minimum requirements, restrictions etc.in AIF- Category III. Further, to grant the certificate of registration as hedge fund investor, the applicant has to submit an application to SEBI Board as per the norms of Schedule I along with all supporting documents such as detail of applicant, copy of draft placement memorandum, legal structure of the

applicant, manager details, business plan and investment strategy etc. The applicant also has to pay the registration fee as specified in schedule II [9]. The Some major inputs are required to invest the fund in hedge funds such are as follows:

- Alternative investment fund may be raised from any investor whether Indian resident, foreign or NRIs by way of issue of units.
- Minimum investment to be accepted by corpus is at least 20 crore rupees.
- Minimum investment to be accepted by an individual investor is 1 crore rupees.
- Alternative Investment Fund may invest in securities of companies situated outside India subject to such guidelines of RBI.
- In case of any dispute the manager or sponsor shall be subjected to Arbitration.

Key Indicators:	
Regulatory requirement	SEBI AIF's -Category III
Other Regulating Authorities	RBI, FEMA, SCRA, COMPANIES ACT, SEBI
Investment requirement for Individual	Min. 1 Crore
Investment requirement for Corpus	Min. 20 Crore
USP	Different techniques & modern Strategies
Strategies of Hedge Fund	<ul style="list-style-type: none"> ▪ Global Macro ▪ Relative Value ▪ Arbitrage Trading Strategy ▪ Event – Driven
Corporate governance	leads to greater tax savings
Major Hedge Funds in India	Motilal Oswal's offshore hedge fund, Quant First Alternative Investment Trust, IIFL Opportunities Fund, Munoth Hedge Fund, India Zen Fund, etc.
Hedge fund value in individual wealth in India	Approx. 112 billion Indian Rupees.
Registered Hedge funds in India	Currently 346 AIFs registered with SEBI.[10]
In case of any Conflict	Arbitration

Conclusion

Hedge fund is becoming an important segment of the asset management industry and gaining popularity form the high net worth investors specially in term of endowments and other institutional investors. Some countries took initiated to provide hedge fund as alternative investment options for retail investors also, India is one of these. India has imposed few restrictions to invest the funds in this new dynamic schemes. Hedge Fund can typically be described as a private actively managed investment fund. It can take variety of positions, deal in undervalued securities, options or bonds and in general invest in any commercial enterprise where there is a likelihood of profit at a reduced risk. Furthermore, it is frequently accused of destabilizing the international financial system. This is especially true for macro funds, which take large positions on the long term direction of macroeconomic developments. While a hedge fund's interest in a country may not be to the government's liking, this does not mean that the hedge fund is necessarily predatory. It may simply be exploiting the difference between the real state of the economy and market prices. The aforementioned observation made in reference to the United States Hedge Funds Regulations stands equally

relevant and true for the Indian hedge fund market. SEBI's 2008 withdrawal of regulations bear sample testimony to the fact that there is no scope to implement a straightforward and categorical regulations as market needs and situations may contradict with such regulations over a period of time as the operation of such hedge funds does not follow a specific operational pattern. This dilemma is characteristic of financial sector regulation where another area of major hedge fund is domiciled in structure 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.

There is no strategy that can be termed as optimal strategy because the needs and consequences vary vastly according to the specific host country and the market operation. Having considered the various options, it can be concluded that registration strategy has the most evident and effective impact as it has elements of disclosure along with power to exercise control over the activities of hedge funds. A differentiation needs to be made between the needs of developing and developed countries. A developed country can impose market regulations along with registration requirements. A developing country cannot combine both methods as state plays a significant role in the economic activity.

In terms of the growth of derivatives markets, and the variety of derivatives users, new hedge funds regulation will represent significant new compliance burdens and a cultural shift for much of the hedge fund industry. Hedge funds, due to their huge size, bring more advantages to host-country markets; they also carry significant risks and bear the potential to cause systemic loss in markets where they invest. The key to effective and successful hedge fund market regulation 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. Furthermore, policy focus should be on long term plans and not short term avoidance of the systemic risks.

In view of the increasing popularity among the institutions as well as their increasing interest in the Indian market, it might be time to provide a limited window to this growing segment of asset management industry within the existing framework of the SEBI (Securities and Exchange Board of India).

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