Chapter IV

LEGAL, REGULATORY FRAMEWORK & FUND STRUCTURE OF UTI MUTUAL FUND

The Fourth chapter is divided into two parts, the first part highlights on the legal framework of the mutual fund industry in India like the necessity for mutual fund regulations, regulatory jurisdiction of SEBI and RBI over mutual fund, role of the ministry of finance, company law board and stock exchange over mutual fund. It also gives the detail of rights and legal limitations of a mutual fund unit holder his obligations, self regulatory organizations in India are also discussed in brief. The second part of this chapter highlights on the fund structure and constituents of mutual fund in India like the sponsors of mutual fund, the trustees of mutual fund, the assets management company and the other constituents like the registrars and transfer agents, stock –brokers, selling and distributing agents and custodians, this part also gives the detail of various forms of fund merger and takeovers in India.

Unit Trust of India was created by the UTI Act passed by the Parliament in 1963. For more than two decades it remained the sole vehicle for investment in the capital market by the Indian citizens. In mid- 1980s public sector banks were allowed to open mutual funds. The real vibrancy and competition in the MF industry came with the setting up of the Regulator SEBI and its laying down the MF Regulations in 1993. UTI maintained its pre-eminent place till 2001, when a massive decline in the market indices and negative investor sentiments after Ketan Parekh scam created doubts about the capacity of UTI to meet its obligations to the investors. This was further compounded by two factors; namely, its flagship and largest scheme US 64 was sold and re-
purchased not at intrinsic NAV but at artificial price and its Assured Return Schemes had promised returns as high as 18% over a period going up to two decades.

As of 2010, UTI has 10 million investors.

Fearing a run on the institution and possible impact on the whole market Government came out with a rescue package and change of management in 2001. Subsequently, the UTI Act was repealed and the institution was bifurcated into two parts. UTI Mutual Fund was created as a SEBI registered fund like any other mutual fund. The assets and liabilities of schemes where Government had to come out with a bail-out package were taken over directly by the Government in a new entity called Specified Undertaking of UTI, SUUTI. SUUTI holds over 27% stake Axis Bank. In order to distance Government from running a mutual fund the ownership was transferred to four institutions; namely SBI, LIC, BOB and PNB, each owning 25%. Certain reforms like improving the salary from PSU levels and effecting a VRS were carried out UTI lost its market dominance rapidly and by end of 2005, when the new shareholders actually paid the consideration money to Government its market share had come down to close to 10%!

A new board was constituted and a new management inducted. Systematic study of its problems role and functions was carried out with the help of a reputed international consultant. Fresh talent was recruited from the private market, organizational structure was changed to focus on newly emerging investor and distributor groups and massive changes in investor services and funds management carried out. Once again UTI has emerged as a serious player in the industry. Some of the funds have won famous awards, including the Best Infra Fund globally from Lipper. UTI has been able to benchmark its employee compensation to the best
in the market, has introduced Performance Related Payouts and ESOPs.

The UTI Asset Management Company has its registered office at: UTI Tower, Gn Block, Bandra — Kurla Complex, Bandra (East), Mumbai - 400 051. It has over 70 schemes in domestic MF space and has the largest investor base of over 9 million in the whole industry. It is present in over 450 districts of the country and has 100 branches called UTI Financial Centres or UFCs. About 50% of the total IFAs in the industry work for UTI in distributing its products! India Posts, PSU Banks and all the large Private and Foreign Banks have started distributing UTI products. The total average Assets Under Management (AUM) for the month of June 2008 was Rs. 530 billion and it ranked fourth. In terms of equity AUM it ranked second and in terms of Equity and Balanced Schemes AUM put together it ranked FIRST in the industry. This measure indicates its revenue-earning capacity and its financial strength.

Besides running domestic MF Schemes UTI AMC is also a registered portfolio manager under the SEBI (Portfolio Managers) Regulations. It runs different portfolios for is HNI and Institutional clients. It is also running a Sharia Compliant portfolio for its Offshore clients. UTI tied up with Shinsei Bank of Japan to run a large size India-centric portfolio for Japanese investors.

For its international operations UTI has set up its 100% subsidiary, UTI International Limited, registered in Guernsey, Channel Islands. It has branches in London, Dubai and Bahrain. It has set up a Joint Venture with Shinsei Bank in Singapore. The JV has got its license and has started its operations.

In the area of alternate assets, UTI has a 100% subsidiary called UTI Ventures at Banglore This company runs two successful funds with
large international investors being active participants. UTI has also launched a Private Equity Infrastructure Fund along with HSH Nord Bank of Germany and Shinsei Bank of Japan.

It is being increasingly believed that the liberalization of the financial sector is necessary for allocative efficiency. Countries world of all, have in the past few decades, witnessed dismantling of regulations and restrictions and the removal of controls in the financial market. However the process of liberalization has not ensured optimum allocation of resources or been able to protect the investors from market failures. This has raised questions regarding uncontrolled liberalization and its impact on the economy in general and investors in particular.

In a free market economy, regulation is considered to be unnecessary, yet it is pursued to achieve certain economic goals. Regulation is considered fundamental in safeguarding the interest of investors in a volatile market environment. While MFs are well organized and regulated schemes, they do not face undue problems of transactions, delays in settlement or risks related to intangible and tangible assets. A major source of risk confronted by them is market failure and malpractices in operations.

No single institution is without a limit, order, and proximity of working for the purpose of defining the limits and working processes. The use of rules and regulations are normally laid down for the sake of such a situation. In India, regulating intermediaries have been brought under the purview Of Securities and Exchange Board of India (SEBI), which specify the degree of responsibility towards investors.

MFs are governed by a uniform set of regulations that require them to be formed as trusts and managed by a separate AMC and
sponsored by a board of trustees or Trustee Company. SEBI (MF) provide for an arms length relationship between the various constituents of the MFs and thus bring about a structural change, which will ensure qualitative improvement in the functioning of MFs. The regulations lay down certain eligibility criterion for the sponsors of MFs, minimum net worth.

The SEBI (MF) regulation also provide for approval of the document of schemes by SEBI. Prescribed minimum amount to be raised by a scheme, different for both open-end and closed-end funds. The utility extent and quality of regulation is an ongoing one. But the most important condition for a competitive market is the free flow of information. Financial information is a high value-added good and its cost is often beyond the reach of individual investors. Mutual funds operating in a free market are exposed to this imperfection of market and carry great risks in transacting their business. That includes organizational (investment form) risk, management process risk, and portfolio selection risk.

Portfolio selection risk arises due to adverse portfolio selection. The investment manager of MFs selects the portfolio on behave of investors yet he is incapable of judging future markets conditionally or intentionally selects securities with the possibility of negative returns or indiscriminately selects high risk securities.

Frauds committed by employees, theft, misuse of clients funds, reckless dealing of funds, non-contractual transfer of funds, portfolio manipulation, reckless churning of funds etc, fall under organizational risks.
NECESSITY FOR MFs REGULATION

Regulatory measures whatever may be their form and structures are designed to correcting market failures and protecting investors from potential loss. Mean Regulations are as follows:

- To correct identified market imperfections and failures in order to improve the market and enhance competition.
- Increase the benefit to investors from economies of scale
- Improve confidence of investors in the market by introducing minimum standard of quality.
- Outline limits of participation
- Define powers and scope of various players
- Streamline operations and protect investor’s interests
- Monitor and inspect the funds operations i.e. ensuring transparency
- Formulate format for valuation of MF investment portfolio
- Keep, check on unhealthy market practices
- Ensure orderly functioning and investor confidence.

Effective regulation should take into account both costs of regulation and value addition. The types of costs include direct and indirect costs.

Regulatory jurisdiction of SEBI:

Securities and Exchange Board of India (SEBI) is the apex regulator of capital markets. Issuance and trading of capital market instruments and the regulation of capital market intermediaries is under
the purview of SEBI. SEBI is the primary regulator of mutual funds in India.

SEBI has enacted the SEBI (Mutual Funds) Regulations, which provides the scope of the regulation of mutual funds in India. All mutual funds are required to be mandatory registered with SEBI. The structure and formation of mutual funds, appointment of key functionaries, operations of the mutual fund, accounting and disclosure norms, rights and obligations of functionaries and investors, investment restrictions, compliance and penalties, are all defined under the SEBI Regulations. Mutual Funds have to send half-yearly compliance reports to SEBI, and also provide all other information about their operations, as SEBI may require. SEBI also regulates other fund constituents such as AMCs, Trustees, custodians, R & T agents and brokers.

**Regulatory jurisdiction of RBI over mutual funds:**

RBI is the monetary authority of the country and is also the regulator of the banking system. Earlier bank-sponsored mutual funds were under the dual regulatory control of RBI and SEBI. Money market mutual funds, which invested in short term instruments, were also regulated by the RBI. These provisions are going longer in vogue. SEBI is the regulator of all mutual funds.

RBI is the issuer of government securities and also the regulator of the money market. Mutual funds invest in these securities, and are affected by the RBI stipulations on the structure, issue a pricing and trading of these instruments. For example, recently RBI has decided that non-banking would be phased out of the call money markets, over a period of time this decision mutual funds ability to invest in call markets.
Role of the Ministry of Finance in mutual fund regulation:

The Ministry of Finance, which is charged with implementing the government policies, ultimately supervises both the RBI and the SEBI. Besides being the ultimate policy making and supervising entity, the MF had also been playing the role of an Appellate Authority for any major disputes over SEBI guidelines on certain specific capital market related guidelines in particular any cases of insider trading or mergers and acquisitions. Since 2003, however, a Securities Appellate Tribunal has been created to provide the apex appeal mechanism for any decisions taken by SEBI. SAT works as an independent judicial authority.

Role of Company Law Board, Department of Company Affairs and Registrar of Companies

Mutual fund Asset Management Companies and corporate trustees are companies registered under the Companies Act, 1956 and are therefore answerable to regulatory authorities empowered by the Companies Act. The primary legal interface for all companies is the Registrar of Companies (ROC). ROCs, in turn, are supervised by the Department of Company Affairs. The DCA forms part of the Company Law Board, which is part of the Ministry of Law and Justice of the Govt. of India. The ROC ensures that the AMC, or the trustee company as the case may be, is in compliance with all provisions of the Companies Act. All AMC accounts and records are filed with the ROC, who may demand additional information and documents from the company. The ROC monitors regulatory compliance by companies. The overall responsibility for formulating and modifying regulations relating to companies lies with the Department of Company Affairs (DCA). The DCA has legal powers to prosecute company directors for failure to comply with any of the provisions of Companies Law, as also for non-
repayment of deposits or frauds and other offences. The Company Law Board (CLB) is the apex regulatory authority under the Companies Act. While the CLB guides the DCA, another arm of the CLB called the Company Law Bench is the Appellate Authority for corporate offences.

**Role of stock exchanges as regulatory authorities, mutual fund operations:**

If a mutual fund has listed its schemes on stock exchanges, such listings are subject to the list regulation of stock exchanges. Mutual funds have to sign the listing agreement and abide by provisions, which primarily deal with periodic notification and disclosure of information that impact the trading of listed units.

**Rights of a Mutual Fund Unit holder**

The offer document of a scheme lays down the investors’ rights. Investors are the owners of the scheme’s assets, and it is, therefore, imperative that they are aware of their rights with respect to the scheme’s assets, its management, and recourse to the trustees, the AMC and other constituents. The important rights of the unit-holders are outlined below:

**Right of Proportionate “Beneficial Ownership”**

- Unit-holders have the right to beneficial ownership of the scheme’s assets, otherwise held in trust for them by the trustees of the fund. They also have the right to any dividend or income declared under the scheme. The right to assets, income, etc. is in proportion that the units held by the unit holder bears to the total number of the fund units issued and outstanding.
• Unit-holders have the option to nominate a person in whom all the beneficial ownership rights in the units will vest in the event of his/her death.

**Right to Timely Service**

• Unit-holders are entitled to receive dividend warrants within 30 days of the date of dividend declaration.

• Unit-holders have the right to payment of interest at a rate specified by SEBI in the event of failure on the part of the mutual fund to dispatch the redemption or repurchase proceeds within 10 working days. Such interest must be borne by the AMC.

• Where any investor has failed to claim redemption proceeds or dividends due to him/her, the investor has the right to do so within a period of three years of the due date at the prevailing NAV. After three years, he will be paid at the NAV applicable at the end of the third year.

• For initial offers in case of open-end schemes, investors have a right to expect the allotment of units and dispatch of account statement to be completed within 30 days from the closure of the issue. Besides the scheme must open ongoing sale and repurchase within 30 days from the closure of the initial offer period.

• Investors also have the right to receive compensation from the AMC representing the difference in NAV amounts in cases where there has been a variation in NAV calculations on account of non-recording of any transaction/s in the scheme accounts in certain cases.
**Right to Information**

- Unit-holders have the right to obtain from the trustees any information that may have an adverse bearing on their investments.

- Unit-holders have the right to inspect major documents of the fund. Such documents include material contracts (the trust deed, the investment management agreement, the custodian services agreement and the registrar and transfer agency agreement), memorandum and articles of association of the AMC, recent audited financial statements, the texts of SEBI (MF) Regulations, Indian Trusts Act and the offer document of the scheme.

- Each unit-holder has the right to receive a copy of the annual financial statements

- Each unit-holder has the right to receive a complete statement of scheme portfolio before the expiry of one month from the close of each half year (that is 31st March and 30th September), unless such statement of portfolio is published in one English daily circulating in the whole of India and in a newspaper published in the language of the region where the head office of the mutual fund is situated.

**Right to approve changes in Fundamental Attributes of the Scheme**

- A change in ‘fundamental attributes’ of a scheme (type of scheme, investment objective and terms of issue), or trust or fees and expenses payable or any other change which would modify the scheme (including merger or consolidation of schemes) and affects the interest of unit holders, cannot be carried out unless investors are individually informed in writing and advertisements about the proposed change are given in an English daily newspaper having nationwide circulation and in a
newspaper published in the language of the region where the Head office of a mutual fund is situated and the unit holders are given an option to redeem their holdings in the fund without any exit load.

**Right to wind up a Scheme**

- Investors can demand the Trustees to wind up a scheme prior to its earlier fixed duration and repay the investors, if 75% of the investors pass a resolution to this effect. This right applies to both closed-end funds, and open-end fixed term plan series.

**Right to terminate the AMC**

- The appointment of an AMC of a fund can be terminated by 75% of the unit-holders of the scheme with the prior approval of SEBI.

**Legal Limitations to Investors’ Rights**

Investors need to note that while they enjoy several rights as outlined above, they are also subject to certain limitations in their capacity as unit-holders. Unit-holders are not distinct from the trust and therefore cannot sue the trust, i.e., they do not have legal recourse to the trust as, under Indian law, the Trust is not a distinct or separate legal entity. However, an investor can initiate legal proceedings against the trustees who are the protectors of the investors’ interests, if they feel aggrieved by any action of the trustees that is seen not to be in their interest. Also, the fundamental concept of a mutual fund is that the investors invest at their own risk and cannot force the AMC to assure a specified level of return. In other countries, mutual funds do not offer “assured return” schemes, as any profits or losses on fund investments in any case belong to the investors. In India, in the initial stages of development of the fund industry, some of the fund sponsors have, however, offered such assured returns to
investors. But, the investors need to understand that except in certain circumstances the sponsors of a mutual fund do not have any legal obligation to meet the shortfall in case the assured return is not achieved. Since assured return schemes do exist in India, an exception has been made by SEBI in case of schemes where such assurance is provided in the offer document, with a guarantee from the sponsor to meet any shortfall. Only if the offer document has specifically provided such guarantee by a named sponsor, the investors will have the right to sue the sponsors to make good any shortfall in promised returns.

It should be noted that there are no new assured returns schemes now being offered by any AMC, and old such UTI schemes are being wound up.

A prospective investor does not enjoy any standing or rights with respect to the fund, the AMC or any other constituent. It is only after he has invested in a scheme that he becomes entitled to the rights discussed earlier. The courts have also upheld this view in relevant cases in India. In case a unit-holder is aggrieved by any actions of the Fund or AMC, the appropriate forum for him to approach is SEBI.

**Investors’ Obligations**

It is the investor’s duty to carefully study the offer document before investing in units of a scheme. He must appreciate the fundamental attributes of the scheme, the risk factors, his rights and the fund’s and the sponsors’ track record. Failure to effectively study the offer document does not entitle him later to have recourse to the fund, the trustees or the AMC.

While applying for a fund investment, the investors are now required by
SEBI to mention their Permanent Account Number (or GIR number where PAN has not been allotted), if the application for purchasing units is for Rs. 50,000 or more, besides being required to provide their bank account details in the application.

The investor must later monitor his investment in a scheme by carefully studying the scheme’s financial statements, its portfolio composition and research reports published by mutual fund tracking agencies.

He can certainly exercise reasonable way his right to ask the trustees for information that he requires. But, the monitoring is entirely the investor’s own responsibility.

**Investor Complaints Redressal Mechanism**

SEBI does entertain receipt of complaints against mutual funds and intervenes with fund managements to help the investor resolve his complaints. Another manner in which SEBI helps the investors in a new scheme is by requiring the sponsors of a new scheme to appoint a Compliance Officer who must issue a Due Diligence Certificate to the effect that all relevant SEBI and other regulations have been complied with by the fund managers and sponsors.

In rare cases involving frauds by the directors of an Asset Management Company, investors may have recourse to the regulators under the Companies Act such as the Department of Company Affairs or even the Company Law Board. These regulators have helped with the cases of investors who did not receive the refunds of company deposits. However, the fund investors are neither shareholders in the AMC nor depositors. Hence, their investments cannot be protected by any of these Companies Act regulators. Investors can at best remove the AMC with 75% vote to
this effect. And they may be able to get the fraudulent directors of AMCs prosecuted. But, clearly, such recourse would be very rare. In any case, SEBI and all other regulators take great care to ensure that only persons of integrity serve as AMC Directors or Fund Trustees, and only companies with track record in investment management are given recognition to manage funds. That is why Mutual Funds are probably the most highly regulated intermediary in financial markets. The objective of the regulators is being investor protection.

**Self Regulatory organizations (SROs):**

Agencies like the RBI or SEBI are regulators with legal powers to set rules and enforce them on market participants over whom they have jurisdiction. For example, SEBI regulates the merchant bankers, stockbrokers, and mutual funds. However, at times regulator grants power to market participants for self-regulation. A Stock Exchange, for example, is an entity that can regulate its own broker-members in a certain limited way, under the overall regulatory supervision of SEBI. A Self Regulatory Organisation (SRO) is an association representing a group of market participants, which is specially empowered by the apex regulatory authority to exercise pre-defined authority over the regulation of their members. For example, in the case of mutual funds in the UK, there are SROs for investment managers, marketing intermediaries and stockbrokers. Stock Exchanges in most countries are granted the status of SROs. These activities of the funds are regulated by respective SROs that report to the main regulatory body (such as Securities and Investment Board in the UK and SEBI in India).

Normally, the SROs are given powers to regulate the criteria and procedures for admission of its members, set a code of conduct for their
members’ market activities, determine the professional rules and bylaws of the association, and so on. SROs facilitate decentralisation in the regulatory structure, involve the market players in the regulatory process and ensure that the regulatory policies and procedures do not ignore market realities or become unmanageable for the apex regulatory body.

It has to be noted that every body representing a group of market participants does not automatically become a SRO; it has to be granted specific powers and approval to become a SRO by the government, appropriate laws and recognition by the regulatory authority. Hence, a brokers’ or banks’ or mutual funds’ industry association may choose to remain just that a trade body representing the interests of its members with the regulatory authorities, without any specific powers as SRO. That is why every trade association is not necessarily a Self Regulatory Organisation.

**SROs in India**

While Stock Exchanges have a definite role as SROs even in India, in other sectors of the capital markets, SROs have yet to emerge as a potent force

**Association of Mutual Funds in India**

As in the USA, where the Investment Company Institute plays a role as an industry association for the mutual fund industry, the Association of Mutual Funds in India (AMFI) plays a similar role in India. AMFI is not a SRO, though it is conceivable that it may choose to apply for that status and become one in the future.

AMFI was incorporated in 1995 with the objective of representing the mutual fund industry collectively. Its principal objectives are:
• To promote the interests of mutual funds and unit-holders, and interact with SEBI/RBI/GOVT./REGULATORS.

• To set and maintain ethical, commercial and professional standards in the industry and to recommend and promote best business practices and code of conduct to be followed by members and others engaged in the activities of mutual fund and asset management

• To increase public awareness and understanding of the concept and working of mutual funds in the country, to undertake investor awareness programmes, and to disseminate information on the mutual fund industry

• To develop a cadre of well trained distributors and to implement a programme of training and certification for all intermediaries and others engaged in the industry.

A Board of Directors elected from their mutual fund members governs AMFI. From time to time, AMFI sets up committees to review and evolve standards for the mutual fund industry on different aspects of mutual fund management or investor relations. For example, one committee has examined the question of securities valuation norms in determining the NAV of a fund. Another has devised an Advertising Code for its member funds. There is a committee on Best Practices in the industry, including one that looks at Risk management practices for the funds. The AMFI Code of Ethics is already an accepted standard in the industry. Two Committees oversee the certification and training of the distributors, and their registration with AMFI.

It has to be noted that AMFI, though technically not an SRO, does perform certain self-regulatory functions. For example, AMFI does
register the fund distributors, test and certify their competence, and has the powers to deny registration to distributors for failing the test or violating AMFI Code of Conduct (AGNI). AMFI has also undertaken the cause of training the mutual fund distributors, as well as educating the investors about the benefits and risks of mutual fund investing. The AMFI Mutual Fund Testing Program has been developed by AMFI to give the opportunity to fund distributors and employees to enhance their knowledge and skills and benefit by the use of this greater understanding.

Representing the interests of the fund managements/AMCs, AMFI also takes up the taxation issues or ideas on regulatory changes required for the mutual funds and their investors in India.

Sales Practices

Just as fund distributors have to follow certain desirable sales practices, the mutual funds themselves have a collective responsibility to follow good practices in the interest of the investors. SEBI and AMFI have been consciously working on evolving some guidelines on the subject. Such guidelines are summarized below:

SEBI’s Advertising Code

SEBI’s Advertising Code lays down guidelines to be followed by funds while advertising their schemes (please refer to Chapter 3 for the text). Recently, AMFI and SEBI have jointly developed a detailed, uniform set of standards for advertising.

AMFI/SEBI guidelines lay emphasis on fund performance reporting. While reporting the performance of their schemes in advertisements, funds are expected to provide a complete perspective to the investor.
The guidelines include uniform practices for computation of yields so that investors can meaningfully and correctly compare the yields given by different funds. Some key points of SEBI guidelines are described below:

- The Code protects investors from misleading advertising by specifying norms for computing returns, management capability and comparisons that may be contained in advertisements.

- The Code classifies advertisements into two categories- one that contains basic information regarding an existing scheme, and the other that contains information on a scheme’s performance.

It further enumerates the items that may be included in each category of advertisement.

The following is a list of important items relevant to performance advertisements:

The dividends declared or paid shall be mentioned in rupees per unit along with the face value of each unit of that scheme and the prevailing NAV at the time of declaration of the dividend.

Only compounded annualized yield can be advertised if the scheme has been in existence for more than 1 year.

All performance calculations shall be based only on NAV and the payouts to the unit holders. The calculation of returns shall assume that all payouts during the period have been reinvested in the units of the scheme at the then prevailing NAV.
Annualized yields when used must be shown for last 1 year, 3 years, 5 years and since launch of the scheme. For funds in existence for less than one year performance may be advertised in terms of total returns and such return should not be annualized. However, in case of liquid schemes/cash and liquid plans, performance can be advertised by simple annualisation of yields if performance figure is available for at least 30 days provided it does not give any unrealistic or misleading picture of the performance/future performance of the scheme.

Where performance is compared against benchmarks, appropriate benchmarks (along with returns on benchmark indices) and identical time periods must be used and mentioned in the advertisement. Once chosen, the benchmark should be used consistently over time.

All advertisements displaying returns / yields must disclose in the main body of the advertisement immediately after the returns / yields and in the same font that past performance may or may not be sustained in future. Where any ranking assigned to a scheme/fund is used in the advertisement, such ranking must be appropriately explained.

**Terms of Appointment of Distributors**

A hind may appoint any resident individual, bank, NBFC or distribution company as its distributor subject to the agreement between the two sides. No approval is required from SEBI or any other regulatory authority. Summarized below are some of the key terms and conditions in an agreement between a fund and its distributor:

- The distributor will provide to the customer a copy of the Key Information Memorandum (KIM) and make available for inspection, a copy of the full offer document.
• The distributor will execute every transaction on behalf of the customer who will not have recourse to the distributor in case of errors, problems or the quality of the investment. The distributor must make appropriate disclosure to the customer that the fund’s units are not endorsed by the distributor and do not constitute his obligation.

• The distributor will offer and sell units only at the public offering price currently in effect, in accordance with terms of the current offer document. All orders become effective only upon acceptance and confirmation by the fund.

• The distributor is responsible at his expense to ensure compliance with applicable regulations in each jurisdiction where he purchases, offers or sells units. The fund will not be responsible for any losses, claims or damages that arise from any breach by the distributor in this regard.

It is to be noted that these terms of appointment are not common to all funds, and are generally in the nature of clarifying the role of the distributor vis-à-vis the investor.

**AMFI Code of Ethics**

SEBI now requires each AMC to evolve and adopt its own Code of Ethics. Earlier, AMFI had published a Code of Ethics for AMCs that laid down suggested practices for hind's with respect to overall fund operations including distribution and selling practices, such as:

• Management of the fund ought to be in the interest of unit-holders

• High standards of service are expected from the funds

• Adequate disclosures by the funds ought to be made to unit-holders and trustees
• Funds are urged to adopt the use of professional selling practices

• Management of funds collected has to be in accordance with stated investment objectives

• Funds should avoid conflicts of interest in dealings by directors, officers or employees

• Funds have to refrain from unethical market practices

Distributors should note that it is compulsory to comply with both the AMFI Code of Ethics as well as with any code of ethics issued by the concerned AMC.

Tax Laws governing investments in mutual funds Under Income Tax Act, 1961

To Unit-holders (Resident)

Section 94(6) of the Income Tax Act, 1961

Section 94(6) of the Income Tax Act 1961 now provides that any person who buys or acquires any securities or unit within a period of three months prior to the record date and such person sells or transfers such securities or unit within a period of three months after such date and the dividend or income on such securities or unit received or receivable by such person is exempt, then, the loss, if any, arising to him on account of such purchase and sale of securities or unit, to the extent such loss does not exceed the amount of dividend or income received or receivable on such securities or unit, shall be ignored for the purposes of computing his income chargeable to tax.
Section 10(33) of the Income Tax Act, 1961

The dividend received by the investors from the scheme will be exempt from income tax for all categories of investors under Section 10(33) of the Income Tax Act, 1961. The scheme will pay a distribution tax currently @10% plus surcharge if the portfolio holds less than 50 percent debt securities on an average during the last one year period.

Section 88 of the Income Tax Act, 1961

Specified units of mutual fund schemes qualify for rebate under Section 88 of the Income Tax Act, 1961, subscription to the Units of the Scheme by Individuals and Hindu Undivided Families, not exceeding Rupees ten thousand would be eligible to a deduction, from income-tax, of an amount equal to 20% of the amount so subscribed. In the case of subscription by an individual, whose income is derived from the exercise of his profession as an author, playwright, artist, musician, actor or sportsman (including an athlete), the deduction admissible would be at the rate of 25%.

Tax Deducted at Source (TDS)

There will not be any Tax Deduction at Source on payment to resident unit-holders towards redemption or dividends.

Capital Gains benefit under Section 112 of the Income Tax Act, 1961

Long-term capital gains in respect of Units held for a period of more than 12 months will be chargeable under Section 112 of the Income Tax Act, 1961, at a concessional rate of tax @ 20% (excluding surcharge)

From the full value of consideration, the following amounts would be deductible to arrive at the amount of capital gains:
- Cost of acquisition as adjusted by Cost Inflation Index notified by the
Central Government and
· Expenditure incurred wholly and exclusively in connection with such transfer Investors can also opt to pay tax @10% (excluding surcharge) on such Long Term Capital Gains, but without the cost inflation indexation benefit.

**Wealth Tax Benefits**

Mutual Fund units are exempt from Wealth Tax.

**To Non-Residents/OCBs**

**Capital Gains under Section 112 of the Income Tax Act, 1961**

Long-term capital gains in respect of Units held for a period of more than 12 months will be chargeable under Sec 112 of the Income Tax Act, 1961 at a concessional rate of tax of 20%. The capital gains would be calculated after indexation of the cost of acquisition. Investors can also opt to pay tax @10% (excluding surcharge) on Long Term Capital Gains, but without the cost inflation indexation benefit.

**Tax Deduction at Source (TDS)**

Redemptions/Exchanges/Switches by non-residents/OCBs/FIIs will be subjected to tax deduction at source at the rates in force and certificates for tax deducted will be issued.

**To Charitable Trusts**

Investment in the units of the scheme is an eligible mode of investment under Section 11(5) of the Income Tax Act read with Income Tax Rule 17 C.
To the Fund

Open Ended Mutual Funds are exempt from income tax under Section 10 [23D] of the Act.

**ELSS Schemes- How do they serve as tax saving instruments?**

ELSS (or Equity Linked Savings Schemes) are diversified equity schemes with a lock-in period of three years. These schemes have, in recent times, emerged as ideal instruments to save tax with the benefit of equity market exposure.

Saving tax through proper investment planning is an important decision for everyone. According to Budget ‘05-‘06, under section 80C of the Income Tax Act, 1961, all taxpayers have been allowed to invest up to Rs. 1,00,000/- in specified investment avenues to avail tax benefits. ELSS schemes have been designated as one of these avenues. Now an investment of Rs. 1,00,000 in these Funds will be deductible from the investor’s taxable income.

Another positive of these schemes is that till date, their average category returns have been far superior as compared to other tax saving instruments. Moreover, they have also outperformed Diversified Equity schemes in terms of returns over most time periods. The following table shows a returns comparison between ELSS schemes and Diversified equity schemes.
Table No: -4.1
Average of Absolute Point-to-Point Returns (%) as on 31\textsuperscript{st} January 2007

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<tr>
<th>Category</th>
<th>1 year</th>
<th>2 years</th>
<th>3 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>ELSS</td>
<td>60.75</td>
<td>118.96</td>
<td>353.10</td>
</tr>
<tr>
<td>Diversified Equity</td>
<td>59.24</td>
<td>106.68</td>
<td>334.28</td>
</tr>
</tbody>
</table>

Source: MFI Explore April 2007

In addition to the above feature, these schemes have a moderate lock in period of 3 years, significantly lower than in the case of other tax saving instruments. The following table shows a comparison of all tax saving instruments with respect to returns and lock-in periods:

Table No: -4.2
Comparison of all tax saving instruments with respect to returns and lock-in periods

<table>
<thead>
<tr>
<th>SR. NO</th>
<th>Products</th>
<th>Returns (p.a.)</th>
<th>Lock –in Period (years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Public Provident Fund</td>
<td>8%</td>
<td>15</td>
</tr>
<tr>
<td>2</td>
<td>National Saving Certificates</td>
<td>8%</td>
<td>6</td>
</tr>
<tr>
<td>3</td>
<td>Tax Saving infrastructure Bonds</td>
<td>5%</td>
<td>3</td>
</tr>
<tr>
<td>4</td>
<td>Life Insurance</td>
<td>5% to 6%</td>
<td>*</td>
</tr>
<tr>
<td>5</td>
<td>ELSS - Equity Market Linked Return</td>
<td></td>
<td>3</td>
</tr>
</tbody>
</table>

Source: MFI Explore April 2007

The Lock-in period of three years for ELSS schemes is in a way beneficial. Currently equity markets are trading at very high levels. In such a scenario, it is advisable to have a longer horizon for equity market investments. The lock-in-period of three years in case of these schemes helps the fund manager to concentrate on long-term fundamentals without being unduly concerned with redemption pressures and short-term market volatility.
The AUM of this category of mutual funds has taken an upward swing in recent times. Currently (as of January 31st, 2006), the AUM of the category is Rs. 3,165 crs. (open ended schemes). At present, there are around 26 open ended ELSS schemes.

The above diagram shows the AUM movement of the ELSS category (open ended) since last 3 years. The graph has suddenly turned upwards after April 2005 i.e. after Budget ‘05-’06 (as mentioned earlier).

Giving an insight into the emerging popularity of these schemes – the AUM of this category has increased from Rs. 728 cr in April 2005 to Rs. 3,165 cr in January 2006, a sharp escalation of 335%.

It is important to understand that since ELSS Funds are intrinsically investments in equity markets, they are prone to a higher risk factor. These are therefore feasible tax saving instruments for investors who are not averse to blocking funds for 3 years and have a higher threshold of risk-appetite.
ELSS schemes, like other equity market investments, are subject to market risks. As such, their returns are not assured. Investors are advised to read the Offer Document and consult their investment advisors before investing in these schemes.

**Fund Structure and Constituents**

**(Sponsor, Trustee and AMC)**

ORGANISATION OF A MUTUAL FUND

There are many entities involved and the diagram below illustrates the organizational set up of a mutual fund:

![Organisation of Mutual Fund Diagram]

Fig No: - 4.2 Organisation of Mutual Fund

Source: - AMFI India 2008

**Regulatory of mutual funds in India:**

The structure of mutual funds in India is governed by the SEBI (Mutual Fund) Regulations, 19 (hereafter referred to as SEBI Regulations). These regulations make it mandatory for most funds to have a three-tier structure of Sponsor-Asset Management Company (AMC). Sponsor is the promoter of the mutual fund, and appoints the Trustees. The trustee responsible to the investors in the mutual funds, and appoints the AMC for managing the investing portfolio. The AMC is the business face of
the mutual fund, as it manages all the affairs of mutual fund. The mutual fund and the AMC have to be registered with SEBI. SEBI Regulations also provide for who can be a sponsor, trustee and AMC, and specify the format agreements between these entities. These agreements provide for the rights, duties obligations of these three entities.

The UTI is also structured as a trust. The important difference though, is that UTI does not have sponsors or a separate AMC. Financial institutions and banks which contributed to the initial capital of the UTI have their representatives on UTI's Board of Trustees, which oversees the operations the UTI. The Chairman appointed by the Board, who in turn employs managers and staff to run activities, manages UTI.

Sponsor and what does the sponsor do:
The Sponsor is the promoter of the mutual fund. The Sponsor establishes the mutual fund registers the same with SEBI. Sponsor must have been profit making in at least 3 of the above 5 years. Sponsor must contribute at least 40% of the capital of the AMC

Mutual funds structured:
- Company from, in which investors hold shares of the mutual fund. In this structure, management of the fund is in the hands of an elected board, which in turn appoints investment managers to manage the fund.

- Trust from, in which the funds of the investors are held by a trust, on behalf of the investors. The trust appoints investment
managers and monitors their functioning, in the interest of investors.

- The company from the organization is very popular in the United States. In India, mutual funds are organised as trusts. The trust is created by sponsor, who is actually the entity interested in creating the mutual fund business. The trust is either managed by a Board of Trustees, or by a trustee company, formed for this purpose. The investor’s funds are held by the trust.

**Who actually manages the mutual fund?**

The sponsors, acting through the trustees, appoint all the functionaries required for managing the investor's money. These functionaries are the following:

- Investment Managers, known as the asset management company (AMC).
- Registrars and transfer agents.
- Brokers.
- Selling agents and distributors.
- Custodians.
- Depository Participants.
- Bankers.
- Legal Advisors.
- Auditors.
Fig No: - 4.3 Mutual Fund Constituents in India

The regulatory requirements for trustees

The mutual fund, which is a trust, is managed either by a trust company or a Board of trustees Board of trustees and trust companies are governed by the provisions of the Indian trust Act. If the trustee is a company, it is also subjected to the provisions of the Indian companies Act. If the responsibility of the trustees to protect the interest of investors, whose fund is managed by the AMC. The AMC and other functionaries are functionally accountable to the trustees.

- The sponsor executers and registers a Trust Deed in favors of the trustees. The Third Schedule of the SEBI Regulations specifies the contents of the trust deed. The trust deed has to be stamped and registered according to the Indian Registration Act.
- The appointment of all trustees has to be done with prior approval of SEBI.
- There must be at least 4 members in the Board of trustees and at least 2/3rd of the members of the board of trustee of trustees must be independent.
• Trustee of one mutual fund can not be a trustee of another mutual fund, unless he is an independent trustee in both cases, and has the approval of both the boards.

The rights of the Trustees:

• Trustees appoint the AMC, in consultation with the sponsor and according to SEBI regulations.
• All mutual fund schemes floated by the AMC have to be approved by trustees.
• Trustees can seek information from the AMC on the operations and compliance of the mutual fund with provisions of the trust deed, investment management agreement and the SEBI regulations these mandatory review and monitoring are to be made on quarterly basis.
• Trustees can seek remedial actions from AMC, and in the extreme situation of dissociation with performance, dismiss the AMC.
• Trustees review and ensure that net worth of the AMC is according to stipulated norms, every quarter.

The obligations of the Trustees:

• Trustees must ensure that the transactions of the mutual fund are in accordance with the trustee deed.
• Trustees must ensure that the AMC has system and procedures in place and that all the fun constituent are appointed.
• Trustees must ensure due diligence on the part of AMC in the appointment of constituents and business associates.

• Trustees must furnish to SEBI, on half-yearly basis, a report on the activities of the AMC.

• Trustees must ensure that the activities of the mutual fund are in compliance with the SEBI regulations.

The SEBI rules regarding compliance and the role of trustees:

SEBI regulations stipulate that the trustees are fully responsible for the compliance of the mutual funds with SEBI regulations, and for the protection of the interest of the investors in the mutual fund.

• Observance of AMC functioning and desirability of its continuance.

• Protections of trust property.

• Ensuring that all constituents and associates are registered entries.

• Review of service contracts and terms.

• Reporting to SEBI any special developments in the mutual fund.

The regulatory requirements for the AMC:

The AMC, which is appointed by the sponsor or the trustees and approved by SEBI, acts like the investment manager of the trust. The AMC functions under the supervision of its own Board of Directors, and also under the direction of the trustees and SEBI. AMC, in the name of the trust, floats and manages the different investment
'schemes’ as per the SEBI Regulations and as per the Investment Management Agreement signed with the Trustees.

- Only SEBI registered AMCs can be appointed as investment managers of mutual funds.
- AMC must have a minimum net worth of Rs.10 crore, at all times.
- AMCs can not indulge in any business other than that of asset management.
- At least half of the members of the Board of an AMC have to be independent

Who appoints the AMC and defines its functions:
The trustees, on the advice of the sponsors, usually appoint the AMC. The trust deed authorizes the trustees to appoint the AMC. The AMC is usually a private limited company, in which the sponsors and their associates or joint venture partners are shareholders. The AMC has to be a SEBI registered entity, and should have a minimum net worth of Rs.10 core. The trustees sign an investment management agreement with the AMC, which spells out the functions of the AMC.

How are Indian mutual funds organized?
Though the trust is the mutual fund, the AMC is its operational face. The AMC is the first functionary to be appointed, and is involved in the appointment of all the other functionaries. AMC structures the mutual fund products, markets them and mobilizes the funds,
manages the funds and service of investors. It seeks the services of the other functionary in carrying out these functions. At all above noted functionaries are required to report to the trustees, who laid down the ground rules, and monitor their working.

The types of AMCs in the Indian context:

- AMCs owned by banks
- AMCs owned by financial institutions
- AMCs owned by foreign institutional investors
- AMCs owned jointly by Indian and foreign sponsors

Obligations of the AMC:

- Investments have to be according to the investment management agreement and SEBI regulations
- The actions of its employees and associates have to be as mandated by the trustees.
- AMCs have to submit detailed quarterly reports on the working and performance of the mutual fund and compliance with SEBI regulations.
- AMCs have to make the necessary statutory disclosures on portfolio, NAV and price to investors.

Other Constituents

Registrars and Transfer Agent (R & T Agent):

The R & T gents are responsible for the investor servicing functions, as they maintain the records of investors in mutual funds. They process
investor applications; record details provided by the investors on application forms; send out to investors details regarding their investment in the mutual fund; send out periodical information on the performance of the mutual fund; process dividend payout to investors; incorporate changes in information as communicated by investors and keep the investor record up to date, by recording new investors and removing investors who have withdrawn their funds.

In many cases they also provide additional services by tracking investor behaviour for mutual funds.

**Role of brokers in a mutual fund:**

Brokers support the investment management function of the mutual fund, by enabling the investment managers to buy and sell securities. Brokers are registered members of stock exchanges. They charge a commission for their services. In many cases, brokers also provide investment managers with research reports on the performances of various companies and industrial sectors, and investment recommendations.

**Role of selling and distributing agents:**

Mutual fund products are reached to investors across the country through selling agents and distributors. Selling agents are usually individuals who bring in investor's funds for a commission. Distributors are institutions that appoint agents and other mechanisms to mobilize funds from investors. Banks which function as distributors, for example, tend to offer mutual fund products to their chosen customers. Some agencies use direct marketing agents to sell mutual fund products. Some agencies cross sell mutual fund products to clients to whom they
are already offering other financial products. Post Offices are the latest entrants in the mutual fund distribution business, and are expected to leverage their geographical reach to sell mutual fund products.

Most agents and distributors are paid commissions of the funds they mobilize from investors. These commissions are split into initial commission, which is paid on mobilization of funds and commission, which is paid depending on the length of stay of the investor in the mutual fund. Some agents also pass on the commissioning they receive, to the investors as an incentive.

**Functions of custodians**

Custodians are responsible for the securities held in the mutual fund's portfolio. They discharge important back-office function, by ensuring that securities that are bought are delivered and transferred to the books of the mutual funds, and that funds are paid out when a mutual fund buy securities. They keep the investment account of the mutual fund, and also collect the dividends and interest payment due on the mutual fund investments. On the advice of the fund managers, they act on these corporate actions.

**Role of legal advisors and auditors:**

Legal advisors advise mutual funds on regulatory and taxation issues. Every mutual fund has employee designated as compliance officer, who works under the advice of the legal advisors. The accounts of the mutual fund are actually the accounts of the pool in which investors have invested. Therefore, each mutual fund scheme created by an AMC has to maintain a separate book accounts, and draw up its
annual report. The AMC also has its accounts and annual reports. The two sets of accounts are required to be statutorily audited. SEBI Regulations stipulate that audit of the fund cannot also be the auditors of the AMC - The two sets of accounts have to be audited two separate audition firms. Auditors charge a fee from the mutual fund for these services. AMC pays the auditors out of its incomes, for auditing its books.

**Various forms of fund mergers and takeovers in India:**
Takeovers generally involve acquisition proponents of takeover argue that they improve the quality of management, facilitate forward aid backward linkages with other operations of the acquirer and afford scope for realizing synergistic benefits. T. Boone Pickens Jr a very eloquent votary of takeovers, regard them as active for purchasing weak management and protecting the investment of the small shareholder. The Leitmotif of his book is that companies should be in the interest of shareholder and not management or as, some executive claim ‘the society at large’.

- Merger of AMCs
- AMC take-over by other sponsors
- Scheme take-over

**Conditions under which two AMCs can be merged:**

- SEBI and Trustees of both funds must approve the merger.
- Unit holders should be notified of the merger, and provided the option to exit at NAV, without load.

An example of merger of AMCs is the merger of the AMCs of HB
mutual fund and Taurus mutual fund.

Concluding Remark:-

SEBI has enacted the SEBI (Mutual Funds) Regulations, which provides the scope of the regulation of mutual funds in India. All mutual funds are required to be mandatory registered with SEBI. The structure and formation of mutual funds, appointment of key functionaries, operations of the mutual fund, accounting and disclosure norms, rights and obligations of functionaries and investors, investment restrictions, compliance and penalties, are all defined under the SEBI Regulations.

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