CHAPTER - III

LEGAL ISSUES & MUTUAL FUNDS
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3.1 INTRODUCTION

Mutual funds should be allowed complete freedom to design their products. Any transgression of the spirit and meaning of the regulations can be adequately tackled through appropriate clauses of the regulations. The regulations do create, a very sound framework for ensuring transparency and accountability among the mutual funds.

Mutual Funds have a distinct mission of imparting the benefit of equity cult to small investors who have scant risk-absorption capacity. Such clarity and convergence in objectives must be spelt out by the regulatory bodies so that the objectives have a high degree of correlation with the mission. There is no comprehensive law to regulate and supervise the mutual funds in India.

As per the recommendations of the Abid Hussain Committee on "Development of Capital Market", Securities and Exchange Board of India (SEBI) was constituted in 1989. SEBI is now the Lead regulatory body for all Mutual Funds excepting the Unit Trust of India which is regulated by UTI Act, 1963.
3.2 SALIENT POINTS OF UTI ACT 1963

3.2.1 RELEVANT SECTIONS

A. Section 19 of the Act includes

(1) The Trust may carry on and transact any of the following business, namely:

(a) Selling and purchasing units

(b) investing in acquiring, holding or disposing of, securities and exercising and enforcing all powers and rights incidental thereto.

(c) keeping money on deposit with scheduled banks or with such other institutions as may be prescribed.

(d) formulating in relation to any unit scheme:

(i) Saving and life Insurance plan or plans in association with or as the agent of the Life Insurance corporation of India but not including the Life Insurance Business, or

(ii) any other plan or plans under which a person may acquire an interest in units;

(e) generally, doing all such matters and things as may promote the sale of units or as may be incidental to or consequential upon the discharge of its functions under this Act.
(2) The trust shall not take on lease, purchase or otherwise acquire except for its own use any immovable property or any interest there in.

B. Income of the Trust: Section 23 of the Act provides: The income of the Trust shall consist of:

(1) in relation to the first unit scheme:
   (a) the income arising out of the capital referred to in subsection (i) of section 22,
   (b) any gifts, grants, donations or benefactions treated as the income of that scheme under section 20 B, and
   (c) any other income allocated to that scheme by the Board, having regard to the nature of the income and other relevant factors.

(2) in relation to any subsequent unit scheme:
   (a) the income arising out of the capital referred to in subsection (2) of section 22,
   (b) any gifts, grants, donations or benefactions treated as the income of that scheme under section 20 B, and
   (c) any other income allocated to that scheme by the Board, having regard to the nature of the income and other relevant factors.
C. Distribution of the income:

Section 25 A of the Act provides:

(1) The income allocated to the initial capital in any year reduced by the interest and the amount of other expenses charged for that year to the initial capital may be distributed in the prescribed manner among the contributing institutions in each case in proportion to their respective contributions.

(2) The income allocated in any year to the unit capital relating to the first unit scheme reduced by the interest and the amount of other expenses charged for that year to such unit capital may, but not less than ninety per cent of such income so reduced, shall be distributed in respect of that year to the unit holders under that unit scheme.

"Provided that in relation to any year in which the Trust has declared a dividend of not less than 10%, on the unit capital the requirement as to distribution of not less than 90% of such income in such year as so reduced shall not apply."

(3) The income allocated in any year to the unit capital relating to each of the subsequent unit schemes reduced by the interest and the amount of other expenses charged for that year to such unit capital may, having regard to the purposes of that scheme and other relevant factors.
(i) be distributed in respect of that year to the unit holders under that scheme in such manner and at such percentage of the income so reduced as the Board may determine; or

(ii) be carried forward and reinvested otherwise utilised for the benefit of the unit holders in accordance with the provisions of that scheme.

3.2.2 INVESTMENT REGULATIONS OF UTI

3.2.2.1 Unit trust of India, General Regulations, 1964
Restrictions on investment in shares etc. of companies:

Regulation 36 (I):

36(I) Investments by the Unit Trust from the funds of the Unit Scheme of 1964 in securities of any one company shall not exceed five percent of the total amount of the funds or fifteen percent of the securities issued and outstanding of such company, whichever is lower:

Provided that aggregate of the investments in the capital initially issued by new industrial undertakings shall not at any time exceed five percent of the total amount of the said funds.

Regulation 36 (IA):

1. 36(IA) The limits prescribed under sub-regulation (I) shall not apply to investments in the following securities and for the purpose of that sub-regulation, such investments shall not be taken into account;
(i) Debentures issued by any company and secured by first charge on any immovable property, plant or equipment or secured by a floating charge on the assets of the company, where the book value of such property, plant or equipment, or, as the case may be, of such assets as shown in the last audited Balance Sheet, or where such Balance Sheet is not available, as certified by company is more than twice the face value of such debenture, provided the company has declared, for the company's financial year immediately preceding the financial year in which the investment in such debentures is or was made by the Unit Trust dividend on its equity shares at not less than six percent of the company's paid-up capital.

"Book Value" means in cases where no adjustment for depreciation has been made, the value as shown in the books less the amount of full depreciation calculated in accordance with the sub-section (2) of section 205 of the Companies Act, 1956.

(ii) Debentures secured by a first charge on any immovable property, plant or equipment of a company which has declared dividend on its equity shares, for the five years immediately preceding the year in which the investment in such debentures is or was made by the Unit Trust, or for at least five out of six or seven years immediately preceding such year.

2. The limit prescribed in sub-regulation (1) shall be applied with reference to circumstances at the time the investments
are made, and shall not be deemed to have been exceeded, not
withstanding that, by reason of the fluctuations in the
market prices of the investments, or by reason of issue of
bonus shares or rights shares by the company in whose
securities investments have been made, the limit is in fact
exceeded.

In this Regulation, the term "company" shall have the same
meaning as is assigned to it in the companies Act, 1956 (1 of
1956).

36A. Investments by the Unit Trust from the funds of any
scheme other than the Unit Scheme, 1964 shall not exceed such
limits and shall be subject to such terms and conditions as
may, with the approval of the "Development Bank", be
specified in this regard in that scheme.

37. Money of the Unit Trust may be kept on deposit with
scheduled banks or with the following institutions, namely :-
i) The Reserve Bank;

ii) Regulation 37(E) of the UTI General Regulations will
read as follows :

"any company as defined in Section 3 of the Companies
Act, 1956 and having paid-up capital and reserves of not less
than one crore of rupees, provided, that the minimum limit of
not less than one crore of rupees shall not be applicable for
placing an advance deposit against Trust's own commitment if
the company gives a bank guarantee in respect of payment to
the trust of both principal amount of deposit and interest
thereon".
iii) any other Corporation incorporated under any law in force in India.

3.2.2.2 CRTS SCHEME 1981

(1) Investments by the Trust from the funds of the scheme in the securities of any one company shall not exceed 15% of the securities issued and outstanding of such companies. Provided that the aggregate of such investments in the capital initially issued by new industrial undertakings shall not at any time exceed 5% of the total amount of the said funds.

(2) The limits prescribed under sub-clause (I) shall not apply to investments of the Trust in bonds and debentures of a company whether secured or not.

3.2.2.3 INCOME UNIT SCHEME

REGULATIONS PERTAINING TO THE INVESTMENTS:

The Unit Trust of India General Regulations, 1964 lay down certain broad guidelines in respect of the Trust's investment. These Regulations mainly aim at diversification of the Trust's investments so as to spread the risks of investment inherent in industrial securities.
(a) **Investment in existing companies**

In terms of regulation 36(1), investments by the Trust from the funds of Unit Scheme 1964, in securities of any one company shall not exceed five percent of the total amount of the said funds or 15 percent of the securities issued and outstanding of such company, whichever is lower. These limits are, however, not applicable in terms of Regulation 36(IA) in respect of investments in:

i) Debentures secured by a first charge on any immovable property, plant or equipment of the company or secured by a floating charge on the assets of the company where the book value of such asset is more than twice the face value of such debenture provided the company has declared minimum 6 percent dividend on its equity capital in the immediate preceding financial year, and

ii) Debentures secured by a first charge on any immovable property, plant or equipment of a company which has declared dividend on its equity capital in the preceding five years for at least five out of six or seven years.

It is, thus observed that there is absolutely no limit on the maximum amount the Trust can invest by way of subscription of debentures in existing companies paying regular dividends and also in existing companies, the book value of whose assets is more than twice the face value of the debentures.
(b) Investments in new companies

As regards investment in new companies, provision to Regulation 36(1) lays down that the total investments of the Trust in the capital initially issued by new industrial undertaking shall not at any time exceed 5 percent of the total investable funds of the scheme. The Regulation, however, does not define up to what time an industrial undertaking could be considered new. The practice in the Trust, however, is to define a company as a new company till it has not started commercial production. Once it commences production, it is regarded as an existing company. The reason perhaps for incorporating this Regulation is to ensure that only a small portion (viz. 5 percent) of the Trust's funds is locked up in new companies, as such companies are not in a position to pay dividends until production commences and the companies start making profits, and some of them even find difficulty in paying regular interest on debentures during the construction period.

Another reason for this limitation is that often long and undue delays are involved in the implementation of projects of new companies, resulting in large cost overruns, and also teething troubles associated with new projects. Regulation 36A further provides that investments by the Unit Trust from the funds of any scheme other than the Unit Scheme 1964 shall not exceed such limits and is subject to such terms and conditions as may, with the approval of the Development Bank, be specified in this regard in that scheme.
Regulation 37 provides as under:

Moneys of the Unit Trust may be kept on deposit with scheduled banks or with the following institutions, namely:

1) The Reserve Bank;

2) any company as defined in Section 3 of the Companies Act, 1956 and having paid-up capital and reserves of not less than one crore of rupees, but this is not applicable for placing an advance deposit against the Trust's own commitment if the company gives a bank guarantee in respect of payment to the trust of both principal amount of deposit and interest thereon;

3) any other Corporation incorporated under any law in force in India.

The above are the only Regulations governing the Trust's investment operations. It is, therefore, seen that they provide only broad guidelines and the Trust's management is left with ample freedom to select securities for investment and to carry out adjustments in investment portfolio as and when it considers necessary.

3.2.3 INVESTMENT OBJECTIVES

3.2.3.1 MASTER SHARE (GROWTH SCHEMES)

The principal objective is to provide long term capital appreciation. The Mutual Fund will make every effort to build a well balanced and diversified growth oriented portfolio investment.
The net proceeds of the offer, after providing administrative expenses, is invested in a diversified portfolio of securities of companies established and operating in India, which are listed on one or more of the Stock Exchanges in India. The Mutual Fund also invests in unlisted securities.

While it is intended that the Mutual Fund invests primarily in equity securities, it invests in money market instruments such as call deposits with and bills discounted by banks, short term borrowing by companies and variable rate debentures, etc. The Mutual Fund also enters into underwriting arrangements for equities, convertible and non-convertible debentures.

The Capital gains—both short and long and interest realised which are free of tax as UTI is totally exempt from tax, is reinvested with a view to improving the NAV. This enables achieving faster capital appreciation.

3.2.3.2 INDIA FUND

The principal objective in the management of the portfolio by UTI is long-term capital appreciation. The net proceeds of the offer, after retaining £60,000 to provide for the initial administrative expenses of the Fund, are to be invested by UTI through the UTI Scheme in diversified portfolio of securities of corporations established and operating in India, which are listed on one or more of the stock exchanges in India. It is expected that under current market conditions the portfolio gives emphasis on the fertilizer, chemical, pharmaceutical, synthetic fibres,
electronics, telecommunications and computer industries. Subject to the "Investment Restrictions" described below, UTI also invests in unlisted securities.

Whilst it is intended that UTI invests primarily in equity securities, UTI invests in money market obligations denominated in rupees, particularly during the first year when the initial equity investments are being made. Such money market obligations are those of institutions and corporate obligers of the highest credit-worthiness and comprises call deposits with, and bills discounted by banks, short-term borrowing by corporations and variable rate debentures. UTI also enters into underwriting arrangements for the account of the UTI Scheme.

In order to assist in the orderly initial investment of the proceeds of the offer in the Indian securities markets, the UTI, after consulting generally with the Advisory Board, resolves to transfer to UTI Scheme investments held by it for the account of other schemes operated by it. Transfer is only made at a value determined on the basis set out under the heading "Valuation" below and with the addition of any costs or commissions. No such transfer, however, is made of any unlisted investments. UTI also sells investment held for the account of the UTI Scheme to such other schemes on the same basis. Transfer to and from the UTI Scheme is effected on terms no less advantageous to the UTI Scheme than a transfer involving an unconnected person.
Capital gains realised by the UTI on the disposal of investments are re-invested but may be used to satisfy operating fees and expenses of the UTI Scheme and the fund in the absence of sufficient income.

The investment objectives as set out above are adhered to for a period of at least three years following admission of the shares to the Official List of the London Stock Exchange, and are only varied thereafter with the consent of the Management Company after it has obtained the sanction of an Extraordinary Resolution of Shareholders unless the Trustee certifies that there is no material prejudice to Shareholders in giving such consent.

3.2.4 INVESTMENT RESTRICTIONS

3.2.4.1 GENERAL RESTRICTIONS

The UTI Schemes prohibits the UTI from doing any of the following in respect of the scheme:

a. investing in securities having unlimited liability.

b. investing more than ten percent of the total assets of the UTI Scheme in unlisted equities.

c. investing in securities issued by a unit trust mutual fund, investment corporation or other similar investment vehicle;

d. borrowing except such short-term credits as is necessary for clearance transactions;

e. dealing short or in options;

f. investing more than five percent of the total assets of the UTI Scheme in the obligations of a single entity provided that such percentage is increased to up to ten percent on
condition that the aggregate of all such obligations in excess of five percent does not exceed twenty percent of the total assets of the UTI Scheme;

g] acquiring any security if as a result the UTI then holds more than 10 percent of any class of securities of an issuer;

h] buying or selling commodities, or futures contracts, commodity contracts, real estate or interests in real estate although UTI purchases and sells variable rate debentures which are secured on real estate and securities of corporations which invest or deal in real estate;

i] making any loan (other than by way of call deposits with and bills discounted by banks, short-term borrowing by corporations and variable rate debentures) or giving any guarantee or granting any security; or

j] making investments for the purpose of exercising legal or management control.

These limitations apply as at the date of the relevant transaction or commitment to invest. Changes do not have to be effected merely because owing to appreciations or depreciations in value, or by reason of the receipt of any rights, bonuses or benefits in the nature of capital or of any scheme or arrangement for amalgamation, reconstruction or conversion or exchange or of any repayment or redemption, any of the limits when considering changes or additions to the investment portfolio.
3.2.4.2 INVESTMENT LIMITATIONS UNDER INDIA GROWTH FUND

The following limitations are fundamental policies, which are not changed without the express approval of a majority of the Fund's outstanding voting securities. If a percentage limitation on investment or use of assets set forth below is adhered to at the time a transaction is effected, later changes in the percentage resulting from changed values are not considered a violation. Also, if the Fund receives from an issuer of securities held by the Fund subscription rights to purchase securities of that issuer, and if the Fund exercises such subscription rights at a time when the Fund's portfolio holdings of securities of that issuer (of that issuer's industry) otherwise exceeds the limits set forth in clauses 4 & 5 below, it does not constitute a violation if, prior to receipt of securities upon exercise of such rights, and after announcement of such rights, the Fund has sold at least as many shares of the same class and value as it receives on exercise of such rights.

The Fund does not:

1. Purchase any securities on margin, except such short-term credits as is necessary for the clearance of transactions.

2. Make short sales of securities or maintain a short position.

3. Issue securities, borrow money or pledge its assets, except that the Fund borrows from a bank (i) to pay any dividends required to be distributed in order for the Fund to maintain its qualification as a regulated investment company under the Internal Revenue Code, (ii) for temporary or emergency
purposes in an amount not to exceed 10% (calculated at the lower of cost or current market value) of its total assets (not including the amount borrowed), and (iii) to finance tender offers and share repurchases, in amounts not to exceed 30 per cent (taken at the lower of cost or current value) of its total assets (not including the amount borrowed). In order to secure such borrowing, the Fund pledges no more than 10 percent of its assets (initial and variation margin in respect of future contracts and options thereon and any collateral arrangements in respect of options on securities or indices are not deemed prohibited by this or any other investment limitation.

43 Purchase any security (other than obligations of the United States Governments or any agency or instrumentality thereof) if, as a result: (i) as to 75 percent of the Fund's total assets, more than 5 percent of such assets (calculated at current market value) are taken invested in securities of a single issuer, or (ii) the Fund would then own more than 10% of the voting securities of any single issuer.

53 Invest 25 percent or more of the total value of its assets in a particular industry.

63 Buy or sell any commodities or commodity future contracts or commodity options, or real estate or interest in real estate or real estate mortgages, except that the Fund buys or sells securities of companies which invest or deal in commodities or real estate, and except that the Fund enters into foreign
- currency and stock index future contracts and options thereon and buys or sells forward currency contracts.

Make loans, except through repurchase agreements to the extent permitted by law and subject to the limitation that the total amount of all repurchase agreements having a maturity greater than seven days, plus the total value of all securities held by the Fund which are not readily marketable, are limited to 15 per cent of the Fund's total assets.

Act as underwriter of securities of other issuers except, in connection with purchase of securities for the Fund's own portfolio, or the disposition of portfolio securities or of subscription rights thereto, to the extent that it is deemed to be an underwriter under applicable securities laws.

Make any investment for the purpose of exercising control or management.

Make any investment which involves the Fund in a situation of unlimited liability, such as that of a general partner.

Subject to the investment limitations described in paragraph (3) above, the Fund borrows funds. Borrowing by the Fund creates an opportunity for greater total return but, at the same time, increases exposure to capital risk. In addition, borrowed funds are subject to interest costs that offset or exceed the return earned on the borrowed funds and which, if the borrowed funds are used to pay dividends or to finance share repurchases or tender offers, reduce the Fund's net income.
3.2.5 EQUITY INVESTMENT POLICY

While day-to-day market operations are decided by the Investment Committee comprising the Chairman, Executive Trustee and Joint General Manager (Market Operations), the following guidelines are intended to provide a broad framework.

3.2.5.1 GUIDELINES FOR MARKET PURCHASES

i) Normally, any company having P/E ratio of more than twenty times is not considered for investment. The companies having P/E ratio on projected profitability basis around ten to fifteen times can be considered to be companies having growth potential. Companies having lower P/E ratio than the average P/E ratio of their industry group are considered good for purchases after a detailed analysis. There is a constant review of P/E ratios of various industrial groups and companies under each group to understand emerging changes in the wide spectrum of groups.

ii) Companies having a yield of over 3 percent, prima facie are considered good for purchase. However, new companies or companies which have been temporarily going through a lean phase are considered on merit.

iii) In case of companies having viable projects for expansion and diversification, shares are purchased even at slightly higher prices and at higher P/E ratio, if the future expansion schemes are expected to generate higher profits and higher earnings per share.
3.2.5.2 GUIDELINES FOR MARKET SALES

i) Shares with 50 per cent and more appreciation are considered prima-facie eligible for sale, and a maximum of 10 percent of holdings at the beginning of the year are considered for sale during a year to book profits. In the case of shares with appreciation of 100 per cent and more, maximum 20 per cent of holdings are sold for booking profits during a year, as chances for further appreciation probability wise, is less.

ii) Those shares which are giving very high yield on cost, exceeding 15 percent are not normally on the sale list since they give high yield and it is impossible to acquire scrips through fresh purchases yielding such high yield. But when they cross 100 percent appreciation level, they are considered prima-facie eligible for sale. High yielding shares with high or even moderate appreciation are not sold unless the analysis and future prospects indicate to declining profitability in the future.

iii) Those shares which have failed to appreciate by more than 10 per cent in the in the past year are under constant scrutiny and if considered less likely to grow more in the near future, are considered for sale.

iv) Industries with limited or adverse prospects in the next six months or a year are identified and scrips of these industries are considered for sale.
v) Scrips which have Price-Earning Ratio higher than 20 are studied and considered for sale unless those like FERA scrips which continuously appreciate despite high P/E beyond 20 and show prospects of appreciation. Scrips with P/E higher than 50 percent of the industry P/E also candidates for sale unless they are likely to show growth within next one year.

vi) The companies having yield of less than 1 percent are considered for sale.

vii) In the event of speculative rise or dip in share prices, and flare up or sudden decline in the index, transactions in some scrips have played an important role in reducing bouts of sudden volatility and from the point of view of long term interests of the market. The UTI does carry out transactions in such stabilization scrips. The sale and purchase of stabilization scrips keeps the speculative frenzy under control. These shares are basically those which have large market capitalization and belong to 'A' or specified category. The list of UTI stabilization scrips includes 30 scrips covered under the BSE sensitive price Index. The scrip is prima facie eligible for sale or purchase if there is more than five percent change in the price of the scrip during one day or 10% change during the last five trading days.
3.3 GOVERNMENT OF INDIA GUIDELINES FOR SETTING MUTUAL FUNDS IN PRIVATE/JOINT SECTOR

Mutual Funds received Government of India guidelines as per letter F No 19(27) SE/90 dt 14.02.92. Those guidelines are as follows:

3.3.1 SCOPE

These guidelines shall be applicable to all mutual funds which invest primarily in the capital market and also partly in money market instruments subject to the following:

(a) Money Market Mutual Funds that would invest exclusively in money market instruments would be regulated by the Reserve Bank of India on the basis of specified guidelines to be laid down by the Reserve Bank of India (RBI). However, money market schemes of other mutual funds would be regulated by the Securities and Exchange Board of India. These regulations will be in conformity with the guidelines to be issued by the Reserve Bank for Money Market Mutual Funds investing exclusively in money market instruments.

(b) Off-shore Funds which have non-resident investors and are regulated by the provisions of the countries where these are registered shall be outside the purview of these guidelines. These funds shall continue to be governed by the rules and procedure laid down for the purpose of approving and monitoring their performance by the Department of Economic Affairs, Ministry of Finance and the Government's/RBI's directives on this subject.

(c) Mutual funds with special characteristics, e.g. funds dealing with assets other than securities, may be specifically exempted by the Government from the purview of these guidelines.
Existing mutual funds should conform to these guidelines within a period of 6 months from the date of issue of these guidelines.

3.3.2 ESTABLISHMENT

Mutual funds shall be authorised for business by the Securities and Exchange Board of India (SEBI). Mutual funds shall be sponsored by the registered companies with a sound track record, general reputation and fairness in all their business transactions.

Mutual funds shall be established in the form of Trusts under the Indian Trusts Act. The sponsoring institution will be free to work out the details regarding the constitution of the Trust.

The Trust shall then be authorised to float one or several different schemes under which units shall be issued to the investors.

Mutual funds shall be operated only by separately established Asset Management companies.

3.3.3 ASSET MANAGEMENT COMPANY (AMC)

3.3.3.1 AUTHORIZATION FOR BUSINESS

AMC shall be authorised for business by SEBI on the basis of the following criteria:

(a) AMCs which are already existing should have a sound track record, general reputation and fairness in all their business transactions.

(b) The Directors of AMCs should be persons of high repute and standing having atleast 10 years of professional experience in the
relevant fields such as portfolio management, investment analysis, financial administration etc.

(c) At least 50 percent of the Board of AMC should be independent Directors not connected with the sponsoring organisation.

(d) The AMC should at all times have a minimum net worth of Rs. 5 crores.

SEBI shall approve the Memorandum and Articles of Association of the AMC.

The name of the directors and any subsequent changes must be intimated to SEBI.

SEBI may lay down additional selection criteria or change them from time to time for regulating the expansion of mutual funds in the larger interest of mutual funds industry and healthy growth of capital market.

Except in the case of bank-sponsored AMCs where the prior concurrence of RBI would be required, SEBI may withdraw the authorization granted to any AMC if it is found to be not serving the best interests of investors or of mutual funds industry or of capital market. The Board of Trustees of a mutual fund in such cases should reappoint another AMC or liquidate the mutual fund as may be necessary within 3 months of withdrawal of authorization of the existing AMC and distribute the proceeds to unit holders.
3.3.3.2 RESTRICTION ON BUSINESS ACTIVITIES

AMC should not be allowed to act as the Trustee of a Unit Trust. In other words, the AMC and the Trustee should be two separate legal entities.

AMC should not be permitted to undertake any other business activity than management of mutual funds and such other activities as financial services consultancy, exchange or research and analysis on commercial basis as long as these are not in conflict with the fund management activity itself. An AMC or its affiliate acting for a fund cannot act as the AMC for any other fund. For this purpose, a company is considered as an affiliate if it is a company:

(a) Which directly or indirectly, and by itself, or in combination with other persons exercises a significant control over the AMC.

(b) Over which the AMC, directly or indirectly, and by itself or in combination with other persons exercises a significant control.

(c) Over which significant control is exercised directly or indirectly by a person or persons or the relatives of such a person or persons whether by themselves or in combination, who exercise significant control over the AMC.

(d) In which any director, officer or employee of the AMC is a director, officer or employee.
Without prejudice to the generality of the above restriction significant control shall be deemed to exist:

(i) In relation to a company where any person or combination of persons directly or indirectly own, control or hold with power to vote 3 percent or more of the voting shares of each of the two companies.

(ii) As between two companies if the same person or combination of persons directly or indirectly own, control or hold with power to vote 3 percent or more of the voting shares of each of the two companies.

No person should be a Director of more than one AMC.

No person who is a Director of an AMC should hold the position of a Trustee, or Director in a Trust company, of funds operated by the same AMC.

No person should be a Director/Trustee in more than one Trust Company/Board of Trustees.

3.3.4 TRUSTEES AND TRUST COMPANIES

Trusteeship functions should be carried out by separately established Trust Companies. Until such companies are formed, existing debenture-trustees, banks and financial institutions may be allowed to act as mutual fund trustees, or a separate Board of Trustees consisting of individuals of sufficient repute and experience may act as mutual fund trustees.

At least 5 percent of the Board of Trustees shall be independent
outside members. They shall not have any affiliation with the sponsoring institution or any of its subsidiaries.

The Trust Company and/or the composition of the Board of Trustees including the eligibility of each member should be intimated to SEBI.

The Trustees should have the responsibility to ensure that managers comply with the Guidelines and report periodically to the investors in the fund that this is the case. This should entail, interalia, the following checks:

- That investments are of the permitted kind and within set limits;
- That the fund's assets are duly protected;
- That transactions in units are properly executed by the manager which may include spot checks on:
  - Pricing of units;
  - Payments into and out of the fund;
  - Internal control (e.g., for capital adequacy);
  - That income due to the fund is properly accounted for;
  - That all expenses and charges to the fund are as permitted;
  - That distributions from the fund are properly made.

In order to effect these checks the Trustees should have the right to obtain from the AMC all information concerning the operations of the Trust. The AMC should submit a quarterly report on the functioning of the mutual fund to the Trustees. The Trustees in turn should submit a six-monthly report to SEBI, and an Annual report to the investors in the fund.
3.3.5  TRUST DEEDS

The sponsor should submit the Trust Deed to SEBI for prior approval.

The Trust Deed should include all safeguards considered to be essential for investor protection.

3.3.6  CUSTODIAN

The Mutual funds shall use the services of a custodian registered with SEBI.

It should be ensured that the custodian should be totally delinked from the AMC.

3.3.7  SCHEMES

Each authorised unit trust should be allowed to float different schemes as long as the concerned AMC meets the required capital adequacy criteria and whose authorization has not been withdrawn by SEBI for any reason whatsoever.

Each scheme floated by a mutual fund should have prior registration with SEBI. The AMC should prepare a prospectus /letter of offer for each scheme and should get it vested by SEBI before inviting public participation. SEBI shall decide each proposal within 30 days of its receipt failing which the scheme may be floated by the fund presuming SEBI's clearance. Mutual funds should be allowed to start and operate both close-end and open-end schemes.
The close-end schemes shall be considered for approval as per the procedure applicable to capital issues by companies.

For each closed-end scheme, the mutual fund should be required to raise at least Rs.20 crores and for each open-end scheme, at least Rs.50 crores. The entire subscription should be refunded to the investors if:

(a) the minimum amount of Rs.20 crores or 60 percent of the targeted amount, whichever is higher, is not raised for a closed-end scheme, or

(b) the minimum amount of Rs.50 crores or 60 percent of the targeted amount, whichever is higher, is not raised for an open-end scheme.

Mutual funds should not be permitted to keep close-end schemes open for subscription for more than 45 days. For open-end schemes, first 45 days of the subscription period should be considered for determining the target figure or minimum size.

Mutual funds should provide continuous liquidity. Closed-end schemes should be listed on stock exchange.

For open-end schemes, Mutual funds shall sell and repurchase units at pre-determined prices based on Net Asset Value and such prices should be published at least once in a week.

Each scheme under the same management should have a clearly identified and responsible fund manager.
3.3.8 INVESTMENT LIMITATIONS

Mutual funds will be allowed to invest only in transferable securities either in the money market or in the capital market, including any privately-placed debentures or securitised debt.

(a) Privately placed debentures, securitised debt and other unquoted debt instruments holdings shall not exceed 10% in case of growth funds and 40 percent in case of income funds.

(b) All debt instruments must have been rated as investment grade by an approved credit rating agency. If not rated, the specific approval of the Board of AMC should be taken to become eligible for holding in the portfolio.

Mutual funds should not be allowed to give term loans for any purpose.

No individual scheme of the mutual fund should invest more than 5 per cent of its corpus in any one company's shares.

No mutual fund under all its schemes should own more than 5% of any company's paid up capital carrying voting rights.

No mutual fund under all its schemes taken together should invest more than 10 percent of its funds in the shares or debentures or other securities of a single company.

No mutual fund all its schemes taken together should invest more than 15 % of its funds in the shares and debentures of any specific industry (such as cotton textiles, tea, tyres etc.). This provision will not however apply to a scheme which has been floated for
investments in one or more specified industries and a declaration to that effect has been made in the Offer Letter.

No scheme should invest in or lend to another scheme under the same AMC.

Mutual funds must take delivery of scrips purchased and give delivery in the case of scrips sold and in no case shall engage in short selling or carry forward transactions or badla finance. The scrips purchased should be transferred to the fund's name and scheme also.

Transfers from one scheme to another in the same mutual fund should be allowed only if:

(a) Such transfers are done at the prevailing market price for quoted instruments on spot basis.

(b) The securities so transferred would be in accordance with the investment objective of the transferee scheme.

(c) Transfer of unquoted instruments should be done only with specific approval of the Board of Trustees.

(d) The registration and accounting of the transaction is completed and is ratified in the next meeting of the Board of Trustees.

3.3.9 WINDING UP

Each closed-end scheme should have a duration fixed in number of years, at the end of which it should be wound up or extended with the permission of SEBI.

An open-end scheme shall be wound up if the total number of units outstanding after repurchases at a point of time falls below 50 percent of the originally issued number of units.
3.3.10 EXPENSES

The Asset Management Company may charge the mutual fund with Investment Management and Advisory Fees which should have been disclosed fully in the prospectus subject to the following ceiling:

(a) 1.25 percent of the weekly average net assets outstanding in the current year for the scheme concerned, as long as the net assets do not exceed Rs.100 crores, and

(b) 1 percent of the excess amount over Rs.100 crores, where net assets so calculated exceed Rs.100 crores.

In addition, the Asset Management Company may charge the mutual fund with the following expenses:

(a) Initial issue costs of sponsoring the fund and its schemes.

(b) Recurring expenses including,

(i) Marketing and selling expenses including Agent's commission, if any,

(ii) Brokerage and transaction costs.

(iii) Registrar Services for transfer of shares sold or redeemed.

The Asset Management Company should be expected to meet all its expenses and be responsible to provide the following:

(a) Office space, supplies and personnel including security analysts and portfolio managers.

(b) Regulatory compliance and reporting services.
(c) Preparation and distribution of the fund's prospectus, annual and periodic reports and other investor communications.

(d) Advertising and other sales material.

(e) Accounting services and preparation of tax returns.

(f) Insurance coverage and other services.

The fees payable to the Trustees shall be charged to the mutual fund.

The fees payable to the custodian for safe keeping of fund assets and related matters shall be charged to the mutual fund. The initial issue expenses should not exceed 6 percent of the funds raised under each scheme.

In any case, the total of all the expenses charged to the fund except the initial issue expenses should not exceed 3% of the weekly average net assets outstanding during the current year and the same small be disclosed through advertisements, account etc.

All expenses should be clearly identified and appropriately attributed to individual schemes.

3.3.11 INCOME DISTRIBUTION

All mutual funds must distribute a minimum of 90 percent of their profit in any given year.
3.3.12 RIGHTS OF THE PARTIES

The Asset Management Company can be changed by either the Trustee Company/Board, or by 75 percent of the investors in the fund.

If a change in the Asset Management Company is recommended by the Trustee Company/Board, it should be subject to scrutiny and approval of SEBI.

If the sponsor of a mutual fund recommends change of the Trustee it should be subject to the scrutiny and approval of SEBI.

SEBI should have the right to review a mutual fund's role in takeovers.

3.3.13 ACCOUNTING REQUIREMENTS

Mutual funds should be required to segregate their earnings as current income, short term capital gains and long term capital gains.

Accounting for all the schemes should be required to be done for the same year-ending.

For all quoted instruments, mutual funds must calculate weekly NAV at the last available closing market prices. For unquoted investments, the valuation may be done once weekly either at cost or by any other method authorised by SEBI. For investments considered doubtful, the "directors best estimate may be accepted, subject to the authors' certificate of reasonability."
3.3.14 DISCLOSURES AND REPORTING

SEBI will have the right to call for any information regarding the operations of the mutual funds and any of its schemes from the mutual fund, Asset Management Company, Custodian, sponsor or any other associated with the mutual fund.

SEBI will require from every mutual fund at least the following periodic reports, in addition to any others it may see fit:

(a) Copies of the duly audited annual statements of accounts including the balance sheet and the profit and loss account for the fund and for each scheme, once a year.

(b) Six monthly unaudited accounts as above.

(c) A statement of movements in net assets for each of the schemes of the fund, every quarter.

(d) A portfolio statement, including changes from the previous periods, for each scheme, every quarter. SEBI shall also lay down the accounting policies to be complied with by all mutual funds and the format and contents for the financial statements and other reports.

SEBI shall require all mutual funds to adopt a written code of ethics designed to deal with the potential conflicts of interest that may arise from transactions by affiliated persons or companies. SEBI shall require a quarterly report from the interested persons or companies, disclosing all reportable transactions as determined by SEBI in a format prescribed by SEBI.
SEBI shall lay down a common advertising code for all mutual funds to comply with.

All mutual funds will be expected to submit to SEBI the texts of the marketing literature and advertisements issued to the investors.

The marketing and publicity brochures for each scheme shall properly disclose the investment objectives, the method and periodicity of valuation of investments, the exact method and periodicity of sales and purchases and other details considered by SEBI to be essential for investors.

SEBI can after due investigation impose penalties on mutual funds for violating the guidelines as may be necessary. However, for cases of penalties of suspension or deauthorisation of mutual fund entities, prior concurrence of RBI and Government shall be taken.

3.3.15 APPEALS

Appeals against decisions of SEBI lie to the Department of Economic Affairs, Ministry of Finance.

3.4 RBI GUIDELINES FOR SETTING MUTUAL FUNDS

Some of the commercial banks in the public sector have set up mutual funds and a few others are in the process of setting them up. On an examination of the operations of the mutual funds already functioning, it was considered necessary to issue guidelines on certain important aspects, as indicated below, with a view to their orderly functioning and in the interest of ensuring investor confidence.
3.4.1 CONSTITUTION AND MANAGEMENT

i) Every "mutual fund" shall be constituted as a Trust under the Indian Trust Act and the sponsoring bank should appoint a Board of Trustees to manage it. The Board of Trustees should have at least two outside trustees, i.e. those who are not connected with the sponsoring bank and who are persons of ability and integrity and have the proven capacity in dealing with problems relating to investment and investor protection. The overall superintendence, direction, control and management of the affairs and business, of the funds should vest in the Board of Trustees.

ii) The day-to-day management of the schemes under the fund, as may be delegated by the Board of Trustees, should be looked after by a full-time Executive Trustee who should not be concurrently discharging any other responsibility in the concerned bank. If the management of the mutual fund has been assigned to the bank's subsidiary, the full-time executive trustee should not be holding any other position.

iii) An "arms length" relationship should be maintained between the sponsor bank and the Board of Trustees who manage the mutual fund and care should be taken that in putting through the transactions, there is no clash of interest between the sponsor bank and the beneficiaries under the schemes of its mutual fund. In case the management of mutual fund has been entrusted to a subsidiary of the bank, similar care should be exercised by the latter to avoid any clash of interest between itself and the beneficiaries under the scheme of the mutual fund.
iv) (a) The sponsor bank's contribution to the corpus of the fund should be a minimum of Rs. 25 lakhs or such higher amount as may be specified by the Reserve Bank. The corpus may be converted at a later date into subscription to any of the schemes of the fund with the approval of the Board of Trustees of the fund. No additional contribution should be made by the sponsor bank to the corpus without the prior approval of the Reserve Bank.

(b) In addition to the contribution to the corpus, the sponsor bank should contribute and maintain in each of the fund's schemes by way of its stake an amount equivalent to 1 percent of the total amount outstanding. This stipulation will not, however, apply to special schemes where in the sponsor bank cannot participate.

v) Banks should obtain the Reserve Bank's prior approval before announcing any scheme of mutual fund, irrespective of whether it is identical or not to any of the earlier schemes approved by the Reserve Bank.

3.4.2 INVESTMENT OBJECTIVES AND POLICIES

vi) The investment objectives and policies of the mutual fund should be launched by the fund must be in accordance with such broad objectives and policies and the rules and regulations framed in connection therewith.
vii) While inviting subscription from the public, the mutual fund should make a clear statement of the investment objectives of the fund and its investment policies, besides the terms and conditions of the scheme.

viii) The subscription amounts collected by mutual funds are primarily intended to be channelised into the capital market instruments like government and other trustee securities, share/debentures of public limited companies, bonds of public sector undertakings, etc. and except for the extent indicated below, the mutual funds should not undertake direct or indirect lending, portfolio/funds managements, underwriting, bills discounting, money market operations, etc., which are essentially banking/merchant banking functions.

ix) There is however, no objection to the mutual funds investing the amounts initially collected for a scheme in the money market instruments, rediscounting of bills, or bank deposits for periods not exceeding six months. The mutual funds may also invest their temporary surplus fund in similar instruments up to not more than 25 percent of their total investible funds. Such short-term/temporary investments can, however, be made only if they are permissible under the Charter of the Fund.

x) The mutual funds should invariably take delivery of scrips purchased and, in the case of scrips sold, give delivery thereof to the purchaser. The scrips purchased should be transferred in the fund’s name.
xi) In no case should a mutual fund make short sale/purchase of securities or carry over the transactions from one settlement period to the next settlement period.

xii) The mutual funds should not make investments in any other mutual funds of similar collective investment schemes. The funds should not also invest in the shares, etc. of investment companies/corporations.

3.4.3 PRUDENTIAL EXPOSURE CEILING LIMITS

xiii) From the point of view of spreading the risk, it is necessary that the portfolio of a fund is diversified. A mutual fund should follow the following prudential guidelines in this regard:

(a) It should not hold, under any one scheme, more than 5 percent of issued share capital or debenture stock of any company. In case more than one scheme is operated by a fund, such holdings in respect of all its schemes put together should not exceed 15 percent of the paid-up capital or debenture stock of a company.

(b) The total amount invested by a fund from any of its schemes in the shares, debentures of any specific industry (such as cotton, textiles, tea, tyres, etc.) should not exceed 15 percent of a scheme's fund. This provision will not, however, apply to a scheme which has been floated for investments in one or more specified industries, and a declaration has been made to that effect.
3.4.4 PRICING POLICY
xiv) The maximum spread between the purchase and selling prices of unit/shares of any scheme should not be more than 5 per cent.

3.4.5 INCOME DISTRIBUTION
xv) The total cost of managing any scheme under a fund, including management fees and other administrative costs, should be kept within 5 percent of the total income of the scheme.

xvi) Income distribution by way of dividend or capitalization of gains should not be made on the basis of revaluation of the stock holdings or unrealised capital appreciation.

xvii) Depreciation on investments held and provision for bad or doubtful debts, if any, have to be provided for the satisfaction of auditors before declaring any dividend. Further, the fund should also create a dividend equalisation fund for each scheme by appropriating a part of its surplus income.

3.4.6 STATEMENT OF ACCOUNTS AND DISCLOSURE
xviii) A mutual fund should maintain separate accounts of each scheme launched by it, segregating the assets under each scheme. No switching of assets between the schemes should take place, except with the prior approval of the Board of Trustees and at the prevailing market rates.

xix) The Board of Trustees of mutual funds should prepare an annual statement of accounts in respect of each of the schemes which should contain inter alia, statement of assets and liabilities and income and expenditure accounts duly audited by qualified auditors.
Further an abridged version of the annual account together with the reports of auditors and the Board of Trustees, should be published for the information of subscribers to the concerned scheme.

xx) The Board of Trustees of mutual funds should disclose the net assets value of each of the schemes and the method of valuation for the benefit of the concerned subscribers.

xxi) Sponsor banks should furnish to the Reserve Bank in duplicate the following reports on a regular basis:

(a) A half yearly report indicating the performance of the mutual fund as a whole as well as each scheme.

(b) Audited annual statement of accounts, together with the reports of auditors and the report of the board of trustees.

(c) Scheme-wise details of investment portfolio of the funds, value of such investments, changes in the portfolio since the previous annual report and industry-wise exposure.

3.5 SALIENT FEATURES OF MONEY MARKET MUTUAL FUNDS (MMMFS)

The Task Force on Money Market Mutual Funds submitted its Report to the Reserve Bank. The recommendations of the Task Force were examined and a scheme for MMMFs is introduced. The salient features of the scheme are set out below:

ELIGIBILITY OF SET UP (MMMFS)

MMMFS are set up by scheduled commercial banks and public financial institutions as defined under section 4A of the Companies Act, 1956 or through their existing Mutual Funds/ Subsidiaries engaged in Funds Management.
STRUCTURE OF MMMFs

MMMFs are set up either as Money Market Deposit Accounts (MMDAs) or Money Market Mutual Funds (MMMFs).

SIZE OF FUNDS

The limit for raising resources under the MMMF scheme should not exceed 2 percent of the sponsoring bank's fortnightly average aggregate deposits during 1991-92. In the case of banks whose limit is less than Rs.50 crore, it is necessary for them to pool their limit with other banks and jointly set up a MMMF. In the case of public financial institutions, the limit should not exceed 2 percent of the long term domestic borrowing as indicated in the latest available audited balance sheets.

WHO CAN SUBSCRIBE

As Money Market Mutual Funds are primarily intended to be a vehicle for individual investors to participate in the money markets, the units/shares of MMMFs are issued only to individuals. Individual Non-Resident Indians (NRIs) may also subscribe to share /units of MMMFs on a non-repatriable basis.

MINIMUM SIZE OF INVESTMENT

MMMFs are free to determine the minimum size of investment by a single investor. The investors are not guaranteed a minimum rate of return.
MINIMUM LOCK-IN PERIOD

The minimum lock-in period for investment is 46 days.

RESERVE REQUIREMENTS,

In the case of MMMFs set up by banks, the resources mobilised by them are not considered as part of their net demand and time liabilities for purpose of reserve requirements and as such these resources are free from any reserve requirements.

STAMP DUTY

The share/units issued by MMMFs are exempt from stamp duty.

REGULATORY AUTHORITY

The setting up of MMMFs requires the prior authorization of the Reserve Bank of India. Furthermore, MMMFs to be set up by banks, their subsidiaries and public financial institutions are required to comply with the guidelines and directions issued by the Reserve Bank of India from time to time.

3.6 SEBI GUIDELINES FOR MUTUAL FUNDS:

The SEBI (Mutual Fund) Regulations, 1993, designed to govern the creation and operation of mutual fund companies, have also come up with several novel instrumentalities which are likely to be useful even in other sectors of the money management business.

To begin with, the regulations offer a clear-cut definition of the industry. They also spell out the responsibilities and privileges of specific market participants in the mutual fund business. The tone of the regulations is one of concern for the interests of the investor.
The three-part framework comprising of 'trust', 'assets management company' and 'custodian' which has been prescribed has been defined in detail, with provisions for the protection of the lay investors. However, the regulations appear to be so excessively oriented towards protection of investors that at times, this concern appears to be restructuring the flexibility of market intermediaries unjustifiably.

Another major contribution of the regulations is the prescription of specific responsibilities of the trustees. The system of over-seeing trusteeship has been a legal requirement in India in the case of public issues of debt. The common perception, however, is one of total passivity on the part of trustees in safeguarding the interests of the holders of the debt instruments.

A standard structure of trusteeship, vesting trustees with specific superintendence rights and obligations, as prescribed in the SEBI regulations, is worth emulating in other sectors of the financial markets. This will go a long way in imparting liquidity to the market for debt instruments, including securitised debts.

The mutual fund business is a matter of trust. Hence the integrity of the market intermediaries becomes an obsolete condition for the health of this industry. In this context, properly designed entry barriers have the potential of serving two different purposes:

* Signaling the level of integrity expected of the market intermediaries; and
* establishing objective yardsticks thereof.
The regulations also prescribe in detail the information to be made available to the investors. Periodic disclosures by the AMC to the trustee, and by both of them to the Securities and Exchange Board of India, coupled with the right of inspection of the books of the mutual fund by SEBI should add to the authenticity of the information to be disseminated.

Standardisation of the contents of the investment management agreement, trust deed, periodic financial reports and the prescription of an advertisement code and restrictions on investments up-front are measures to impart transparency to the functioning of mutual funds.

All the provisions of the regulations are specified in detail, thereby minimising the prospect of ambiguity in their interpretations. The basic structure of the regulations appear to be oriented towards protection of investors' interests using a three-dimensional strategy:

* allowing entry to strong and honest market intermediaries;
* an elaborate system of periodic information dissemination and
* adequate systematic checks and balances internally within the mutual fund market intermediaries, subject to SEBI's supervision, if required.

The regulations rightly do not seek to vest the regulator with the role of developing the mutual fund industries. They have the correct philosophy at the broad level.
However, nuances of some of the provisions lack the softness required to nurture the industry. One needs to keep in mind that the Indian mutual fund industry is no longer at the nascent stage.

Also, the most effective regulatory role can and ought to be performed by a competitive market place. Investors need to be made aware of the right facts and material possibilities. The 'theme of investors' protection should end with that.

The new regulatory structure should be created with a firm faith in the ability of the market mechanism to discipline the market intermediaries themselves. A competitive market place should be able to weed out the weaker or dishonest elements.

If it is felt that the current conditions do not warrant sufficient trust in the efficacy of the market mechanism, then it may be too early to create a mutual industry at all in India. However, acceptance of the latter possibility would belie all that has been happening in the Indian Financial markets for some time.

Some of the provisions in the regulations appear to have the effect of vesting SEBI with indirect management of the mutual funds. SEBI has the powers to nullify the appointment of any trustee without assigning any specific reason (vide clause 15(2)). At the same time, clause 16(2) prohibits indemnification of the trustees against loss or damage caused by their acts of negligence or acts of commissions and omissions. This provision is likely to have an unintended effect of otherwise eligible persons viewing the position of a trustee as one fraught with undue risk.
The trustees ought to be liable only to the extent of not observing due diligence in the discharge of their responsibilities.

The regulations provide for approval of the memorandum and articles of association of the AMC by SEBI. However, Annexure II, rather than the main body of regulations, requires submission of the draft articles and memorandum of association without at all mentioning what SEBI would be doing with these. Annexure-II also lists the coverage of the trust deed, and schedule III specifies the contents of the trust deed. However, it is nowhere mentioned in the regulations whether and how SEBI would try to scrutinise the trust deed.

It is not at all clear how a sponsor can design the trust deed and memorandum and articles of association of the trust company without first, getting the memorandum and articles of the AMC vetted by SEBI. Yet, SEBI appears to be enjoying arbitrary discretion in regard to the timing of the submission of the documents relating to the trust company. While the existing structure may provide some convenience to SEBI in its regulatory role, it is likely to be harsh on the market intermediaries.

The process of grant of approval under SEBI regulations appears to provide wide amplitude and flexibility to the regulator. Thus clause (2) allows the board to take into account, while granting approval, all matters which are relevant to efficient and orderly conduct of the affairs of the AMC. However, the span of the term "all matters" is huge and is unclear, and perhaps unintentionally so. The regulations which require mutual funds to
operate tightly even in the matter of change of management and investment policy, ought not allow the regulator excessive flexibility in the application of rules to individual applicants.

SEBI is allowed discretion for being discriminating in the enforcement of entry barriers to the mutual fund industry. However, even subsequently SEBI has its invisible presence in the management of the AMC, since no change in the management of the AMC can be made without prior SEBI approval. The term "management" has nowhere been defined in the regulations.

The net effect of these provisions is that SEBI will in effect administer the mutual fund participants at all the stages. Such a framework would have been more appropriate for a controlled mutual fund regime (prevalent up to 1988) under a free market setting, the scope for discretionary intervention available to the regulator should be minimal. Otherwise, the regulator will have the tendency to prescribe even the nitty-gritty of the business practices, as the current regulations seem to be doing vide clause 24(4).

In this clause, it is prescribed that the AMC shall be expected to meet all its expenses and make provision for:

* Office space, personnel including security analysts and portfolio managers;
* Regulatory compliance and reporting services;
* Preparation and distribution of the fund's prospectus, annual and periodic reports and other investor communications;
* Advertising, and other sales material;
accounting services and preparation of tax returns; and insurance coverage and other services.

Such a detailed prescription is hardly necessary in regulations seeking to define the board contours of the industry. Smaller details should be left to the market participants.

Clause 27(1) is a further and more telling example of excessive intervention. This clause prohibits announcement of any mutual fund scheme without the approval of the regulator. Clause 27 (3) empowers SEBI to force the AMC to carry out any modifications it deems fit in the proposed scheme. Furthermore, clause 28(1) provides that no letters of offer or brochure or any advertisement material can be issued without prior approval of the regulator.

The clause appears to violate the spirit of the very next clause, 28(1), which provides for the guiding principles for the marketing and publicity brochures for each scheme and is quite well constructed. The overriding power acquired through clause 28 (1) appears to be in a bureaucratic would rather than the business-like spirit of the regulations.

The transfer of regulatory powers from a governmental department to an independent regulatory body has two underlying philosophical bases:

* the highly specialised character of the financial intermediation process; and
* faith in the efficiency of the market system.

The regulatory structure is only a part of the financial infrastructure required to facilitate the process of financial
intermediation. The ultimate objective of the regulator has to be
only the facilitation of the process of financial intermediation.
Transgression by the regulator into the creative process of the
financial intermediaries has therefore two undesirable effects:

* It equates the financial infrastructure with the intermediation process and thereby violates the purpose of the financial infrastructure; and

* It injects ignorance and rigidity into the financial markets, arising due to lack of understanding likely in case of any agency over-reaching itself.

The restrictions on investments stipulated in schedule VI of the regulations are bound to have the effect of injecting rigidity in the mutual fund regulations, even if they may have been unintended. The prescribed investment norms are precise. They also reflect a feel of the underlying attributes and wider linkages of the financial instruments mentioned there. Yet, the net effect of these restrictions is likely to be floatation of essentially plain vanilla funds, with which the regulator is likely to be more comfortable due to its general comprehension of the mutual fund products.

Mutual funds are not allowed to invest more than five percent of their corpus in the shares of any company. Hence products of the type of Janus Twenty Fund, investing only in 20 securities according to pre-specified criteria, are straight-away ruled out for Indian investors.

Moreover, the regulations hardly leave scope for the creation of sectoral funds, especially in emerging industries.
Else, a sectoral fund would have to be compulsorily of a small size. Or, only a few funds can be floated in the case of emerging sectors, since a closed-end (open-end) fund is required to have a minimal size of Rs. 20 (50) crores vide clause 31(1).

Diversification of unsystematic risk is a major advantage of the mutual fund vehicle. However, this should not be forced as an objective upon a mutual fund. Existence of a few insufficiently diversified (i.e. focussed) mutual funds will allow individual investors and portfolio managers a much wider option in diversifying their own portfolio according to the specific needs of the individuals.

What is needed is that the investors be made aware of the undiversified character of the fund. Negation of the utility of such funds will in no way help the investors. Risk-pooling cannot be only a plain-vanilla business.

Moreover, the existing regulations entirely ignore the possibility that an investor may be able to hedge the riskiness of a personal asset portfolio using derivative products, as and when these become available in India. Any regulation ought to be accommodative - mere introduction of new instruments should not render it stale.

Mutual funds will be able to provide superior risk hedging service and products to their investors as and when 'options' become available in India. However, clause 42 of the regulations ban investment in options products altogether. Also, item 10 of schedule VI prohibits mutual funds from borrowing funds to finance
their investments. In the light of tight transparency norms prescribed under the regulations, both these provisions are likely to unnecessarily restrict the choices that could be available to the investors otherwise. Hence these two provisions should be dropped.

Item 7 of the schedule containing restrictions on investments requires that no mutual fund under all its schemes taken together should invest more than 15 percent of its fund in the shares and debentures of any one industry.

It is possible to define industry in a broad as well as a narrow sense. One may stretch the definition of the chemical industry from merely 'dyes' upto everything involving chemical processing, even dry-cleaning.

However, such vagueness in the definition of a term appears to be inconsistent with the underlying tone of the SEBI (mutual fund) Regulations 1993. For example, clause 20 of the regulations prescribes that SEBI may take into account all matters relevant to efficient and orderly conduct of the affairs of an AMC. Clause 8 of the regulations describes a few particulars of "all matters", namely;

* the sponsor has a sound track record and experience in the relevant field of financial services, for a minimum period of five years, professional competence, financial soundness and general reputation of fairness and integrity in all his business transactions (explanation: for the purposes of this
clause "sound track, record" shall mean net worth, dividend paying capacity and the profitability of the sponsor);

* an asset management company which holds an approval of the board, has been appointed to manage the affairs of the schemes of such funds;

* the sponsor contributes at least 40 percent to the net worth of the asset management company

* the sponsor, or any of its directors or the principal officer to be employed by the mutual fund having the management of the affairs of its business, is or has at any time been convicted for any offence involving moral turpitude or has been found guilty of any economic offence.

It would be better to specify at least the broad character of "all relevant matters" the same way. The sponsors should not be left in doubt about the basis of the eligibility criteria. Also, items (b) to (d) above prescribe the structure of the mutual fund to be established after the approval of the regulator. These conditions relate to the structure of the mutual fund and hence should not have been part of the eligibility criteria.

A statement of assumptions and the likely scenarios is an integral and efficient aspect of information dissemination in case of risky investments. Some of the information dissemination-related provisions of the regulations may be excessively restrictive.

Item 6 of the advertisement code states that the advertisement shall not contain information the accuracy of which
to any extent is dependent on assumptions. The entire business of financial instruments is that of marketing risk-return trade-off packages. How can any risky instrument be advertised without informing the investors about the various assumptions from which risk originates?

At the same time, item 10 of the advertisement code requires that all advertisements shall also make a clear statement to the effect that all mutual funds and securities investments are subject to market risks, and there can be no assurance that the objectives of the fund will be achieved.

Some of the clauses appear to be incomplete. Clause 31(1) stipulates minimum amounts to be raised in case of both close-ended and open-ended funds. The same clause also states that there shall be no maximum limit on the amount which the mutual fund may collect under an open-ended scheme. One is left wondering why the same is not mentioned regarding the close-ended scheme. Reference to stipulation regarding the maximum limit is unnecessary.

Similar loose ends are also visible in several other clauses. Clause 60(2) (c) empowers the regulator to review the role of the mutual fund, trustees or asset management company in the case of takeovers. Clause 52(2) requires every mutual fund to create in respect of every open-ended scheme, a dividend equalisation reserve by suitable appropriation from the income of the scheme. Clause 51 requires every mutual fund to distribute, by way of dividend, an amount not less than 90 percent of the profits earned during the year.
All these provisions have been created without stating the underlying rationale. These unnecessarily infringe upon the initiative and operational freedom of the fund managers.

In the current era of active share holders, clause 60(2) (c) is anachronistic and will strangulate the market for corporate control in India. Clause 52(2) appears to be duplicating the corresponding provision in case of debenture redemption reserve from the Companies Act. However, this fails to recognise the basic difference in the end use of funds in the case of a company and a financial intermediary, resulting in very different types of risk. Clause 51 is likely to be unfriendly to the existence of hybrid mutual fund products like balanced funds.

A new set of regulations unencumbered by the past legacy of discretionary controls by the government will provide SEBI —unrestricted opportunities to create a set of guidelines which are development-oriented.

The mutual fund industry has the potential of being the magic wand of the financial markets, since mutual fund mechanism can liquefy assets otherwise very difficult to liquefy. Development of the mutual fund industry ought to be visualised as necessary and helpful in the growth of other sectors of the financial markets.

The current regulations need to fully take into account the potential of the financial sector as a whole and the very important role that the mutual fund industry can play. They have thus to be less prescriptive in structure and should be designed for market-
friendliness in addition to servicing the prime objective, the interests of the investors.

3.7 REFERENCES

1. UTI Manual for market operations.

2. Govt. of India Letter F.No. 19(27)SE/90 dt. 14.02.92.


4. RBI Credit Policy dt. 21.04.92 for MMMF.
