

Chapter 2
**Background of the Mutual Fund Industry – Theoretical
Framework**

2.1 Introduction

This chapter is organized into two sections namely Part I and Part II. The Part I, discusses for India : Progression of mutual fund industry, trends in mutual fund asset holding pattern, scheme-wise AUM, mutual funds as an asset class in India and world, distribution channels and pattern, AMC Rankings and Mutual Funds road ahead. In Part II the researcher undertakes comparative study of Financial Advisor Regulations in India with select world economies and key learning's for India.

Part I

2.2 The Indian Mutual Fund Industry

The origin of the Indian mutual fund (MF) industry can be traced to the establishment of UTI as a state monopoly in 1964. Over the years, the industry has evolved in to a high growth and competitive market due to the reforms impetus, economic conditions and favorable demographics. As per AMFI reports for March 2013, there are 44 Asset Management Companies (AMCs) managing a total AUM of INR 8.16 Trillion with a growth of 18% over the previous year. This industry has grown during 2009-2013 at an annual compounded growth rate (CAGR) of 18 % (AMFI, 2013). The growth in Asset under management (AUM) in 2013 was driven by growth in AUMs in Debt Schemes (36%) and Exchange traded Funds. This phenomenal growth in AUM has been under the vigilance of SEBI which introduced regulations in 1993, revised them in 1996 followed by amendments from time to time.

2.2.1 Progression of the Mutual Fund Industry in India

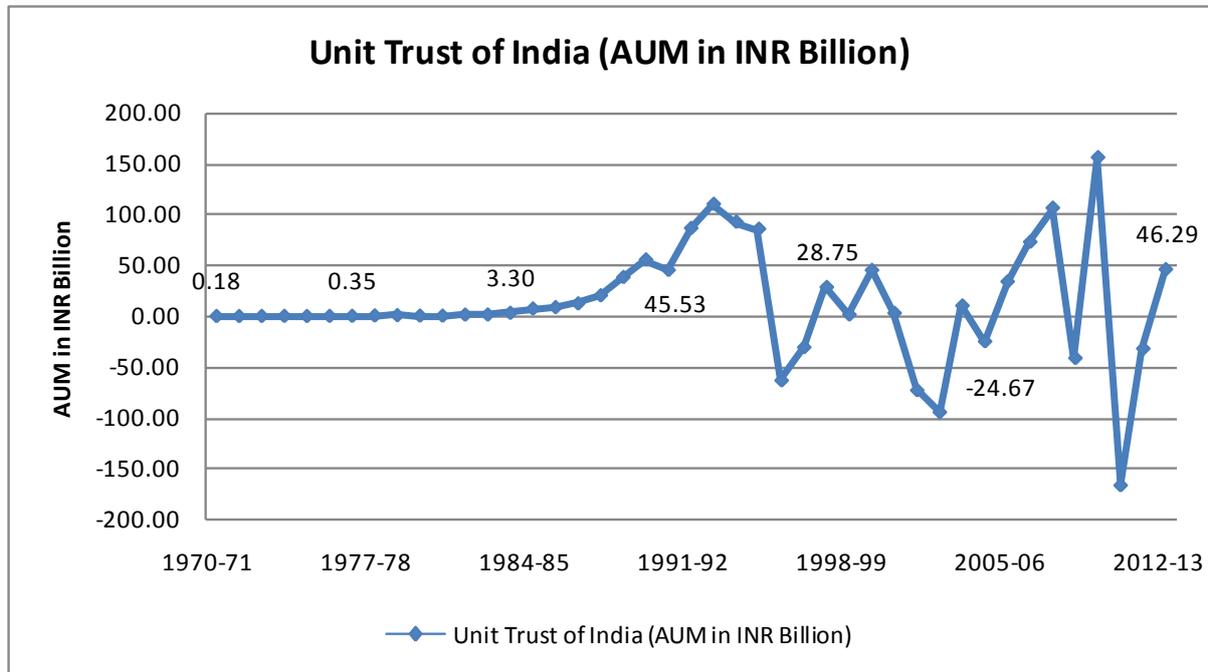
The mutual fund industry in India began in 1963 with the formation of Unit Trust of India (UTI), at the initiative of the Government of India and Reserve Bank of India. The history of mutual funds in India can be broadly divided into four distinct phases (AMFI, 2013; Bang, 2012) which is covered in brief hereunder.

Phase I - 1964-1987 (Establishment and growth of UTI)

Unit Trust of India (UTI) was established in 1963 by an Act of Parliament. It was set up by the Reserve Bank of India and functioned under the Regulatory and administrative control of the Reserve Bank of India. In 1978 UTI was de-linked from the RBI and the Industrial Development Bank of India (IDBI) took over the regulatory and administrative control in place

of RBI. The first scheme launched by UTI was Unit Scheme 1964. At the end of 1988 UTI had amassed Rs. 38.55 Billion in Assets under management.

Figure 1 : Unit Trust of India - Growth in AUM in INR (Inception to 1988)



Source :UTI(2013)

Phase II - 1987-1993 (Entry of Public Sector Funds)

The year 1987 marked the entry of non-UTI, namely public sector mutual funds set up by public sector banks and Life Insurance Corporation of India (LIC) and General Insurance Corporation of India (GIC). SBI Mutual Fund was the first non-UTI Mutual Fund established in June 1987. This was followed by Can Bank Mutual Fund (Dec' 87), Punjab National Bank Mutual Fund (Aug' 89), Indian Bank Mutual Fund (Nov'89), Bank of India (Jun '90), Bank of Baroda Mutual Fund (Oct' 92).

LIC established its mutual fund in June 1989 while GIC had set up its mutual fund in December 1990.

At the end of 1993 as per AMFI the mutual fund industry had assets under management of Rs. 47,004 crores.

Phase III - 1993-2003 (Entry of Private Sector Funds)

Post liberalization, the private sector funds were allowed entry in India 1993, and a new era started in the Indian mutual fund industry, giving the Indian investors a wider choice of fund families. Also, 1993 was the year in which the first Mutual Fund Regulations came into being, under which all mutual funds, except UTI were to be registered and governed. The erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private sector mutual fund registered in July 1993.

The 1993 SEBI (Mutual Fund) Regulations were substituted by a more comprehensive and revised Mutual Fund Regulations in 1996. The industry continues to function under the SEBI (Mutual Fund) Regulations 1996.

The number of mutual fund houses went on increasing, with many foreign mutual funds setting up funds in India and also the industry has witnessed several mergers and acquisitions. As at the end of January 2003, there were 33 mutual funds with total assets of Rs. 1, 21,805 crores. The Unit Trust of India with Rs. 44,541 crores of assets under management was way ahead of other mutual funds.

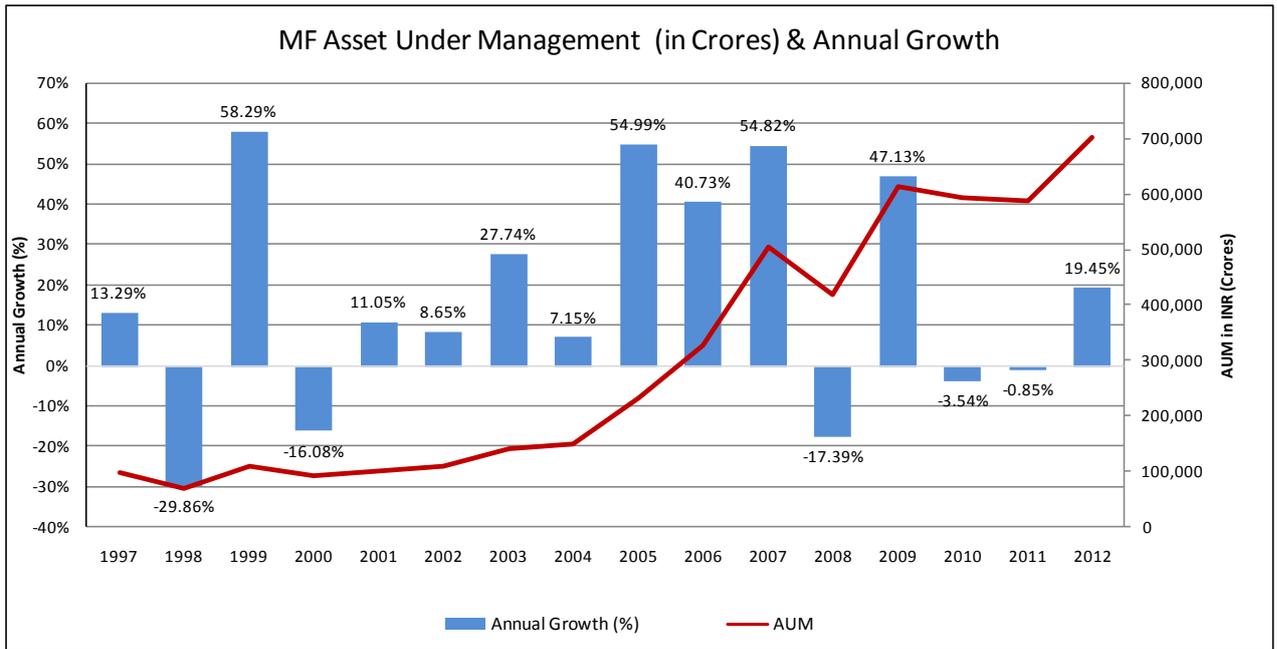
Phase IV - February 2003 onwards

In February 2003, following the repeal of the Unit Trust of India Act 1963, UTI was bifurcated into two separate entities. One is the Specified Undertaking of the Unit Trust of India with assets under management of Rs. 29,835 crores as at the end of January 2003, representing broadly, the assets of US 64 scheme, assured return and certain other schemes. The Specified Undertaking of Unit Trust of India, functioning under an administrator and under the rules framed by Government of India and does not come under the purview of the Mutual Fund Regulations.

The second is the UTI Mutual Fund, sponsored by SBI, PNB, BOB and LIC. It is registered with SEBI and functions under the Mutual Fund Regulations. With the bifurcation of the erstwhile UTI which had in March 2000 more than Rs. 76,000 crores of assets under management and with the setting up of a UTI Mutual Fund, conforming to the SEBI Mutual Fund Regulations, and with recent mergers taking place among different private sector funds, the mutual fund industry has entered its current phase of consolidation and growth. As seen

from Figure 2 below, prior to 2008 there was a robust growth in AUM. Average growth from 1997 was 18%. However, post the financial crisis, AUM's have seen immense volatility. As things stabilized in financial markets globally, in 2013, Indian mutual fund market saw an annual growth in AUM by 19%.

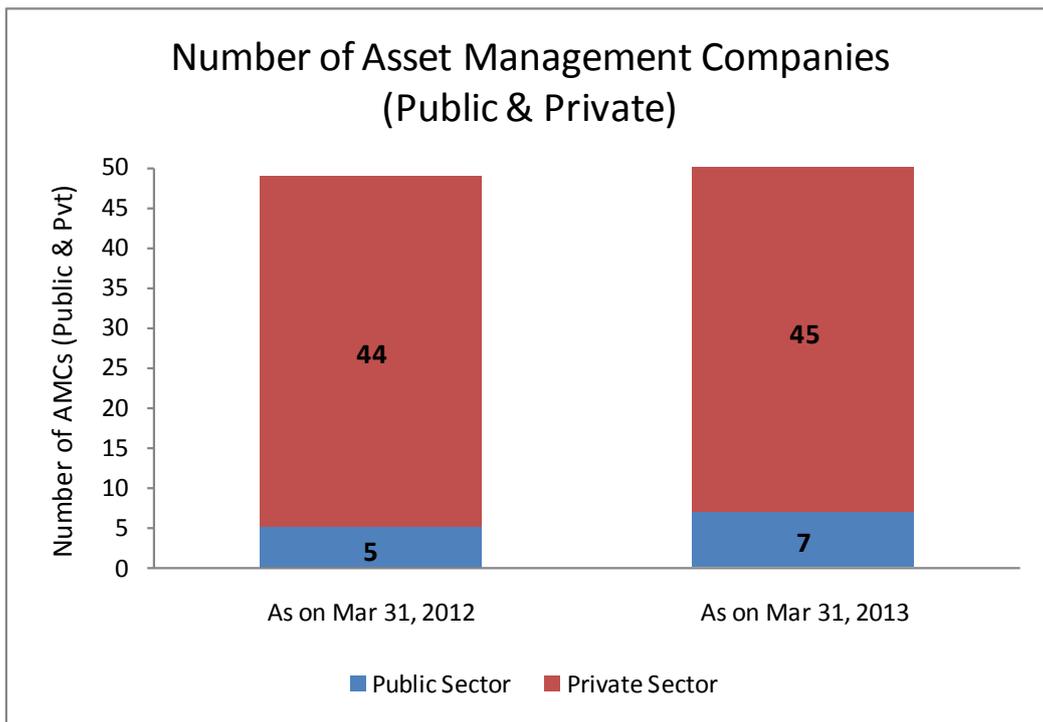
Figure 2 : MF Assets under Management & Annual growth. (In INR.)



Source: Sebi (2013)

The current number of Asset Management Companies in India is given in the figure 3 below.

Figure 3: Number Asset Management Companies (Private and Public)

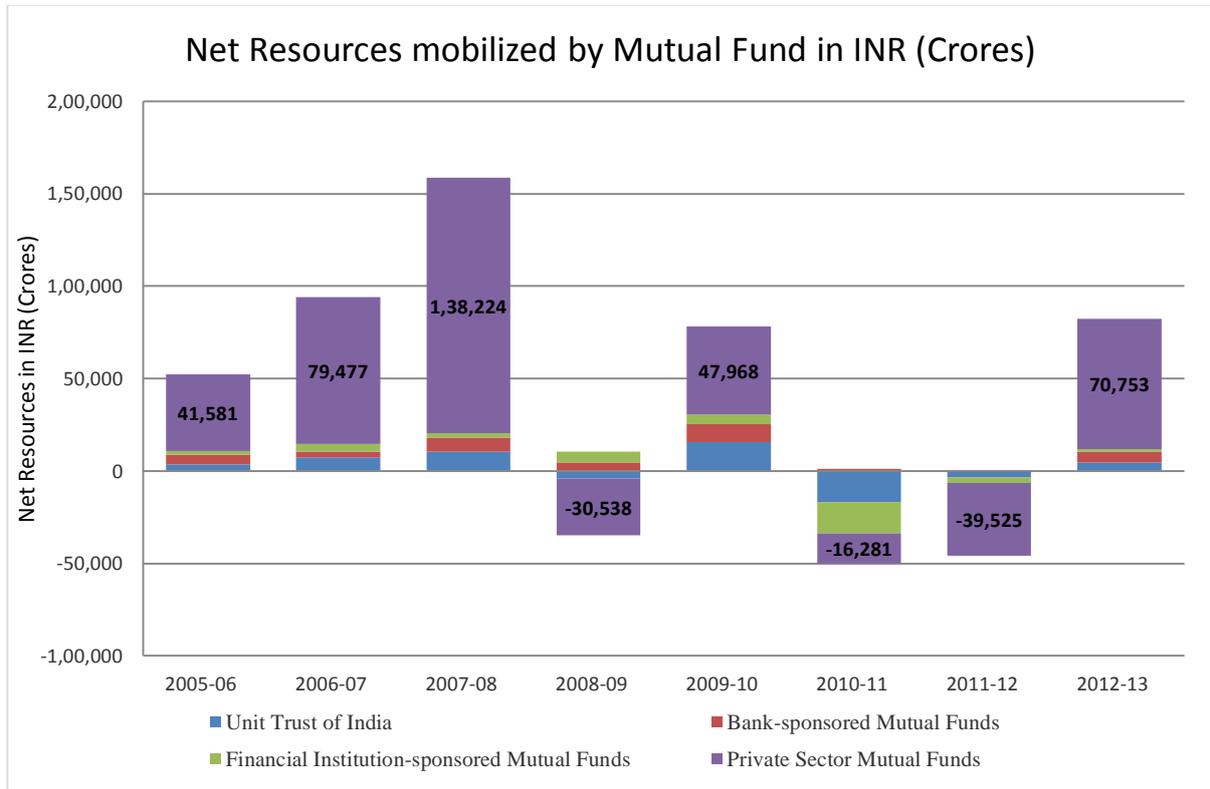


Source: Sebi (2013)

As seen from the figure above, the asset management business is largely dominated by Private sector mutual fund players. In the number of AMCs in Public Sector UTI is included.

Figure 4 below reflects the net asset mobilization trend. Private sector mutual funds have the largest AUM net holding. Post 2008, as seen from the figure, AUMs have witnessed huge volatility.

Figure 4 : Net Resources mobilized by Mutual Funds (In INR.Crores)



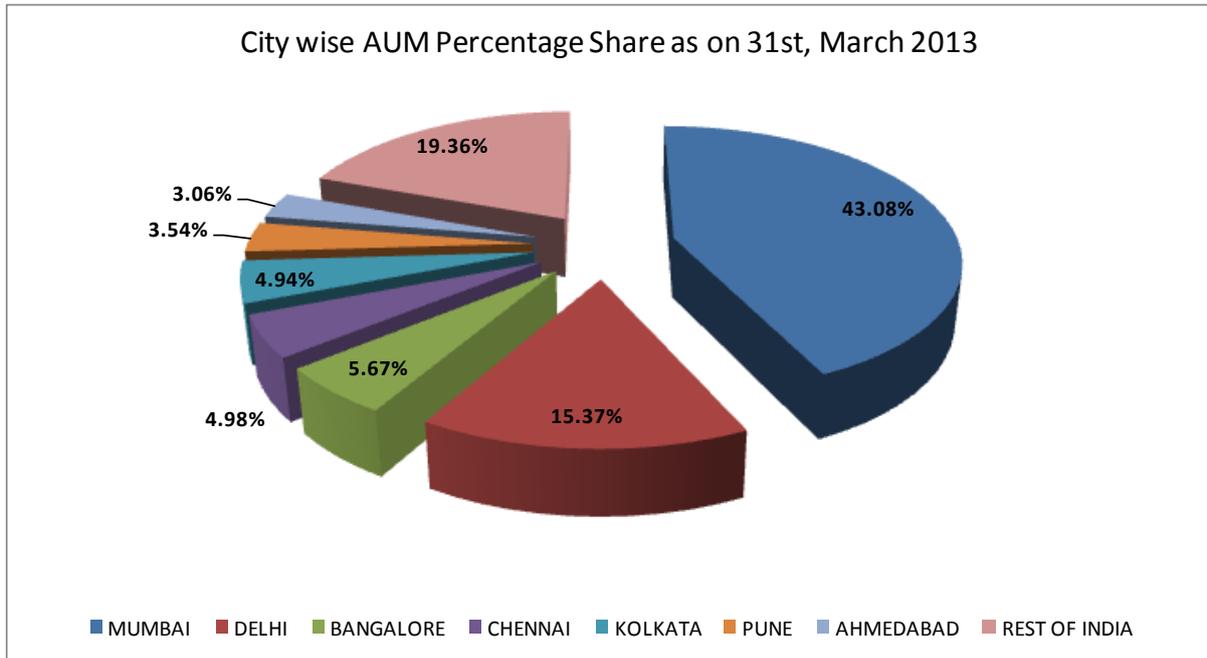
Source : UTI and Respective Mutual Funds

2.2.2 Trends in Asset Holding pattern

2.2.2.1 City wise distribution of Assets under Management

The mutual fund industry's AUM is concentrated in the Top 5 cities, and these 5 hold 74% of the industry AUM. These 5 include Mumbai, Delhi, Bangalore, Chennai and Kolkata. Mumbai solely holds 43.08% of the country's AUM. This data clearly reflects the low geographic penetration of this asset class in India. Refer Figure 5 below.

Figure 5 : City-wise AUM share on 31st March 2013



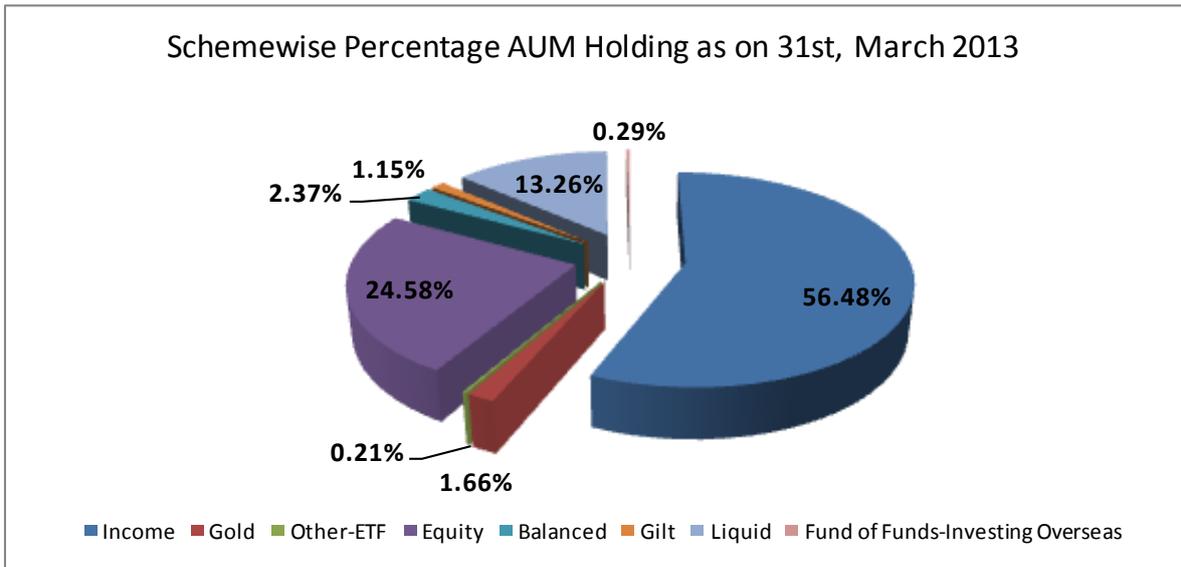
Source : AMFI (2013)

2.2.2.2 Scheme-wise AUM Distribution pattern

The country witnessed a fall in interest rates in 2012-13, which in turn impacts in higher returns for Income and gilt funds as interest rates and price / returns are inversely proportional. 72% of the industry AUM is concentrated in Debt schemes namely Liquid and Income Funds as on March 2013 as per AMFI .

Income funds constitute the highest holding of 57% followed by Equity at 22% and Liquid 13%. ELSS (Tax saving scheme) constitutes 3%, followed by Gold at 2% and Gilt Funds at 1% in the overall pie. Refer Figure 6 below.

Figure 6 : Scheme wise % holding as on 31st March 2013



Source : AMFI (2013)

2.2.3 Mutual Funds as an Asset Class

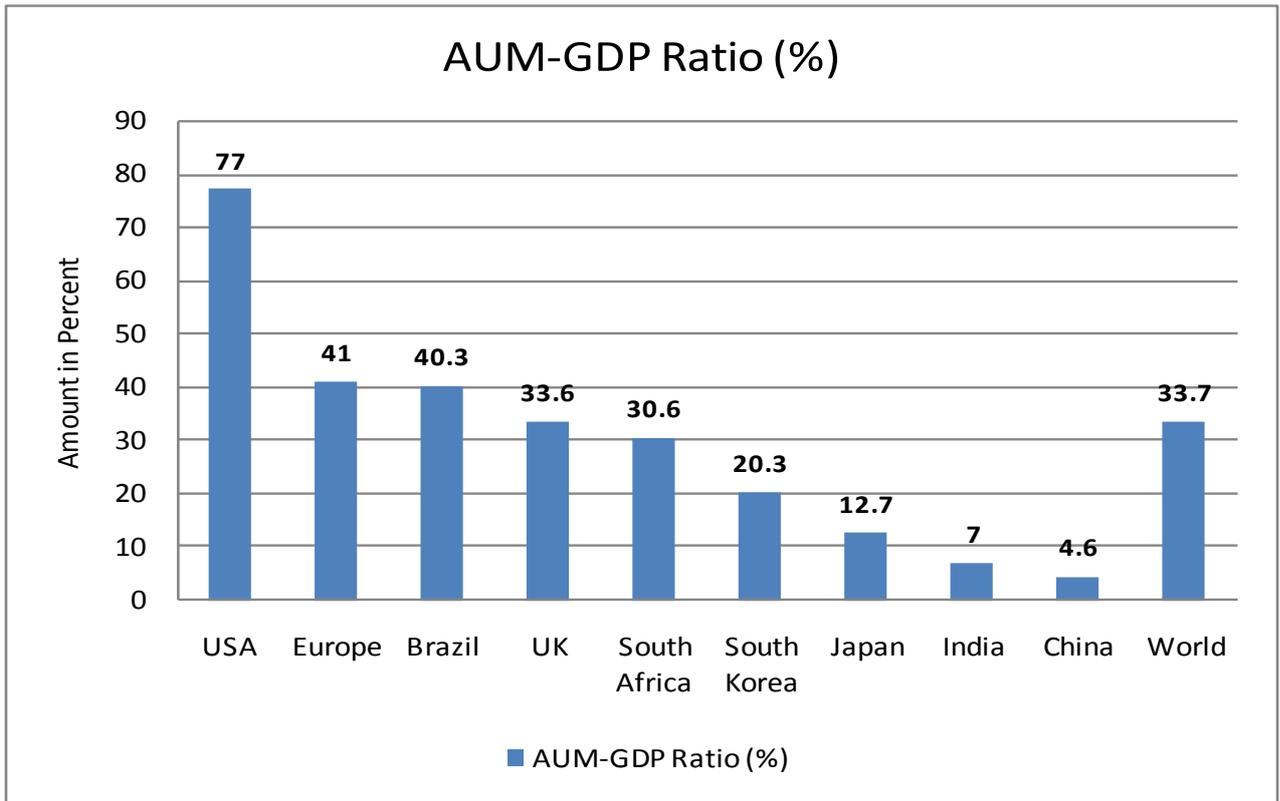
India's attractiveness as an under penetrated market for financial inclusion stems from it being at a dismal low of 10.9 Bank branches per 0.1 million compared to 25.5 (UK), 35.7 (US) with even Brazil having 13.8 branches (PWC, 2013). This has been a matter of contention and the flow to Real Assets namely Real Estate and Gold reflects that. Keeping this data on inclusion as a backdrop, **Table 1** below captures the percent of households that have invested in various instruments. Since households invest in more than one saving instrument the sum will not be 100%. This table is from the Centre of Monitoring Indian Economies (CMIE) quarterly survey of 140000 households referred as Consumer Pyramid. Real Estate (75.54%) followed by Gold (66.54%), Life Insurance (26.34%) and Fixed Deposits (25.32%) are the saving instruments in descending order. Only 1 percent of households hold investment in Mutual Funds, thus showing the low investments in this asset class (Sahoo & Sane, 2011).

Table 1 : Pattern of Investments by Indian Households

Saving Instrument	Percent of Households that have invested in the instrument.
Fixed Deposits	25.32
Bonds	0.48
Post Office Savings	8.86
National Savings Certificate	0.79
Kisan Vikas Patra	1.62
Provident Fund	11.34
Life Insurance	26.34
Mutual Funds	1.00
Listed Shares	0.72
Business	4.65
Gold	66.54
Real Estate / Housing	75.54
Other Financial Instruments	6.66

Source : CMIE - Consumer Pyramids(July 2011)

Figure 7 : AUM-GDP % Ratio



Source : ICI, USA (2012)

Figure 7 above shows a comparison across some nations of the penetration of mutual funds (as measured by AUM-GDP% ratio). India is at a mere 7% and much below the world average AUM-GDP % Ratio of 33%. The highest is the US where MF holding is 77% of the GDP followed by Europe at 41% and Brazil at 33.6%. There is immense potential for mutual fund market penetration as depicted. As per RBI data compiled up to financial year 2012, Mutual Funds constituted only 3.3% of households' financial savings in FY 10, contracted to -1.2% in FY 11 and -1.1% in FY12.

Along with the GDP slowdown, the last couple of years has also seen a drop in savings rate from 34% (2010-11) to 30.8% (2011-12) as per RBI(2013). For these savings to be further streamlined into capital markets, investors first and foremost need to be aware of avenues and opportunities (PWC, 2013).

2.2.4 Distribution Channels of Mutual Funds:

In India, mutual funds are distributed through four main channels:

1. Banks-which includes Indian private banks, public sector (PSU) banks and foreign banks
2. National distributors
3. Independent Financial Advisors (IFA)
4. An emerging Direct Channel

A detailed analysis (Shah, Garg, Radhakrishna, & Prasad, 2010) tabled using data from CAMS - a leading registrar who handles over 57% of the industry's Assets under Management (AUM) had revealed the average distributor wise break-up in mutual fund as Banks (29%), National Distributor (29%), IFA (36%) and Direct Channel (6%). Refer Table 2 below.

Table 2 : Distribution Channel

Distributor Type	Percentage
Banks	29%
Large Distributors (National & Regional)	36%
Independent Financial Advisor	29%
Direct	6%

Source : Adapted from *Shah et al.* 2010

2.2.4.1 : Banks : They are one of the main distribution channels for mutual funds, with their access to a nationwide network of branches. This channel comprises of two main categories of banks. Each category has a small but not exhaustive listing. Bank data as per Ministry of Finance (GoI, 2013).

- Public Sector Banks (total no's : 21) namely Indian Banks with Government stake like State Bank of India, IDBI, Bank of Baroda, Canara Bank etc.
- Private Sector Banks comprising of Indian Private Banks (old and new) and Foreign Banks.

- Indian Private Banks (total no's : 20) are led by HDFC Bank, ICICI Bank, Kotak Bank, Ing Vyasa etc.
- Foreign Banks (total no's: 43) like Standard Chartered, HSBC and Citi Bank.

2.2.4.2 : Large Distributor : This category includes National and Regional Distributors. These distributors specializing in the sale of financial products (particularly for mutual funds) have a substantial share of the marketplace and are a unique feature of India's mutual fund industry. They are considered Non-Banking financial companies (NBFC) under the 1956 Companies Act, and hence are in principle unable to take deposits or make loans. These distributors have various origins. Some, used to be securities firms or banks and then began specializing in the sale of financial products, while others started out as a division within a leading financial institution (Subrahmanyam, 2009). The difference between national distributor and a regional distributor is that, as the name implies, the former operates on a nationwide basis, while the latter targets only a specific region.

Some of the leading national distributors, are NJ, Anand Rathi, India Infoline, Karvy and their name recognition is equal to that of India's leading domestic banks. Some of the leading regional distributors in Pune are Wealth Managers Pvt. Ltd. and the erstwhile Finest.

High Net worth clients and institutions targeted generally by Banks, National and regional distributors.

2.2.4.3: Independent Financial Advisors (IFA): IFAs do not belong to any specific financial institution. A large number of IFAs work out of their home or private offices and they serve a local and familiar clientele. Many IFAs in India began their career either as sales agent for Life Insurance Corporation (LIC) or were employed with a securities firm or a Bank (Subrahmanyam, 2009). IFAs generally target local clientele.

Shahetal., (2010) has classified this channel, further based on the Assets Under Management (AUM) as hereunder:

- Large IFA -AUM >INR 100 Lacs (INR 1 Cr)
- Medium IFA- AUM >INR 10Lac <INR 100Lac
- Small IFA -AUM <INR 10 Lacs

Online Option : A select number of these Banks, National Distributors and Regional Distributors and IFAs also provide the online investment option to their clients through their website login access.

2.2.4.4 : Direct Channel : An important emerging channel is the direct channel including both offline and online mode of investment. The direct channel comprises of investing into the mutual fund without any of the intermediaries mentioned above. This can be done in either of the following way :

- Handing over the physical form by the customer directly to the AMC.
- Using the AMC / Amfi or other website to invest online into the fund, by selecting the mutual fund scheme and putting DIRECT in the Broker code section.

Crisil Research (2013) revealed that direct plans, launched since January 1, 2013, had attracted large investors. Average assets under management (AUM) of direct plans offered by mutual funds rose by almost 70% to Rs 2.14 trillion during the June (2013) quarter from Rs 1.27 trillion in the March quarter. **Direct plans now constitute 25% of the total industry AUM against 15% in the previous quarter**(Capital First, 2014).

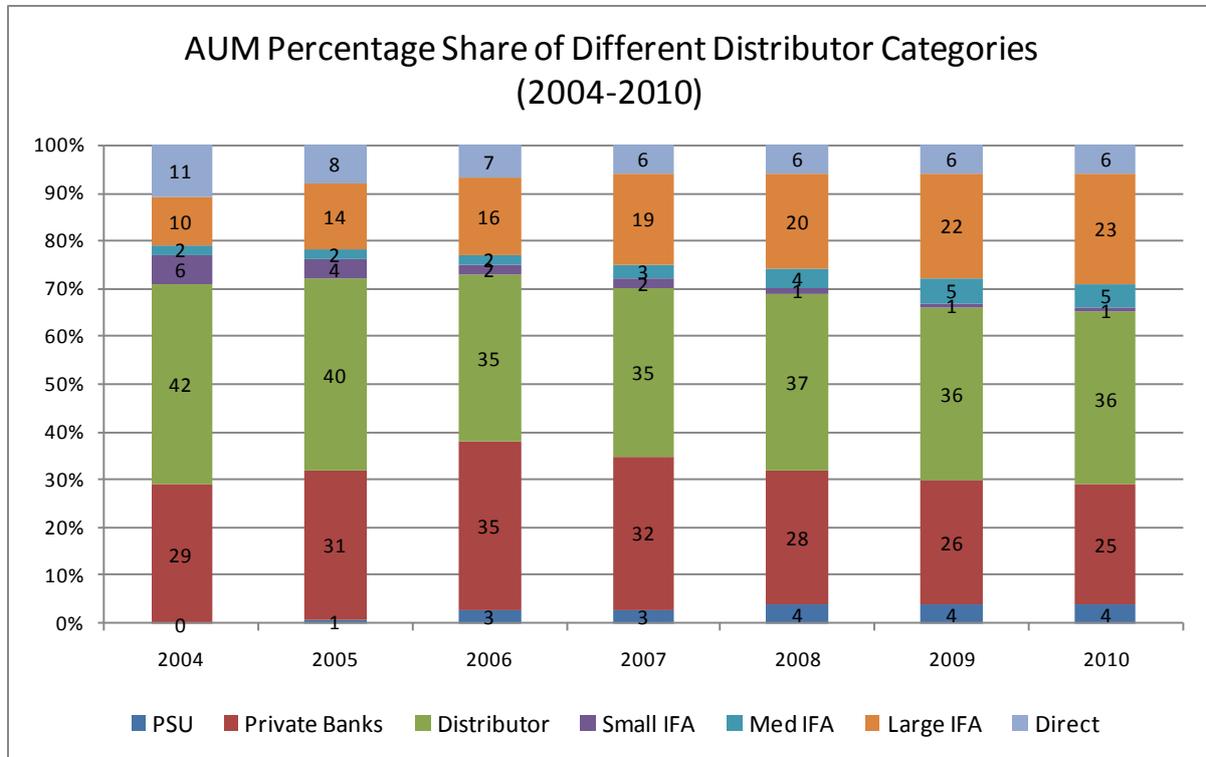
2.2.4.5: Other channels : In addition, India's post offices have also recently begun selling mutual funds. India Post, which runs India's largest domestic bank, the Post Office Savings Bank, began selling mutual funds in January 2001. They currently distribute mutual funds for UTI, ICICI Prudential, and SBI. No official data exists, on mutual fund sales by the post office, these are said to be on a very small scale. Some view the post office's nationwide network as having substantial sales potential, and this makes it a sales channel to watch out in the future. Indian Post primarily targets regular retail investors.

In the later section of this research is a detailed discussion on the holding and changing pattern across the main distribution channels.

2.2.5 : Prerequisite for Mutual Fund Sales : Guidance from the SEBI in 2003 requires that personnel who sell mutual funds in India pass the AMFI Mutual Fund Advisors Module and receive a registration number from the AMFI called as Amfi Registration Number (ARN). This requirement has been helpful in improving the knowledge and skills of personnel working in all of the above sales channels, and of IFAs, in particular. As per AMFI data as on 31st

Dec'2012 there were 50,949 entities of which 47100 were individuals and remaining 3849 were corporate. There were also 29,505 Corporate Employee ARN Holders.

Figure 8 : AUM % share of different distributor categories (2004-2010)



Source: Adapted from Shah *et al.* 2010

2.2.5: Asset holding patter across various Distribution channels.

The figure 8 above shows the recent trend in changing % holding of different distribution categories.

In the banking space PSU's have slowly started gaining a share, after starting off with a mere 1% in 2005 to a 4% in 2010. This is majorly dominated by SBI. Private Banks in turn have seen volatile AUMs, but they continue holding a strong penetration in this segment, an average of 29 % over 7 years.

The Large distributor segment, the most dominant of the distribution channels has also seen volatile AUM's, but an average of 37% share in the total AUM.

The share of large IFA has seen a steady increase from a mere 10% in 2004 to 23% in 2010. The share of the small IFA (AUM < 10 Lacs) has been falling and as per Shah *et al.* (2010) this has either moved to the Larger IFA or they have grown bigger and become medium IFAs (AUM 10 Lacs-<1 Crore).

The Direct channel has seen a steady dip from 11% in 2004 to 6% from 2007, however with increased awareness and regulator focus, this channel share is expected to increase.

In the Figure below the investor category wise holding is depicted. The categories are namely:

- Institutional Investor (Non Individual)
- HNI (>INR 100 Lacs, < INR 100 Lacs, < INR 25 Lacs)
- Retail (<INR 5 Lacs, <INR 1Lacs)

Institutional holding is largely dominated by Private Banks, Regional Distributors and Large IFAs. This segment requires intensive knowledge and technology enabled interaction and hence these segments dominate and a very small proportion is Medium and Small IFA. In recent times, post 2010, the direct channel is being used by Institutional investors to invest online considering economies of scale. As per Sebi regulation, there is lower expense ratio for direct investments which results in the consumer getting a higher yield.

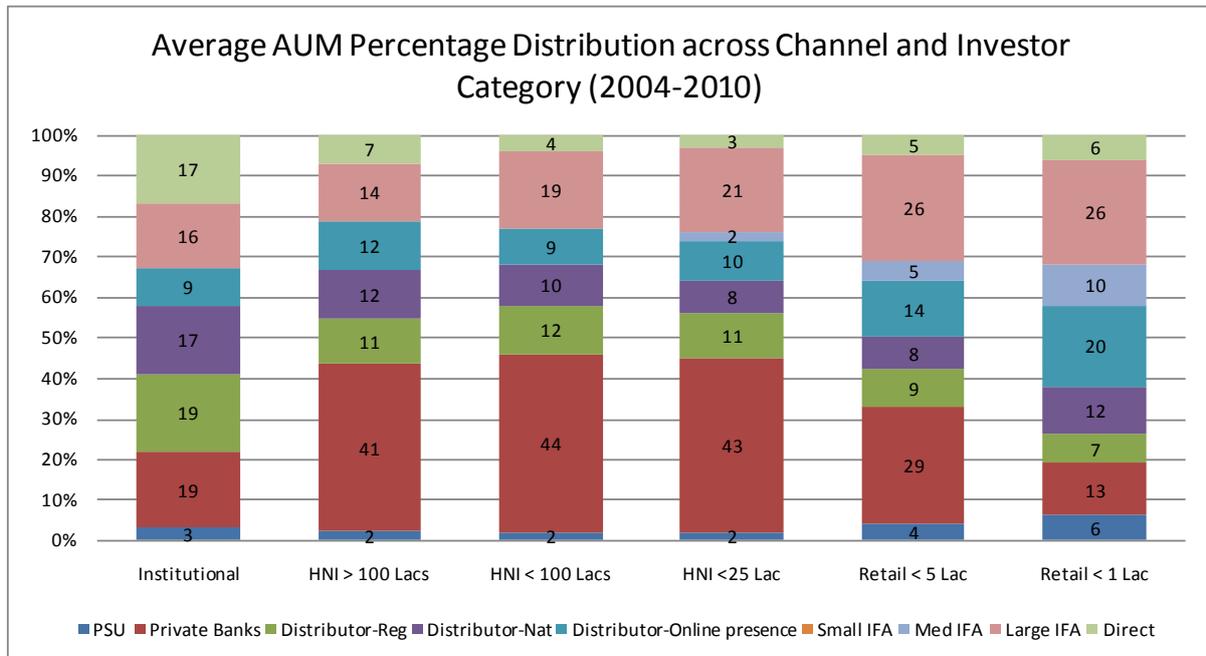
The most dominant player in the HNI segment (all 3 sub categories) is the Private Banks (above 40%) followed by Large IFAs. Private Banks use a detailed segmentation strategy to target acquisition of clients. Further, using sophisticated data mining these clients are mapped based on their liability/asset relationship and potential to bank employees called as Relationship Managers (RM). Based on the client potential the competent RM is mapped. The classification of clients as HNI varies across Banks and is branded exclusively. For example HNI > INR 25 Lacs in AUM (including deposits, bonds, mutual funds) are classified as Premier Clients and HNI (>INR 3.5 Lacs and < INR 25 Lacs) is classified as Advance client. Bank of Maharashtra classifies an HNI as an individual with relationship value \geq INR 1 Lac. Thus, though the nomenclature and AUM corpus may vary across Banks, this is a concentrated and focus piece for most Banks.

The Retail category (AUM < INR 5 Lacs) has three main players Private Banks, Distributors with online presence and Large IFAs.

In the AUM < 1 Lacs bucket, the two main players are Large IFAs followed by distributors with online presence.

This shows that the retail segment is emerging to be technology intensive.

Figure 9 : Average AUM % Distribution across channel and investor category (2004-2010)

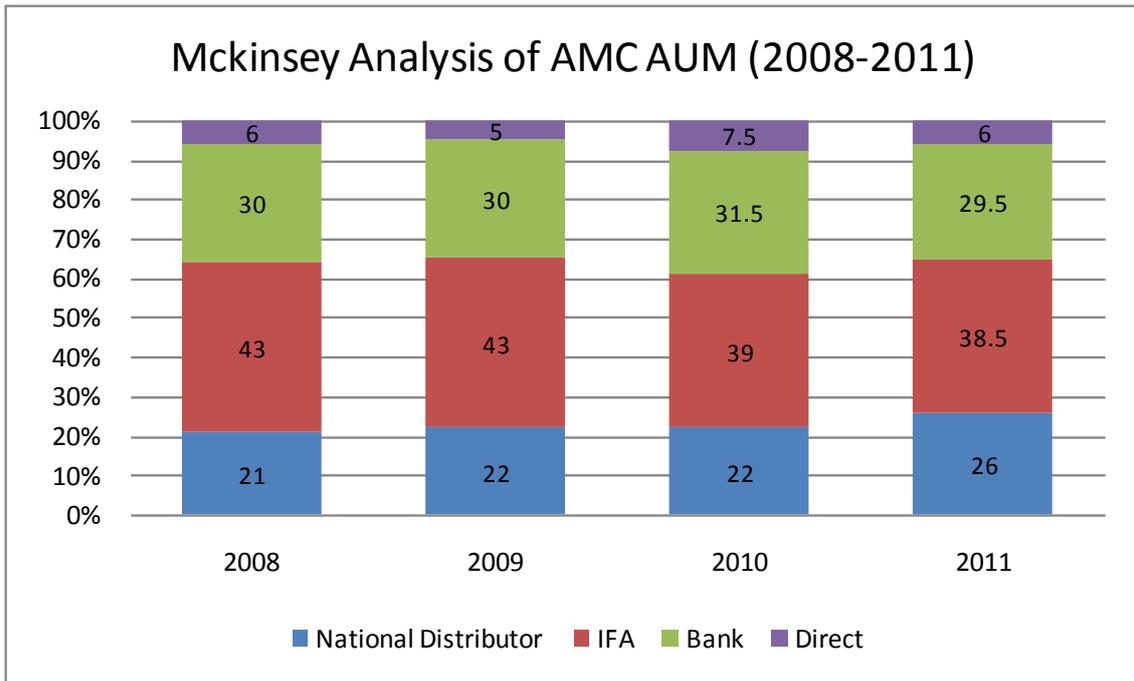


Source : Adapted from Shah *et al.* 2010

2.2.7 Studies on Pre-Post ELR AUM holding across intermediaries.

The period from Jan-June 2009 is the pre Entry Load removal period and the August 2009 onwards is treated as Post Entry Load Removal. Two pertinent studies discussed here are the Mckinsey Asset Management Survey (2011), a privately circulated study covering all AMC data and the Shah *et al.* (2010) which covers Cams Registrar data. Mckinsey analysis showed that National or Large distributors having countrywide presence had witnessed the highest growth in last 3 years, attributed to being beneficiaries of the consolidation in IFA space. The figure below is the Mckinsey analysis of the AMC AUM for the period 2008-2011.

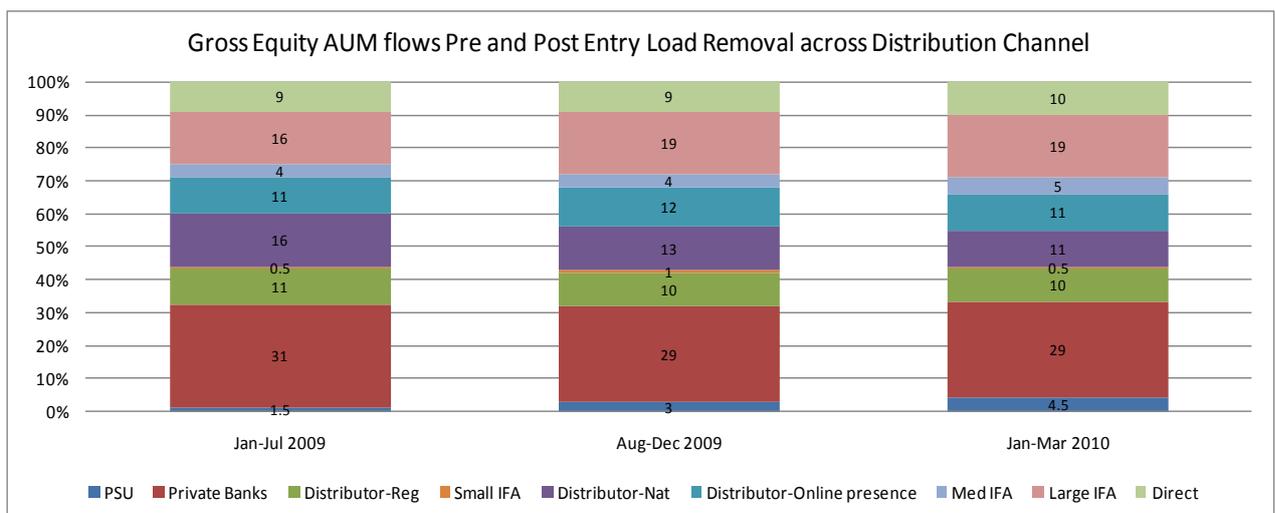
Figure 10 : Mckinsey Analysis of AMC AUM (2008-2011)



Source: Adapted from Mckinsey Asset Management Survey 2011

Figure 11 below depicting the Cams data reconfirms the Mckinsey (2011) report and shows that the Large IFA and medium IFA holding has gone up post Entry Load Removal.

Figure 11 : Gross Equity AUM flows Pre and Post Entry Load Removal across distribution channel



Source: Adapted from Shah *et al.* 2010

2.2.7 : Asset Management Companies (AMC) Rankings.

Table 3 below shows the AMC ranking for the last 4 years based on Assets under Management (AUM). While HDFC AMC has been the top ranked based on AUM for the last 2 years, Reliance AMC and ICICI Prudential AMC have been fighting for the 2nd slot. UTI AMC which was once the dominant player is now at number fifth position. The AMC list top ranking AUM list is dominated by Bank backed AMCs.

Table 3 : Ranking of AMC (2009-20113) as per AUM.

AMC	Mar-2013	Mar-2012	Mar-2011	Mar-2010	Mar-2009
HDFC Asset Management Company Limited	102096	90086	86282	88780	57956
Reliance Capital Asset Management Limited	96851	80232	101718	110413	80963
ICICI Prudential Asset Management Company Limited	87968	68816	73552	81018	51456
Birla Sun life Asset Management Company Limited	77144	61174	63733	62367	47111
UTI Asset Management Company Private Limited	69450	58922	67189	80218	48754
SBI Funds Management Private Limited	55760	42671	41672	37417	26383
Franklin Templeton Asset Management (India) Private Limited	42897	36081	39582	34034	19365
Kotak Mahindra Asset Management Company Limited	35945	26236	32253	34787	18370
IDFC Asset Management Company Limited	33068	25764	21851	25775	14377
DSP Blackrock Investment Managers Private Limited	32342	29298	30601	21491	14413
Rank	1		2		3
By	1		2		3
AUM:	1		2		3

Source: ACEMF, AUM in Crores

2.2.8 Mutual Funds –Way Forward

2.2.8.1 Investor Awareness and Protection

In the financial year 2012-13, as per AMFI data, 32 AMC's have conducted 12,208 programs in 485 cities covering 2, 48,047 participants (PWC, 2013). It further states that AMC's have realized that they need to invest in financial education and awareness so as to reap long term benefits. They have tried novel and interactive methods to connect with the target customer. One of the foremost campaigns is been Amfi's 360 degree campaign called as "Savings kanayatarika", launched in September 2011. The campaign required an sms to be sent by the investor to a specific number, and based on its receipt a booklet on Mutual fund investments would get dispatched. Most AMC's have used a blend of print and television media for their investor awareness initiative. A major push has been given by Sebi's directive in 2013 to AMC's to set aside at least 2 basis points (0.02) of Daily Net Assets within the maximum limit of Total Expense Ratio (TER) for investor awareness and initiatives. Another major initiative by Sebi in July 2013, is the requirement for labeling considering the level of risk associated with the product (PWC, 2013).

2.2.8.2 Challenges of an under penetrated market

India's under penetrated market presents huge opportunities but it also has systematic constraints and roadblocks. As per the Price Waterhouse Cooper's report (PWC, 2013) following are the key challenges of the Indian environment.

- Low Level of Awareness and Financial literacy
- Cultural and Attitudinal Barriers
- Adapting the distribution channel
- Reach and scalability

Even though the ability to invest may exist with the individual, the savings are prevented from being directed into mutual fund products. This may be attributed to the slow growth in capital markets, low awareness of mutual funds as a low cost investment avenue and the returns they generate. There is also an interplay of culture and behavioral changes which prevents the savings from being directed into investment products, diverting it from gold and property. The other challenge is documentation, with regard to Pan Card and Bank account. The rollout of Aadhar will help resolve the issue in the longer run, but in the short term getting complete KYC documentation is one of the biggest challenges.

The previous section traversed the mutual fund landscape in India from inception till date with regard to its progression, trends in asset holding, scheme wise AUM, distribution channels, AMC Rankings and current investor education initiatives. In the next section, a comparative analysis of the Financial Advisor regulations in India along with select economies is undertaken to complete the mutual fund industry coverage.

Part II

2.3 Comparative Analysis of Financial Advisor Regulations in India and Select Economies

2.3.1 Background of Financial Advisor regulation in India:

Mutual funds are considered an investment avenue for investors who would like to diversify their risks and avail of the services of professional fund managers. Retail investments are herein pooled into a MF scheme with a defined investment objective and deployed into select securities investments. The Invest Indian Market Solutions Private Ltd 2007 survey (IIMS, 2007) of investors revealed that mutual fund investments are most influenced by Agents, and over 72.2% had confirmed this.

A long standing need was perceived for reforms in distribution space. One of the foremost proposals in Indian context has been the Expert Group on Protection of Interests of Small Investors and New Avenues for Safe Investment of their Savings (Govt. of India 2005).

USAID Report 2007 called for registration of all kinds of advisers as well as firms and individuals. It suggested the setting up of an Apex Body for registration and regulation, a Regulatory Organisation (RO) in the form of a private, nonprofit corporation authorized by Government of India, but with Sebi overseeing it.

SEBI initiated regulation in the period 2006 onwards and they are discussed hereunder.

For investment services provided by Indian Asset Management Companies (AMC), two types of expenses were charged to investors (Sebi 2009), upfront expenses called 'sales load' or entry load and annual scheme expenses. Besides, a few schemes also charged an exit load. Till 2009 as per Sebi the schemes charged an entry load as a percentage of the amount invested.

Many mutual fund investors availed the services of a distributor who also acted as financial adviser (FA). This adviser was expected to assist investors in helping select schemes that best suited their respective risk-return appetite besides assisting them in completing an investment application.

A classification of the mutual fund regulations on basis of cost charged into regulatory regimes has been undertaken (Thomas, 2010). These regimes are explained hereunder:

- Pre 2006: Both open and close ended funds were allowed to charge maximum of 6% as initial expenses (Indirect costs which include sales and distribution fees) as well as entry and exit loads (Direct costs). Industry practice was to charge a maximum of 2.5% on equity funds whereas entry load on debt funds was non-existent.
- 2006-2008 : Initial issue expenses was only permitted for close ended schemes with a maximum limit at 6% and *close ended schemes* were not allowed to charge entry load. Open ended schemes were stipulated to meet all expenses connected with sales and distribution from the entry load with a maximum limit of 6%.
- 2008: Disallowing of initial issue and related amortization. Mutual Fund schemes to adjust expenses connected with sales and distribution of schemes from entry load.
- 2009-Phase 1: Removal of entry load from August 2009 and exit load made uniform across all fund categories. (Maximum 1%)
- 2009-Phase 2: All MFs made tradable for entry and exit on the stock exchange platform.

Table 4 below captures the Load structures present prior to 2009. This entry load was deducted from the total amount invested and was generally passed on to the distributors by AMC. A load bearing product has advice embedded in it (Zhao, 2008). The use of the initial issue expenses for compensating distributors became extremely widespread, and no New Fund Offering (NFO) could enter the market without promising the large distribution chains 7-8 percent commissions. The investor was charged 6%, plus an upfront load of 2.25% and s/he did not have any say in the commission that was paid to the distributor from the entry load. This gave rise to a situation of potential conflict of interest between a distributor providing financial advice to the investors (Adviser) and his role as an Agent of the AMCs and this seized the attention of various jurisdictions including India. As per non formal interviews conducted by Committee on Investor Awareness and Protection (2010) with US Regulators, “the agent will go where the money is”. This adage seemed to have been revalidated. The distributor

chose schemes which would give him better sales incentives rather than schemes which would be best suited to the customer. As repeated investments by investor entailed the distributor to more commissions, s/he encouraged investors to sell existing mutual fund investments and buy new mutual fund units and this practice was identified as churning. This churning was neither to the advantage of investor nor to the mutual fund industry. The widespread practice of churning, and payment of large commission to the distributors during 2004 and 2005 was noted by the Indian regulator Sebi. It was in 2007 that Sebi first released its draft regulations governing investment advisors' which suggested structural changes in the nature of service provided by these advisors with restrictive definitions and regulated disclosure norms (Sebi, 2007).

Table 4: Summarization of charges across open and close ended mutual funds (%)

Source : Adapted from Thomas (2010)

Summary of changes in costs across Open & Close ended MF		Maximum charges allowed across open ended & close ended mutual funds							
		Up to April 2006		Apr 06-Jan08		Jan08-Aug09		Aug09-Mar2010	
		Open	Close	Open	Close	Open	Close	Open	Close
Initial Issue Expense		6	6	0	6	0	0	0	0
Entry Load		6	6	6	0	6	6	0	0
Exit Load		6	6	6	6	6	6	1	1
Expense Ratio *		2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5

In India, it was mandated on December 31, 2008, that there would be no entry load on investments made directly by the investors (not routed through any distributor). Subsequently, in cases of all mutual fund investments, Regulator felt that, to empower the investor in deciding commissions being paid to the distributors and also to ensure transparency in commissions being paid, the amount of payment to the intermediary would be decided by investor depending on the level of service received, not by AMC (as was in form of entry load).

On August 1st, 2009, the regulation on removal of Entry Load came into existence which was notified vide Sebi Circular no. IMD/CIR No. 4/ 168230/09 (Sebi, 2009). This regulation opined that the upfront commission to distributors had to be paid by the investor directly, depending on quality of service rendered. It was expected that this would segregate the streams of payment for the two roles of distributor, as Point of Sale for the AMC (Agent) and an Advisor to the investor. The time line for the distributors to realign their business was June 2009 till 31st July 2009, which was extremely tight.

The Committee on Investor Awareness and Protection 2010: This committee was setup by the High Level Coordination Committee on Financial Markets (HLCCFM) and submitted its report in March 2010. Its aim was primarily to strengthen the ongoing efforts for imparting financial education and promoting investor protection. This report highlighted the low participation of Indian households in market linked products and pointed out that the key to increased allocation was building faith in risk based financial products. It emphasized the presence of a trustworthy, regulated retail intermediated industry with common minimum standards for enhancing household participation in financial markets. It clubbed all the agents, advisers and planners in the market for advice and decided that the selling of commission based products would be treated as advice. The committee further recommended setting up the Financial Well Being Board of India (FINWEB) to bring about order to the adviser market and building a financial literate community.

A brief summarization of the key reforms introduced by Sebi from 2009 is enclosed hereunder:

The **Entry Load Removal norms** were the foremost of the changes initiated by Sebi in 2009. It was geared towards protecting investor interest and bringing in more transparency in India's Mutual Fund industry. This regulation impacted both the investor and the distributor segment.

Introduction of the Know your distributor (KYD) process for Mutual Fund Distributor in August 2010 & Know your Customer (KYC) in December 2010: As a measure to control fraudulent investment distribution, this regulation mandated distributor to submit his ARN card with address proof document to the registrar. Under KYC norm, client's address and identity proof was to be submitted and also risk based due diligence carried out while taking his investments.

Introduction of Transaction Charges & Process for Distribution of Mutual Fund Products: Sebi Vide circular dated August 22nd 2011, allowed charging of separate transaction charge of Rs.100 for investments above INR 10,000/-. Investors could continue to pay directly to the distributor for services rendered and other factors. For distribution of Mutual Funds by distributor, a classification of the distributor (based on parameters like AUM, commission received, geographical presence) and due diligence process was outlined which was to be undertaken by AMC. It also mentioned that risk profiling of investors was mandated. It further classified customer relationship and transaction charges into Advisory & Execution only. Here, Advisory refers to a scenario where a distributor represents to offer advice while distributing the product and it will be subject to the principle of ‘appropriateness’ of products to that customer category. In case of Execution Only, there is a mandated requirement of a customer confirmation to the effect that the transaction is ‘execution only’ notwithstanding the advice of in-appropriateness from that distributor, which is to be obtained prior to the execution of the transaction (Sebi, 2011).

Steps to Re-energize the Mutual Fund Industry: The regulator on September 13th 2012 laid out steps primarily geared to bring in transparency and simplicity in the mutual fund distribution space. Some of the key steps undertaken are discussed hereunder and the circular is available as an annexure in this research. Foremost was allowing additional Total Expense Ratio (TER) and Service Tax. The TER is a measure of the total costs associated with managing and operating a mutual fund. The additional TER was to push investor participation from beyond the top 15 cities¹. Secondly, the *single plan* structure was introduced for investor across categories, thus doing away with a multiple expense structure and multiple plans. This was clearly directed towards simplifying investment process and avoiding miss-selling. Thirdly, it was mandated that each scheme have a direct *plan option* wherein an investor had an option to directly invest into the mutual fund with lesser expenses. Under the direct channel option the regulator mandated, 1st January 2013 as the launch of Direct Plans by Asset Management Companies, which offered the intelligent and large investor a direct investment platform at a saving of 50 to 75 bps. Fourthly, introduction of newer cadre of distributors with simplified certification and registration to widen the reach of the intermediary channel. Finally, to emphasize investor education AMCs were mandated to allocate 2 bps towards investor education programs by AMC amongst others (Sebi, 2012). Other initiatives included crediting

of exit loads charged to the schemes, claw back of initial expense in case of redemption within one year for inflows from beyond Top 15 cities, creation of Unique Identification number (UIN) by AMFI for sales persons of distributors, inclusion of mis-selling of mutual fund units as a fraudulent and unfair trade practice' under the relevant Regulations and enabling the setting up of a Self-Regulatory Organisation for distributors.

The above regulations were geared towards transparency and investor protection. Along the same time, in 2010, there were regulatory issues related to wealth management and Private Banking in India namely the Citibank Fraud case (TNN, 2011) and hence to further strengthen investor protection by regulating advisors, SEBI introduced the Concept paper- a discussion document seeking public opinion. After two such consultation papers issued by SEBI in 2007 and 2011 seeking stakeholder opinions relating to the framework for the regulation of investment advisers (IA), the much-debated regulations came into force in April 2013 (Sebi, 2013). The main highlights of this regulation are:

Registration of investment advisers: Individuals acting or holding themselves out as an investment adviser are required to register with SEBI. There is an exhaustive list of exempted persons which includes advisers exclusively in areas like insurance and pension products provided they are regulated by sectorial regulations.

Eligibility criteria for registration: Investment adviser regulations mandate different requirements and thresholds for registrations, including raising the bar for minimum qualification and capital adequacy to act as an investment adviser.

Investment adviser obligations and responsibilities: Apart from stipulating strict risk profiling, suitability, and "Know Your Customer" requirements, investment advisers are held to the highest level of ethical and moral standards to protect clients. They must act in a fiduciary capacity towards clients and disclose conflicts of interests arising from various other activities carried out by the investment adviser that may compromise the investment adviser's objectivity and independence.

The *new regulations prohibit an investment adviser from receiving compensation*, in any other form, from any person relating to the underlying securities or investment products other than the client being advised by the investment adviser.

In other countries, the rollout of Advisor regulations has tilted towards a complete ban of commissions and volume based payments and a stringent requirement from advisors to meet the suitability standards. These economies mostly have investment mandated through retirement plans along with a much higher level of product penetration (Sahoo & Sane, 2011). A comparative study of the sequence of regulations of the four developed and larger markets is undertaken below.

2.3.2 Comparative study

The four economies being researched for the study along with India are United States, United Kingdom, Singapore and Australia is enclosed. The table below captures the AUM in USD Million as per ICI Fact Book which does not mention Singapore. India's AUM is a very small proportion as compared to the rest.

Table 5 : Total Net Assets in USD

Country	AUM in USD Million – 2013 Q4
United States	15,017,682
United Kingdom	1,166,834
Australia	1,624,081
India	107,895

Source: Adapted from ICI Fact book (2014)

In this research, UK and Singapore have been selected since, India's recent mutual fund regulations are largely based on UK and Singapore regulations. UK, where English Law originated, is the world's oldest law making jurisdiction and the law in its colonies have had its antecedents in English Law. United States is the world's largest mutual fund market and its unique investment regulation giving fee autonomy along with stringent reporting norms to brokers and advisors makes it an important market study. Australia is one of the foremost nations to ban entry load and hence has been included in this research.

Two pertinent studies with regards to applicability of Investment Advisor regulations in India are Sahoo and Sane (2011) and the comment report presented by Federation of Independent Financial Advisors (FIFA) to the regulator. In both these studies, a comprehensive coverage of progression of financial advisory regulations across specific economies was undertaken alongwith recommendation for a model suitable in Indian context. The FIFA study was also formally presented to Sebi giving a detailed feedback on the Investment Advisor concept paper (FIFA, 2011). However, there was no feedback received from the regulator on it. Both these study findings are discussed hereunder.

2.3.2.1 United States of America (USA): The Investment Advisors Act (IAA), 1940 is the oldest piece of legislation in the United States and it sets a fiduciary duty for investment advisers. Securities as defined in this Act include a range of financial products namely stocks, bonds, debentures, derivatives amongst others. The Investment Advisor Act does not stipulate the segregation of the fee structure into "fee-based" or "commission based advice". The Act mentions that *compensation maybe in the form of fee from investors, commission for product*

manufacturers or a combination of both. The Act mandates, the registered firms to file an ADV disclosure form with the SEC within 45 days and this form needs to be updated at least once a year. It contains 2 parts. Part 1 primarily for SEC use, describes the nature of the Advisor business and Part II providing detailed disclosures to the clients on the type of service, fee structure and conflict of interest which may arise.

The advisors in the US are regulated both at the State and Federal Level. In the US, there was the lack of a single agency to oversee and regulate the entire spectrum of the consumer finance products. The setting up of the Bureau of Consumer Financial Protection within the Federal Reserve setup under the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (Dodd-Frank Act) was a step in that direction. The main thrust of the Bureau comes across as regulating disclosures and ensuring transparency in the products sold to the consumer along with promotion of Financial Literacy.

2.3.2.1.1: Regulatory Check in USA:

The following checks are in place in US:

Any person qualifying with the definition of Financial Advisor is to be registered mandatorily with the Securities Commission under the s.203 of the Act.

No Advisor will be registered under the s.203 until the entity has assets worth USD 25,000,000, and unless the entity is an advisor to an investment company registered under the Investment Companies Act 1940.

The Commission has been given expansive powers to regulate all investment Advisors such as revoking registrations, imposing suspension and pecuniary penalties if it finds that the Advisors have made false statements or have violated any provision of the Act.

The Commission has power to impose penalty for violations under this Act.

The Commission requires specific records to be maintained by Investment Advisors, one in the form of accounting records and secondly any additional records which the commission may believe to be necessary for maintaining fiduciary duty towards clients.

The Commission is empowered to make three different types of investigation / examination; routine, sweeping and forceful.

2.3.2.2 United Kingdom (UK) : One of the foremost reforms initiated worldwide to address the concept of mis-selling of mutual funds was the Financial Services Act (FSA) of UK 1986 (Ring, 2002). The Gower Review 1982 had expressed concern about the then existing methods of regulation and in particular the lack of protection for the consumer against unfair selling practices and / or recommendation of inappropriate products. Until 2005, UK followed a polarization regime, wherein advisors were categorized as agents of product manufacturers or independent advisors. Post polarization regime, three categories were introduced namely, Tied Advisors who worked with one financial institution, second Multi tied Advisors who offered products from a selection of the market and were paid on a commission basis and thirdly Independent Financial Advisors who had to offer their clients the option to pay for advice by fee as an alternative to commission (Financial Services Authority, 2009)

Encapsulated below is the transparent and interactive flow of the FSA model:

- June 2007, discussion paper published by FSA was based on the inputs from the workings of five groups of practicing members, consumer representatives and other stake holders. The regulator held over 100 meetings to explain and discuss this proposed regulation.
- April 2008, interim report published by FSA, which summarized the feedback on the discussion paper and its incorporation of the feedback.
- Proposals were then taken and a Consultation Paper drafted by FSA in 2010 under the “Retail Distribution Implementation Program ” which asserted that there needs to be a distinction between ‘advice’ and ‘sales’
- FSA then set out reduction of commissions paid by product provider in a **phased manner** with the year 2013 as final time line for complete detachment of advisor remuneration from product providers’ remuneration
- Final Retail Distribution Review (RDR) was to be effected from 31st December’ 2012.

Under the RDR, Advisors will be required to set their own charges for advice and product provider influence will be removed. Both independent and non-advisory firms will have to disclose, separately, the costs of advisory services and differentiate these from the underlying product costs. The proposals in this scheme include basic, restrictive and independent advice. Basic advice is based on the advisor seeking answers to a specific set of questions relating to financial products and hence there is no actual advice which is given. Independent advisors are those who do not have any contractual right with the manufacturers of the product or any

biases and give a fair recommendation. Restrictive advisors limit their product range to the manufacturers they represent and would only permit them to receive advisory fee for those restrictive products. Both independent and restrictive advisors, however will have to disclose their nature of advice to their clients for them to make an informed decision.

UK has now presently implemented a Fee Based regime for ALL investment products, including life insurance policies (except pure protection), under its Retail Distribution Review on 31st December 2012 (Financial Services Authority , 2013)

Consumer Studies: Certain steps are also being undertaken by UK Regulator to access consumer feedback regularly:

The FSA carries out various Consumer Survey including on Platform awareness, every year since 2000 as per data available on its official website with regard to the Financial Services through independent research bodies. This survey comprises of questions related to awareness about FSA, feedback on regulations of FSA, Frauds, Products *and is used by the body to realign its policy stance from time to time.*

These are independent methodologies adopted by the regulator to regularly gauge the consumer feedback, ascertain impact and sustain the rollout of regulations. (Financial Services Authority, 2013)

2.3.2.3 Singapore: The Monetary Authority of Singapore (MAS) the regulating body for capital markets, had released the Financial Advisory Industry Review (FAIR) panel report for industry comments and review before its final implementation in 2013. (Monetary Authority of Singapore, 2013).

Following were the key points:

- Raising the competency level of Financial Advisory representatives with minimum entry-level requirement and ongoing professional development.
- Raising the quality of Financial Advice through enhanced requirements on minimum base capital and continuing financial resources, professional indemnity insurance, and dedicated compliance arrangements.

- Making Financial Advising a dedicated service by recruiting representatives with ‘Advisory’ as a key focus and with no conflicts of interest with their business and better accountability and disclosure to customers.
- Lowered distribution fees by allowing market dynamics instead of banning of commissions.
- Adoption of a balanced scorecard framework and banning all product specific incentive.
- Balanced Scorecard Framework for Remuneration of Financial Advisory Representatives.

Singapore Structure for FA:

Governing Regulations:

The Financial Advisors Act, 2012 to be read with Financial Advisors Regulations, 2002.

Definition of Financial Advisors:

The term “financial advisor” means a person who carries on a business of providing any financial advisory service, but does not include any person specified in the First Schedule, for example advocate solicitor, law corporation etc.

Independent Advisors:

The Regulations state that all Licensed Financial Advisors would not qualify as an “Independent Advisor”, if:

- They either received commission/incentive from manufacturers of financial products which may create a product bias, or
- They acted with any restrictions, directly or indirectly, or
- They act with a conflict of interest created by any association with product manufacturers.

Importantly, this regime *does not impose absolute restrictions in so far as banning financial advisors* from receiving commissions is concerned. Regulation 21 suggests that those financial advisors who want to use the term ‘independent’ for giving independent advice are restrained from representing a particular financial manufacturers interests to the investors and from receiving any form of remuneration/gratitude from them. Therefore, it only provides an option to the advisors to either represent themselves as a “financial advisor” or be categorized as an “independent advisor” with restrictions.

Fee structure:

The advisors are allowed to charge fees either in the form of commission, trailer fee or as advisory fee, without any restriction. However a person falling within the ambit of an 'Independent Advisor' cannot charge a commission from a product manufacturer under Regulation 21 of the Act. Any person who contravenes with this provision will be held as guilty of an offence.

Disclosure:

An advisor shall disclose, to every client and prospective client, all material information relating to any designated investment product that the licensed financial advisor recommends to such person, including the terms and conditions assigned to the products, the benefits to be derived by investment in the product, fees and other charges to be imposed by investment in financial product and any other disclosures which the client may require.

Any contravention of this provision shall be guilty of an offence and shall be liable on conviction to a fine not exceeding \$25,000 or to imprisonment for a term not exceeding 12 months or to both.

2.3.2.4 Australia: In Australia, Future of Financial Advice (FOFA) reforms have now been undertaken to tackle conflicts of interest that had earlier threatened advice quality and caused mis-selling of products. The collapse of Storm Financial in 2008 (Government of Australia, 2013), led to a stringent review and reform of the financial distribution market. Prior to this rollout, there existed in Australia a combination of customer based and provider based, fee leading to dilution in the development of investor focused advisory market. The FOFA reform rollout measure in Australia envisages advisers having their own "product neutral" charges and this fee based regime under its Financial Advisors initiative took effect on 1st July 2013. The important proposals of FOFA are encapsulated below:

- Ban of up-front and trail commission, volume based payments and Soft Dollar benefits
- Setting up a Statutory best interest duty for Financial Advisers
- Opt-in scheme wherein clients would have to agree to paying fees to advisers every two years
- Option of Scaled advice Client compensation scheme for bad / unsuitable advice.

Australia was one of the foremost to separate prudential regulation from distribution regulation and it has a dedicated regulator – Australian Securities Investment Commission (ASIC) for customer protection. The Corporation Act 2001 is the legal framework for the regulation of advisers under the ASIC and the Regulator Guide 146,175 of ASIC. It clearly defines what constitutes a financial product and service. A compliance with the suitability and basis of advice rule is mandatory for personal advisors for understanding the client’s personal background and ensuring appropriate advice. FAs are required to hold an Australian Financial Services License (AFSL) and also comply with the disclosure agreement.

The disclosure agreement includes the following:

- Handover of Financial Advisor Guide to the client
- Statement of Advice which states the advice and basis of on which it was rendered.
- Details of remuneration and other benefits the adviser received
- Disclosure of any relationship of the adviser that may have influenced the sale.
- Trainings and competency requirements are earmarked.

2.3.3 Learning’s for India: Lessons from the developed markets and suggestions for regulatory support for India Rollout of Financial Advisor norms are discussed in this section. In the Indian Mutual Fund Sector, the pace of reforms has been fast and furious from 2009 as compared to other economies.

In the economies discussed, rollout of the FA regulations has been in a phased manner as mentioned in the discussions above, including realistic timelines for adherence, a comprehensive participative decision making process through feedback capturing mechanism and also the regulators update on his action.

While in the Indian context, the speedy pace of FA regulations has generated intense debates and media fury (Indian Express, Mint, Times of India) impact analysis studies are still emerging (Marisetty 2011; Anagol 2011), *no commissioned study by the regulator is in place yet to gauge the regulation impact. Thus, what has been the impact of the regulation on the Indian investor needs to be ascertained on an ongoing basis by the regulator.*

Secondly, reiterating that in developed economies investment is most often mandatory through retirement plans and the product penetration is much deeper whereas in a transition

Economy like India, agent community continues to play an important role in educating and driving sales of financial products, both researchers and industry bodies (IIMS 2007; Sahoo & Sane 2011; FIFA 2011) have suggested *different hybrid distribution models*. While FIFA suggests the coexistence of both the fee and commission based model, Sahoo and Sane(2011) formulated a comprehensive model which segregates advice from distribution. It advocates FA to be recognized as professionals and be regulated by a new independent entity. Distributors, they suggest should continue to remain under the purview of product regulators.

Thirdly, while the regulation rollout in India, geared towards enabling a more transparent and customer friendly environment is a welcome move, it will be more appropriate, if going ahead there are also in place *effective tracking mechanisms for feedback received* from various consumer forums, incentives and recognition for implementing it. Regulatory Impact Assessment (RIA) and its need in Indian context are discussed in detail in the later section.

Fourthly, considering the emphasis on product disclosure to be followed, in practice disclosure is not seen to have the intended effects (Beshears, Choi, Laibson, & Madrian, 2009 ; Choi, Laibson, & Madrian, 2010). Studies clearly show that subjects most often do not understand loads, overlook them, and do not make optimal choices.

Hence though disclosure will definitely help in providing the necessary information, it is not going to solve the problem of mis-selling (Sahoo & Sane, 2011).

Conclusion:

Review of the regulation and policy flow showed that the Regulator had carried out steps from 2007 both for data mining and to gauge the market reality, through setting up of high profile committee's like D Swarup Committee, introducing Concept Papers. This was subsequently converted into a Regulation applicable 1st August 2009 banning the Entry Load completely. However, unlike the other developed markets, a participative approach to policy making was clearly seen as lacking in the Indian context. Secondly, unlike other geographies where there are commissioned surveys to gauge consumer awareness of a Financial Regulation and a structured attempt to educate investors about all policy changes, in India both of this has been still lacking. The recent regulation on earmarking .02% of the AUM to investor education is therefore a positive step in this regard. However, this has to be clearly tracked, documented and audited regularly to help effectively manage the rollout.