CHAPTER -2

CONCEPTUAL AND LEGAL FRAMEWORK OF MUTUAL FUND INDUSTRY

2.1 Introduction
2.2 Concept of Mutual Fund
2.3 A Brief History of Mutual Fund Business
2.4 Origin of mutual fund in India
2.5 Growth of Mutual Fund
2.6 Organization of a Mutual Fund
2.7 Operation of the Mutual Fund Industry
2.8 Advantages of Mutual Fund
2.9 Disadvantages of Mutual Fund
2.10 Type of Mutual Fund Schemes
2.11 Net Asset Value (NAV)
2.12 Mutual Fund Fees and Expenses
2.13 Association of Mutual Funds in India (AMFI)
2.14 Asset Management Companies of Mutual Funds
2.15 Regulatory Framework of Mutual Funds in India
2.16 Conclusion
Chapter 2

Conceptual and Regulatory Framework of Mutual funds in India

2.1 Introduction

The previous chapter was devoted to the introduction of the study that includes the review of the available literature and how to carry out the research work systematically. The present chapter is related to the genesis of Mutual funds, its concept and the growth of the Mutual fund industry in India. It also deals with the various entities of Mutual fund, classification, advantages and disadvantages in the mutual funds.

2.2 Concept of Mutual Fund

Mutual fund is one of the important instruments of financial system of the country. The main objective of all financial instruments is to mobilize the saving of investor and make the investment in the capital market and money market. Keeping in view this objective mutual fund was established in India in 1964. Mutual Fund as a means of investment is the most suitable investment for a common man. It gives an opportunity to invest in diversified financial instruments managed by professionally experienced fund managers. Mutual fund offers the best possible return with flexibility and liquidity. This mutual fund industry is controlled by some regulating authorities in each country. In India these authorities are Securities and Exchange Board of India (SEBI).

Mutual fund basically aims to pool the savings of small investors having small amount of knowledge about capital market and make the investment through professional fund managers in diversified portfolio. Mutual Fund is a trust that pools the savings of a number of investors who share a common financial goal. The money thus collected is then invested in capital market instruments such as shares, debentures and other securities. The income earned through these investments and the capital appreciation realized is shared by its unit holders in
Chapter 2 Conceptual and Regulatory framework of Mutual funds in India

proportion to the number of units owned by them. Thus a Mutual Fund is the most suitable investment for the common man as it offers an opportunity to invest in a diversified, professionally managed basket of securities at a relatively low cost. The flow chart below describes broadly the working of a mutual fund:

Chart 2.1 Working of a Mutual Fund

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SEBI regulation 1993 defines Mutual Fund as follows:

"Mutual Fund means a fund set up in the form of a trust by a sponsor to raise money by the trustees through the sale of units to the public under one or more schemes for investing in securities in accordance with these regulations."²

"Frank Reilly defines mutual funds as financial intermediaries which bring a wide variety of securities within the reach of the most modest investors"³

The VNR dictionary of business and finance defines mutual fund as an investment fund that pools the invested funds of others and invest those funds on their behalf, usually in a specified kind of investment, such as money market instruments, municipal bonds or common stock.⁴

U.S. Securities and Exchange Commission defines, a mutual fund is a company that brings together money from many people and invests it in stocks, bonds or
other assets. The combined holdings of stocks, bonds or other assets the fund owns are known as its portfolio. Each investor in the fund owns shares, which represent a part of these holdings.5

Therefore, from the above definitions it can be concluded that the Mutual Fund is a financial intermediary established in the form of a trust sponsored by banks, financial companies and other industrial concerns with an objective of mobilizing savings through various schemes and investing the pooled savings in various instruments of capital and money market. Buying a mutual fund is like buying a small slice of a big pizza. The major benefits of investing in mutual funds are to capitalize on the opportunity of a professionally managed fund by a set of fund managers who apply their expertise in investment. This is beneficial to the investors who may not have the relevant knowledge and skill in investing. Each investor owns a portion of the fund and hence shares the rise and fall in the value of the fund. Mutual funds may invest in stocks, cash, bonds or a combination of these.

2.3 A Brief History of Mutual Fund Business in the World

The Concept of Mutual fund is very old. There is an ambiguity about the fact that when and where the Mutual Fund Concept was introduced for the first time. Mutual funds go back to the times of the Egyptians and Phoenicians when they sold shares in caravans and vessels to spread the risk of these ventures.6 According to some historians, the closed-end investment companies launched in the Netherlands in 1822 by King William I were the first mutual funds. It was in 1822, the concept of Investment Diversification was properly incorporated in the mutual funds by the trust called "society General Belgique". In fact, the Investment Diversification was the main attraction of mutual funds as the small investors are also able to allocate their little Funds in a diversified way to lower Risks7. After 1822, the Mutual Funds Concept came in Switzerland in 1849 and thereafter in Scotland in the year 1880s8. In addition, "the foreign and colonial government Trust" of London in 1868 is considered to be the fore-runner of the modern concept of mutual funds9. Later in 1873 Robert Fleming in Dundees,
Scotland established the Scottish American Investment Trust for the purpose of investing in high risk, high return American railroad bonds. Flemings was involved in the successful restructuring of numerous North American railroads in the 1870s, 1880s and 1890s. Each restructuring produced significant gains for the Fleming investment trusts and drew more investors.¹⁰

During this period a few investment companies came up in the U.S; however their growth was in nowhere similar to that achieved in U.K. The reason for this was lack of investor’s interest in stock market. But in 1920 booming stock market led to the arrival of investment companies in the U.S.¹¹ In 1924, the Massachusetts Investors’ Trust introduced the first open-end fund. It allowed holders to sell shares back to the Trust at the day's current value (what we call the Net Asset Value). Similarly, buyers could purchase new shares directly from the Trust at any time. In 1929, the majority of funds were still based on the original Dutch closed-end structure and only a few were open-ended. The crash of the stock market in 1929 changed the situation and closed-end funds lost their popularity and open-end funds skyrocketed in popularity¹².

The third phase of evolution of investment companies started with the creation of SEC (Securities and Exchange Commission) in USA. The enactment of the securities exchange act of 1934 to protect the investors, Mutual funds were required to get registered with the SEC and to provide the disclosures in the form of prospectus. The investment company’s act of 1940 put in place additional regulation that required more discussions and sought to minimize grievances of investors of different categories. It also provided rules and regulations for the establishment and management of Mutual Funds¹³.

During the Second World War period Mutual funds lost their popularity, as security market was worse affected. This condition was altered after world war II, renewed interest in mutual funds developed as, stock market rose. By offering professional management to small and medium size investors, Mutual funds were able to attract more funds and acquire more assets for investment in rising stock markets. As a result they increased their assets at a compound annual rate
of nearly 18% from 1945 to 1965 in the USA. As these funds invest predominantly in the equity market, the decline of the stock market in 1970's again resulted in poor returns on Mutual funds, thereby becoming unattractive for the investors. This made investors to look for the other attractive avenues for investment. In the absence of any such attractive avenues, investors were inclined towards to invest in money market which was at the time offering higher returns. With the growing interest of investors in money market, mutual funds came up with money market funds, funds that invest exclusively in the money market. The success of money market mutual funds accelerated the evolution of other kinds of innovative mutual funds like Fixed income funds, tax exempt mutual funds, emerging market mutual funds etc. It became the starting point of development of present day Mutual funds Industry. Today Mutual funds offer various kinds of schemes for different categories of investors. This has become the prime factor for the growth and development of Mutual Funds industry all over the world. The number of Mutual funds grew from 68 funds in 1940 to more than 3000 funds all over the world as shown in table below:

Table 2.1 Total number of Mutual funds/Schemes around the world

<table>
<thead>
<tr>
<th>Year</th>
<th>Mutual Funds</th>
<th>Year</th>
<th>Mutual Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1940</td>
<td>08</td>
<td>2001</td>
<td>52849</td>
</tr>
<tr>
<td>1945</td>
<td>73</td>
<td>2002</td>
<td>54110</td>
</tr>
<tr>
<td>1950</td>
<td>103</td>
<td>2003</td>
<td>54569</td>
</tr>
<tr>
<td>1960</td>
<td>161</td>
<td>2004</td>
<td>55524</td>
</tr>
<tr>
<td>1970</td>
<td>361</td>
<td>2005</td>
<td>56868</td>
</tr>
<tr>
<td>1975</td>
<td>426</td>
<td>2006</td>
<td>61506</td>
</tr>
<tr>
<td>1980</td>
<td>564</td>
<td>2007</td>
<td>61506</td>
</tr>
<tr>
<td>1985</td>
<td>1531</td>
<td>2008</td>
<td>69032</td>
</tr>
<tr>
<td>1990</td>
<td>3000</td>
<td>2009</td>
<td>65735</td>
</tr>
</tbody>
</table>


The Table 2.1 clearly shows that total mutual fund companies during 1940 were only 8 and in 1990 total mutual fund companies tremendously increased to 3000.
During 2009, the total number of mutual funds were as high as 65735. Therefore the table clearly shows that the mutual fund industry has grown in leaps and bound since it starts.

Table-2.2 Total Number of Indian Mutual Funds (Sector-Wise)

<table>
<thead>
<tr>
<th>Year</th>
<th>Public Sector</th>
<th>Private Sector</th>
<th>Total</th>
<th>CAGR</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997-98</td>
<td>10</td>
<td>21</td>
<td>31</td>
<td></td>
</tr>
<tr>
<td>1998-99</td>
<td>10</td>
<td>22</td>
<td>32</td>
<td>3%</td>
</tr>
<tr>
<td>1999-00</td>
<td>11</td>
<td>21</td>
<td>32</td>
<td>0%</td>
</tr>
<tr>
<td>2000-01</td>
<td>11</td>
<td>24</td>
<td>35</td>
<td>9%</td>
</tr>
<tr>
<td>2001-02</td>
<td>10</td>
<td>25</td>
<td>35</td>
<td>0%</td>
</tr>
<tr>
<td>2002-03</td>
<td>9</td>
<td>24</td>
<td>33</td>
<td>-6%</td>
</tr>
<tr>
<td>2003-04</td>
<td>8</td>
<td>23</td>
<td>31</td>
<td>-6%</td>
</tr>
<tr>
<td>2004-05</td>
<td>6</td>
<td>23</td>
<td>29</td>
<td>-6%</td>
</tr>
<tr>
<td>2005-06</td>
<td>5</td>
<td>24</td>
<td>29</td>
<td>0%</td>
</tr>
<tr>
<td>2006-07</td>
<td>5</td>
<td>25</td>
<td>30</td>
<td>3%</td>
</tr>
<tr>
<td>2007-08</td>
<td>5</td>
<td>28</td>
<td>33</td>
<td>10%</td>
</tr>
<tr>
<td>2008-09</td>
<td>5</td>
<td>30</td>
<td>35</td>
<td>6%</td>
</tr>
<tr>
<td>2009-10</td>
<td>5</td>
<td>33</td>
<td>38</td>
<td>9%</td>
</tr>
<tr>
<td>2010-11</td>
<td>6</td>
<td>35</td>
<td>41</td>
<td>8%</td>
</tr>
<tr>
<td>CGR</td>
<td>-4%</td>
<td>4%</td>
<td>2%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Figures collected from different years, - Booklets of AMFI

The table 2.2 shows the total number of Public and Private sector Mutual funds since 1997-98 to 2010-11. From the table it can be seen that the total number of Indian Mutual funds had a positive growth rate from 3% (1998-99) to 8% (2010-11) in terms of number of funds in operation. However, the Industry also had a negative growth rate of (-) 6 percent from the year 2003 to 2005. Private sector Indian mutual funds had grown by 4 percent whereas Public sector mutual funds had decreased by (-4) percent since 1997-98. The number of Public sector mutual funds has declined from 11 in 2001 to five in 2009, with UTI, LIC and SBI being the main PSU players.

The CAGR of the number of funds in operation shows wide fluctuations with positive and negative figures revealing that the industry had undergone a lot of mergers, acquisition and closures during the period of study. The CGR of the
industry shows a positive trend (2 percent) due to the increase in the number of funds from 31 to 41 since 1997-98.

2.4 Origin of Mutual Fund in India

The mutual fund industry in India began with the setting up of the UTI in 1964 July by the government of India. The need for the establishment of unit trust type of institution was felt in 1931 by the Indian central banking enquiry committee. The committee observed in this report that "An immeasurable benefit to India is bound to grow from the establishment and proper working of unit trusts, and the assistance which they will give to the investor in the creation of intermediate securities which do not exist, now in providing a channel for investment in industrial and other fields, where the primary investor would be too scared too ignorant."16

Again the committee on finance for private sector in India (1954) popularly called as the Shroff committee retreated the desirability of introducing units trust in the Indian capital market. The committees observed that in order to increase the capital available for industries, small savings have to be drawn in to the investment market. For mobilization of such savings unit trust are suitable17.

As a result, the impetus for establishing a formal institution came from the desire to increase the tendency of the middle and lower groups to save and to invest. Therefore, on the recommendation of Shroff committee in 1963, finance minister Mr. T.T. Krishnamachari had moved the bill on the unit trust of India in the parliament. In the debate on the bill, members expressed apprehension that the investment policy of the trust might come under the control of large business houses or the Finance Ministry, or that 'pro-government companies' might walk away with a lion's share of its investments. Some members expressed concern for small investors who might suffer capital losses and adverted to the possibility of speculative transactions in the absence of limits on the ownership of units. Replying to the debate, the Finance Minister clarified that the government did not intend to interfere in the investment policy of the trust and that it was not practical
to limit the holding of units by individuals. The question of unit holders being represented on the Board of Trustees of the trust was raised in both houses, with the government holding to the view that the nomination of such representatives was best left to the Bank. The Government decided that the new institution would be managed by the Bank which had its head office in Bombay. The bill, which passed the Lok Sabha on 5 December and the Rajya Sabha on 12 December, received the President's assent on 30 December 1963. It came into effect on 1 February 1964, on which date Unit Trust of India came into existence as an offshoot of the Bank. Soon after its inception the Trust opened branch offices in Calcutta (1964), Madras (1965), and Delhi (1967).

The Unit Trust of India came into existence with an initial capital of Rs 5 crores allocated between the Reserve Bank (Rs 2.5 crores), the Life Insurance Corporation (Rs 75 lakhs), and the State Bank of India and its subsidiaries (Rs 75 lakhs). Scheduled banks and other financial institutions were allocated Rupees one crore, despite their subscriptions exceeding this amount by about 10 per cent. Almost all foreign scheduled banks in India contributed to the initial capital. The Industrial Finance Corporation (Rs 25 lakhs), the ICICI (Rs 15 lakhs), and the Bank of India (Rs 10 lakhs) between them accounted for half the contribution from scheduled banks and other financial institutions. The Trust was allowed to raise resources by borrowing from any person or institution in or outside India other than the government or the Bank. It was also authorized to borrow from the Bank for short periods up to ninety days against trustee securities and for the medium-term up to eighteen months against the security of its bonds, with the approval and guarantee of the central government. The Unit Trust Act, as originally passed, allowed the organization to float only one unit scheme. However, in 1966 this limiting provision was relaxed to enable it to borrow against any other securities specified by the Bank for schemes other than the first unit scheme, subject to a ceiling of Us 5 crores for each such scheme and Rs 10 Crores in all. According to the Unit Trust of India Act, the general superintendence and management of the Trust was vested in a board of ten trustees, of whom the Chairman, the executive trustee, and four other trustees
were nominees of the Bank. While the Life Insurance Corporation and the State Bank of India would each nominate a trustee, two others were to be elected by the other contributing financial institutions and scheduled banks.19

Thereafter, the government of India amended banking regulation act in 1987 to enable commercial banks to launch mutual funds in India.20 Various public sector banks and insurance companies have set up mutual funds like SBI Mutual fund Canara bank mutual fund, LIC mutual fund etc. The success of Mutual Funds and their growth forced the Indian government to allow private sector corporate to join mutual fund industry on Feb 14, 1992. On February 19, 1993, the first batch of 12 private sector mutual funds was given "in-principle approval" by the Securities Exchange Board of India (SEBI). The erstwhile Kothari Pioneer Mutual fund (now merged with Franklin Templeton) was the first fund established in July 1993 in the private sector. The SEBI formulated the Mutual Fund Regulations in 1993 which was replaced by SEBI mutual fund regulations, 1996 provide guidelines for regulation, constitution, management and schemes of mutual funds in India (except UTI). With the rise of the mutual fund industry in India, establishment of a mutual fund association became a prerequisite. This is when AMFI (Association of Mutual Funds India) was set up on 22nd August, 1995 as a nonprofit organization. Today AMFI ensures mutual funds function in a professional and healthy manner thereby protecting the interest of the mutual funds as well as its investors. 21

2.5 Growth of mutual fund Industry

The mutual fund industry can be broadly put into five phases of growth according to the development of the sector. Each phase is briefly described as:

2.5.1 Pre liberalization Era of Mutual Funds Industry

Phase-1 Establishment and Growth of Unit Trust of India - 1964-87
Unit Trust of India enjoyed complete monopoly when it was established in the year 1963 by an act of Parliament. UTI was set up by the Reserve Bank of India and it continued to operate under the regulatory control of the RBI until the two
were de-linked in 1978 and the entire control was transferred in the hands of Industrial Development Bank of India (IDBI). UTI launched its first scheme in 1964, named as Unit Scheme 1964 (US-64), which attracted the largest number of investors in any single investment scheme over the years. UTI launched more innovative schemes in 1970s and 80s to suit the needs of different investors. It launched ULIP in 1971, six more schemes between 1981-84, Children's Gift Growth Fund and India Fund (India's first offshore fund) in 1986, Master share (India's first equity diversified scheme) in 1987 and Monthly Income Schemes (offering assured returns) during 1990s. By the end of 1987, UTI's assets under management grew ten times to Rs 6700 crores.  

Phase II. Entry of Public Sector Funds - 1987-1993

The Indian mutual fund industry witnessed a number of public sector players entering the market in the year 1987. In November 1987, SBI Mutual Fund from the State Bank of India became the first non-UTI mutual fund in India. SBI Mutual Fund was later followed by Can bank Mutual Fund, LIC Mutual Fund, Indian Bank Mutual Fund, Bank of India Mutual Fund, GIC Mutual Fund and PNB Mutual Fund. By 1993, the assets under management of the industry increased seven times to Rs. 47,004 crores. However, UTI remained to be the leader with about 80% market share.  

Table 2.3 Amount mobilized and asset under management in UTI and other Public Sector Mutual funds

<table>
<thead>
<tr>
<th>Year 1992-93</th>
<th>Amount Mobilised</th>
<th>Assets Under Management</th>
<th>Mobilisation as % of gross Domestic Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>UTI</td>
<td>11,057</td>
<td>38,247</td>
<td>5.2%</td>
</tr>
<tr>
<td>Public Sector</td>
<td>1,964</td>
<td>8,757</td>
<td>0.9%</td>
</tr>
<tr>
<td>Total</td>
<td>13,021</td>
<td>47,004</td>
<td>6.1%</td>
</tr>
</tbody>
</table>

Source: website of SEBI (www.ugc.gov.in)

The table 2.3 shows the figure of total amount mobilized by Public Sector Mutual Funds in the year 1992-93 which was Rs13021, out of which UTI alone constitute 5.2% of gross domestic savings and other Public Sector MF only 0.9 percent.
2.5.2 Post liberalization Era of Mutual Funds Industry

Phase III. Emergence of Private Sector Funds - 1993-96
The liberalization policy and new economic policy advocated by Dr. Manmohan Singh paved way for the entry of private sector in to mutual fund industry. The SEBI accorded approval to a number of players in the private sector to launch mutual funds in October 1993. The permission given to private sector funds including foreign fund management companies (most of them entering through joint ventures with Indian promoters) to enter the mutual fund industry provided a wide range of choice to investors and more competition in the industry. Private funds introduced innovative products, investment techniques and investor-servicing technology. By 1994-95, about 11 private sector funds had launched their schemes.

The mutual fund industry witnessed robust growth and stricter regulation from the SEBI after the year 1996. The mobilization of funds and the number of players operating in the industry reached new heights as investors started showing more interest in mutual funds. The Assets Under Management of UTI was Rs. 6700 crore by the end of 1987, thereafter the Assets Under Management rose to Rs. 47000 crore in March 1993 and again the figure had a three times higher performance by April 2004 as the AUM rose as high as Rs. 1,54000 crore. Inventors' interests were safeguarded by SEBI and the Government offered tax benefits to the investors in order to encourage them. SEBI (Mutual Funds) Regulations, 1996 was introduced by SEBI that set uniform standards for all mutual funds in India. The Union Budget in 1999 exempted all dividend incomes in the hands of investors from income tax. Various Investor Awareness Programmes were launched during this phase, both by SEBI and AMFI, with an objective to educate investors and make them informed about the mutual fund industry. On sep 19th 2002 board of trustees of the Unit Trust of India (UTI) decided to split its flagship fund, Unit Scheme-1964 (US-64), by carving out a Rs 181-crore corpus comprising investments of unit holders who came aboard after
January 2001. In December 2002, the UTI Act was repealed and UTI was stripped of its Special legal status as a trust formed by an Act of Parliament. The primary objective behind this was to bring all mutual fund players on the same level. 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. February 2003 marked the birth of UTI Mutual Fund with 47 schemes and a modest corpus of Rs 15000 crores, which is just a fifth the size of Unit Trust of India (UTI) at its peak. With the bifurcation of the erstwhile UTI which had in March 2000 more than Rs.76000 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. After 1999, there was a significant growth in mobilisation of funds from investors and assets under management which is supported by the following data:

Table 2.4 Gross Fund Mobilization by Mutual Fund Companies

<table>
<thead>
<tr>
<th>FROM</th>
<th>TO</th>
<th>UTI</th>
<th>Pub Sector</th>
<th>Pvt Sector</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>01-April-98</td>
<td>31-March-98</td>
<td>11,679</td>
<td>1,732</td>
<td>7,966</td>
<td>21,377</td>
</tr>
<tr>
<td>01-April-99</td>
<td>31-March-99</td>
<td>13,536</td>
<td>4,039</td>
<td>42,173</td>
<td>59,748</td>
</tr>
<tr>
<td>01-April-00</td>
<td>31-March-00</td>
<td>12,413</td>
<td>6,192</td>
<td>74,352</td>
<td>92,957</td>
</tr>
<tr>
<td>01-April-01</td>
<td>31-March-01</td>
<td>4,643</td>
<td>13,613</td>
<td>1,46,267</td>
<td>1,64,523</td>
</tr>
<tr>
<td>01-April-02</td>
<td>31-March-02</td>
<td>5,505</td>
<td>22,923</td>
<td>2,20,551</td>
<td>2,48,979</td>
</tr>
</tbody>
</table>

Source—AMFI Reports
Chapter 2 Conceptual and Regulatory framework of Mutual funds in India

The table 2.4 given in the previous page shows the total fund raised by mutual fund companies from the year 1998 to 2003. In the year 1998-1999, the UTI mobilized Rs 11679 crores, public sector mutual funds mobilized Rs 1,732 Crores and private mutual fund companies mobilized Rs. 7966 Crores. The year 2002-2003 shows the declining trend for the fund raised by the UTI as the fund mobilized only Rs 5505 Crores, public sector mutual funds mobilized Rs 22923 Crores and private mutual fund companies mobilized Rs 220551 Crores showing the increasing trend.

Phase V. Growth and Consolidation - 2004 Onwards

The industry has also witnessed several mergers and acquisitions in the recent past, examples of which are acquisition of schemes of Alliance Mutual Fund by Birla Sun Life, Sun F&C Mutual Fund and PNB Mutual Fund by Principal Mutual Fund. Simultaneously, more international mutual fund players have entered India like Fidelity, Franklin Templeton Mutual Fund etc. There were 29 funds as at the end of March 2006 to 33 funds at January 2003 managing assets of Rs. 79464.32 This industry indeed come a very long way with 41 players in the market and more than 1131 schemes in 2011. This is a continuing phase of growth of the industry through consolidation and entry of new international and private sector players. The size of Indian mutual fund industry has grown in recent few years. India can now boast of having dominance in this industry.33

Chart 2.2 Growth in Assets under Management in India

![Growth in Assets under Management in India](chart.png)

Source: AMFI website

63
2.6 Organization of a Mutual Fund

Organization of a Mutual Fund helps in the proper management of the Mutual Fund portfolio. A number of entities are involved in the Organization of the mutual fund. The names of the players involved in setting up a mutual fund are sponsor, mutual fund trust, and asset management company (AMC). They are again assisted by other independent administrative entities like banks, registrars, transfer agents, and custodians (depository participants).

Chart 2.3 Mutual fund structures in India

Source: www.amfi.com

2.6.1 Sponsor

Sponsor means any person acting alone or with another body corporate, establishes a mutual fund. The sponsor of a fund is akin to the promoter of a company as he gets the fund registered with SEBI. The sponsor should have a sound track record and general reputation of fairness and integrity in all his business transactions. This means that the sponsor should have been doing business in financial services for not less than five years, with positive net worth in all the immediately preceding five years. The net worth of the immediately preceding year should be more than the capital contribution of the sponsor in AMC and the sponsor should show profits after providing depreciation, interest, and tax for three out of the immediately preceding five years. The sponsor forms
a trust and appoints a Board of Trustees. He also appoints an Asset Management Company as fund managers. The sponsor, either directly or acting through the Trustees, also appoints a custodian to hold the fund assets. The sponsor is required to contribute at least 40% of the minimum net worth of the asset management company34.

2.6.2 Mutual Funds as Trusts

A mutual fund in India is formed in the form of a Trust under the Indian Trusts Act, 1882. The fund sponsor acts as the settler of the Trust registered the trust with SEBI, contributing to its initial capital and appoints a trustee to hold the assets of the Trust for the benefit of the unit holders, who are the beneficiaries of the Trust. The fund then invites investors to contribute their money in the common pool, by subscribing to 'units' issued by various schemes established by the Trust as evidence of their beneficial interest in the fund. Thus, a mutual fund is just a 'pass through' vehicle. Most of the funds in India are managed by the Board of Trustees, which is an independent body and acts as protector of the unit holders' interests. At least, 50% of the trustees shall be independent trustees (who are not associated with an associate, subsidiary, or sponsor in any manner). The trustees shall be accountable for and be the custodian of funds/property of respective scheme35.

2.6.3 Asset Management Company

A sponsor or the trustees appoint an Asset Management Company (AMC) with the prior approval of SEBI. According to Regulation 20(1) of SEBI (Mutual funds) Regulation, 1993, an Asset Management Company means a company formed and registered under Company Act, 1956 and approved by the board under regulation 20 of the company act36. It charges a fee for the services it renders to the mutual fund trust. It acts as the investment manager to the Trust under the supervision and direction of the trustees.

The AMC, in the name of the Trust, floats and then manages the different investment schemes as per SEBI regulations and the Trust Deed. The AMC
Chapter 2 Conceptual and Regulatory framework of Mutual funds in India

should be registered with SEBI. The AMC of a mutual fund must have a net worth of at least Rs 10 Crores at all times and this net worth should be in the form of cash. It cannot act as a trustee of any other mutual fund. It is required to disclose the scheme particulars and base of calculation of NAV. It can undertake specific activities such as advisory services and financial consultancy. It must submit quarterly reports to the mutual fund. The trustees are empowered to terminate the appointment of the AMC and may appoint a new AMC with the prior approval of the SEBI and unit-holders. At least 50% of the directors of the board of directors of AMC should not be associated with the sponsor or its subsidiaries or the trustees.

2.6.4 Custodian

Custodian is often an independent organization and takes the custody of securities and other assets of the Mutual Fund. Mutual fund shall appoint custodian for carrying out custodial services for schemes of the funds and intimate the same to SEBI within 15 days of appointment. Its responsibilities include receipt and delivery of securities, collecting income-distributing dividends, safekeeping of the units and segregating assets and settlements between schemes. Their charges range from 0.15% to 0.2% of the net value of the holding. Custodians can service more than one fund.

2.7 Operation of the Mutual Fund Industry

Mutual Funds offer units or shares to the Public by issuing an offer document or prospectus for collecting the funds. The money collected from this offer document is invested in the market as per the investment objectives stated in the prospectus. The aim of Mutual funds is to invest in variety of securities in different industries so that the exposure to risk can be minimised.

An expert fund manager is appointed under each scheme for the purpose of portfolio building and sale and purchase of the shares and debentures at the appropriate time in the market. The fund manager manages the schemes professionally which a common man cannot do. These fund managers are under
the control of the board of trustees of fund. Trustees guide the operation of the funds.

All the Mutual funds websites permits the investors to download the application forms and offer documents of their products. They also permit to download their financial accounts to see their past performance. It is mandatory for the Mutual funds to disclose all the information regarding their activities. Mutual funds publish their Net Asset Value every closing day. After the annual accounts are audited, the mutual funds ascertain the income earned by them. They distribute at least 90% of the income earned by them by way of dividend to the unit holders. After the duration of the schemes is over, they sell the securities of the scheme and thereby redeem the units by paying the investors their capital and also pay capital gains according to the number of units held by them.

2.8 Advantages of Mutual Fund

The following advantages may be obtained in the mutual fund investment:

2.8.1 Professional Management

Mutual Funds provide the services of experienced and skilled professionals, backed by a dedicated investment research team that analyses the performance and prospects of companies and selects suitable investments to achieve the objectives of the scheme.

2.8.2 Economies of Scale:

The pooling of large sums of money from so many investors makes it possible for the mutual fund to engage professional managers to manage the investment. Individual investors with small amounts to invest cannot, by themselves, afford to engage such professional management. Large investment corpus leads to various other economies of scale. For instance, costs related to investment research and office space get spread across investors. Further, the higher
transaction volume makes it possible to negotiate better terms with brokers, bankers and other service providers.\footnote{41}

\subsection{2.8.3 Tax benefits}

Specific schemes of mutual funds (Equity Linked Savings Schemes) give investors the benefit of deduction of the amount invested, from their income that is liable to tax. This reduces their taxable income, and therefore the tax liability. Further, the dividend that the investor receives from the scheme is tax-free in his hands. The options offered under a scheme allow investors to structure their investments in line with their liquidity preference and tax position.\footnote{42}

\subsection{2.8.4 Diversification}

Mutual Funds invest in a number of companies across a broad cross-section of industries and sectors. This diversification reduces the risk because seldom do all stocks decline at the same time and in the same proportion. By purchasing mutual funds, an investor is provided with the immediate benefit of instant diversification and asset allocation without the large amounts of cash needed to create individual portfolios.\footnote{43}

\subsection{2.8.5 Convenient Administration}

Investing in a Mutual Fund reduces paperwork and helps you avoid many problems such as bad deliveries, delayed payments and follow up with brokers and companies. Mutual Funds save your time and make investing easy and convenient.

\subsection{2.8.6 Divisibility}

"Investors can purchase mutual funds in smaller denominations, ranging from Rs. 5,000 minimum to onward. Smaller denominations of mutual funds provide mutual fund investors the ability to make periodic investments through monthly purchase plans while taking advantage of dollar-cost averaging. So, rather than having to wait until you have enough money to buy higher-cost investments, you..."
can get in right away with mutual funds. This provides an additional advantage — liquidity.  

2.8.7 Low Costs

Mutual Funds are a relatively less expensive way to invest compared to directly investing in the capital markets because the benefits of scale in brokerage, custodial and other fees translate into lower costs for investors.

2.8.8 Return Potential

Over a medium to long-term, Mutual Funds have the potential to provide a higher return as they invest in a diversified basket of selected securities.

2.8.9 Liquidity

In open-end schemes, the investor gets the money back promptly at net asset value related prices from the Mutual Fund. In closed-end schemes, the units can be sold on a stock exchange at the prevailing market price or the investor can avail of the facility of direct repurchase at NAV related prices by the Mutual Fund.

2.8.10 Transparency

Investors get regular information on the value of their investment in addition to disclosure on the specific investments made by their scheme, the proportion invested in each class of assets and the fund manager’s investment strategy and outlook.

2.8.11 Flexibility

Through features such as regular investment plans, regular withdrawal plans and dividend reinvestment plans, you can systematically invest or withdraw funds according to your needs and convenience.

2.8.12 Choice of Schemes

Mutual Funds offer a family of schemes to suit your varying needs over a lifetime.
2.8.13 Affordability

Investors individually may lack sufficient funds to invest in high-grade stocks. A mutual fund because of its large corpus allows even a small investor to take the benefit of its investment strategy.

2.8.14 No speculative trading

In stock trading investors react to price movements instantly but this benefit will be missing in Mutual Funds investment units' trading, Mr. Sundaram said: "The concept of investing in mutual fund is going to remain the same. Investors are not going to trade in MF units the way they do in stocks." 

2.8.16 Well Regulated

All Mutual Funds are registered with SEBI and they function within the provisions of strict regulations designed to protect the interests of investors. The operations of Mutual Funds are regularly monitored by SEBI.

2.9 Disadvantages of Mutual Fund

As with any investment, there are risks involved in buying mutual funds. These investment vehicles can experience market fluctuations and sometimes provide returns below the overall market. Also, the advantages gained from mutual funds are not free: many of them carry loads, annual expense fees and penalties for early withdrawal. To learn about the other realities of mutual funds following Disadvantages of Mutual Funds are given below.

2.9.1 Entry and Exit load

Mutual funds are a victim of their own success. When a large body like a fund invests in shares, the concentrated buying or selling in adverse price movements lay at the time of buying, the fund ends up paying a higher price and while selling it realize a lower price. This problem is especially severe in emerging markets like India, where, excluding a few stocks, even the stocks in the SENSEX are not
liquid. Let alone stocks in the NSE 50 or the CRISIL 500. So there is simply no way that a fund can beat the SENSEX or any other index, if it is blindly invests in the same stocks as those in the SENSEX and in the same proportion.

2.9.2 No control over costs

The costs of the fund management process are deducted from the fund. This includes marketing and initial costs deducted at the time of entry itself, called, 'Load'. Then there is the annual asset management fee and expenses, together called the expense ratio. Usually, the former is not counted while measuring performance, while the latter is. A Standard 2 percent expense ratio means that, everything else being equal, the fund manager under performs the benchmark index by an equal amount.

2.9.3 No tailor-made portfolio

The portfolio of a fund does not remain constant. The extent to which the portfolio changes is a function of the style of the individual fund manager i.e. whether he is a buy and hold type of manager or one who aggressively churns the fund. It is also depends on the volatility of the fund size i.e. whether the fund constantly receives fresh subscriptions and redemptions. Such portfolios changes have associated costs of brokerage, custody fees, registration fees etc. that lowers the portfolio return commensurately.

2.9.4 No Guarantee of return

No investment is risk free. If the entire stock market declines in value, the value of mutual fund shares will go down as well, no matter how balanced the portfolio. Investors encounter fewer risks when they invest in mutual funds than when they buy and sell stocks on their own. However, anyone who invests through a mutual fund runs the risk of losing money.
2.9.5 Taxes

During a typical year, most actively managed mutual funds sell anywhere from 20 to 70 percent of the securities in their portfolios. If your fund makes a profit on its sales, you will pay taxes on the income you receive, even if you reinvest the money you made.

2.9.6 Management risk

When you invest in a mutual fund, you depend on the fund's manager to make the right decisions regarding the fund's portfolio. If the manager does not perform as well as you had hoped, you might not make as much money on your investment as you expected. Of course, if you invest in Index Funds, you forego management risk, because these funds do not employ managers.

2.10 Type of Mutual Fund Schemes

The mutual fund schemes may be classified on different basis like objectives and structure of mutual funds which are explained on the next page;
Chapter 2 Conceptual and Regulatory framework of Mutual funds in India

2.10.1 Classification on the basis of structure

Open Ended Schemes

SEBI regulation defines open ended schemes as, “schemes of Mutual fund which is offering unit for sale or has outstanding any redeemable units and which does not satisfy any duration for redemption or repurchase of units”. An open-end fund is one that is available for subscription all through the year. These do not have a fixed maturity. Investors can conveniently buy and sell units at Net Asset Value ("NAV") related prices. Open ended Mutual funds are more transparent as the units are directly bought and sold by the funds. The key feature of open-end schemes is liquidity.

Close Ended Schemes

A closed-end fund has a stipulated maturity period which generally ranging from 3 to 15 years. The fund is open for subscription only during a specified period. Investors can invest in the scheme at the time of the initial public issue and thereafter they can buy or sell the units of the scheme on the stock exchanges where they are listed. In order to provide an exit route to the investors, some close-ended funds give an option of selling back the units to the Mutual Fund through periodic repurchase at NAV related prices. SEBI Regulations stipulate that at least one of the two exit routes is provided to the investor. Close ended funds were very popular in India, however the popularity of these funds has decreased since 1991. As during 1990-1991 18 schemes were launched out of which 15 (83%) were close ended and 3(17%) were open ended.

Interval Schemes

Interval Schemes are that scheme, which combines the features of open-ended and close-ended schemes. The units may be traded on the stock exchange or may be open for sale or redemption during pre-determined intervals at NAV related prices.
2.10.2 Classification on the basis of nature

A. Equity fund

These funds invest a maximum part of their corpus into equities holdings. The structure of the fund may vary different for different schemes and the fund manager’s outlook on different stocks. The Equity Funds are sub-classified depending upon their investment objective, as follows:

- Diversified Equity Funds
- Mid-Cap Funds
- Sector Specific Funds
- Tax Savings Funds (ELSS)

Equity investments are meant for a longer time horizon, thus Equity funds rank high on the risk-return matrix.

B. Debt funds

The objective of these Funds is to invest in debt papers. Government authorities, private companies, banks and financial institutions are some of the major issuers of debt papers. By investing in debt instruments, these funds ensure low risk and provide stable income to the investors. Debt funds are further classified as:

- **Gilt Funds**: Invest their corpus in securities issued by Government, popularly known as Government of India debt papers. These Funds carry zero Default risk but are associated with Interest Rate risk. These schemes are safer as they invest in papers backed by Government.

- **Income Funds**: Invest a major portion into various debt instruments such as bonds, corporate debentures and Government securities.

- **MIPs**: Invests maximum of their total corpus in debt instruments while they take minimum exposure in equities. It gets benefit of both equity and debt
market. These scheme ranks slightly high on the risk-return matrix when compared with other debt schemes.

- **Short Term Plans (STPs):** Meant for investment horizon for three to six months. These funds primarily invest in short term papers like Certificate of Deposits (CDs) and Commercial Papers (CPs). Some portion of the corpus is also invested in corporate debentures.

- **Liquid Funds:** Also known as Money Market Schemes, These funds provides easy liquidity and preservation of capital. These schemes invest in short-term instruments like Treasury Bills, inter-bank call money market, CPs and CDs. These funds are meant for short-term cash management of corporate houses and are meant for an investment horizon of 1 day to 3 months. These schemes rank low on risk-return matrix and are considered to be the safest amongst all categories of mutual funds.

### C. Balanced funds

As the name suggest they, are a mix of both equity and debt funds. They invest in both equities and fixed income securities, which are in line with pre-defined investment objective of the scheme. These schemes aim to provide investors with the best of both the worlds. Equity part provides growth and the debt part provides stability in returns. Further, the mutual funds can be broadly classified on the basis of investment parameter viz; each category of funds is backed by an investment philosophy, which is pre-defined in the objectives of the fund. The investor can align his own investment needs with the funds objective and invest accordingly.

#### 2.10.3 Classification on the basis of investment objectives

- **Growth Schemes:** Growth Schemes are also known as equity schemes. The aim of these schemes is to provide capital appreciation over medium to long term. These schemes normally invest a major part of their fund in equities and are willing to bear short-term decline in value for possible future appreciation.
Chapter 2 Conceptual and Regulatory framework of Mutual funds in India

- **Income Schemes**: Income Schemes are also known as debt schemes. The aim of these schemes is to provide regular and steady income to investors. These schemes generally invest in fixed income securities such as bonds and corporate debentures. Capital appreciation in such schemes may be limited.

- **Balanced Schemes**: Balanced Schemes aim to provide both growth and income by periodically distributing a part of the income and capital gains they earn. These schemes invest in both shares and fixed income securities, in the proportion indicated in their offer documents (normally 50:50).

- **Money Market Schemes**: These funds were initiated during 1973 in the USA. Money Market Schemes aim to provide easy liquidity, preservation of capital and moderate income. These schemes generally invest in safer, short-term instruments, such as treasury bills, certificates of deposit, commercial paper and inter-bank call money. This scheme enables retail investor to earn return, otherwise available only to large and institutional investors. Money Market Mutual fund scheme also offer the advantage of bulk purchases, access to short term markets, expertise of a professional fund manager, lower transaction cost, liquidity and flexibility.

**Other schemes**

- **Tax Saving Schemes**: Tax-saving schemes offer tax rebates to the investors under tax laws prescribed from time to time. Under Sec. 88 of the Income Tax Act, contributions made to any Equity Linked Savings Scheme (ELSS) are eligible for rebate.

- **Index Schemes**: Index schemes attempt to replicate the performance of a particular index such as the BSE SENSEX or the NSE 50. The portfolio of these schemes will consist of only those stocks that constitute the index. The percentage of each stock to the total holding will be identical to the stocks index weight age. And hence, the returns from such schemes would be more or less equivalent to those of the Index.
- **Sector Specific Schemes**: These are the funds/schemes which invest in the securities of only those sectors or industries as specified in the offer documents. e.g. Pharmaceuticals, Software, Fast Moving Consumer Goods (FMCG), Petroleum stocks, etc. The returns in these funds are dependent on the performance of the respective sectors/industries. While these funds may give higher returns, they are more risky compared to diversified funds. Investors need to keep a watch on the performance of those sectors/industries and must exit at an appropriate time.

### 2.11 Net Asset Value (NAV)

Since each owner is a part owner of a mutual fund, it is necessary to establish the value of his part. In other words, each share or unit that an investor holds needs to be assigned a value. Since the units held by investor evidence the ownership of the fund’s assets, the value of the total assets of the fund when divided by the total number of units issued by the mutual fund gives us the value of one unit. This is generally called the Net Asset Value (NAV) of one unit or one share. The value of an investor’s part ownership is thus determined by the NAV of the number of units held.

#### 2.11.1 Calculation of NAV

Let us see an example. If the value of a fund’s assets stands at Rs. 100 and it has 10 investors who have bought 10 units each, the total numbers of units issued are 100, and the value of one unit is Rs. 10.00 (1000/100). If a single investor in fact owns 3 units, the value of his ownership of the fund will be Rs. 30.00 (1000/100*3). Note that the value of the fund’s investments will keep fluctuating with the market-price movements, causing the Net Asset Value also to fluctuate. For example, if the value of our fund’s asset increased from Rs. 1000 to 1200, the value of our investors holding of 3 units will now be (1200/100*3) Rs. 36. The investment value can go up or down, depending on the markets value of the fund’s assets.
2.12 Mutual Fund Fees and Expenses

Mutual fund fees and expenses are charges that may be incurred by investors who hold mutual funds. Running a mutual fund involves costs, including shareholder transaction costs, investment advisory fees, and marketing and distribution expenses. Expense ratio of the scheme tells the investors how much the fund is charging from them. It is a charge paid by an investor to an asset management company for managing his money. It is an ongoing expense and charged as a percentage of net assets of the fund. SEBI regulations permit equity funds to charge a maximum of 2.5% as expense ratio, while in the case of debt funds, the maximum is 2.25%. Funds pass along these costs to investors in a number of ways.

(A) Transaction Fees

Purchase Fee: It is a type of fee that some funds charge their shareholders when they buy shares. Unlike a front-end sales load, a purchase fee is paid to the fund (not to a broker) and is typically imposed to defray some of the fund’s costs associated with the purchase.

ii) Redemption Fee: It is another type of fee that some funds charge from their shareholders when they sell or redeem shares. Unlike a deferred sales load, a redemption fee is paid to the fund (not to broker) and is typically used to defray fund costs associated with a shareholder’s redemption.

iii) Exchange Fee: Exchange fee that some funds impose on shareholders, if they exchange (transfer) to another fund within the same fund group or “family of funds.”

(B) Periodic Fees

i) Management Fee: Management fees are fees that are paid out of fund assets to the fund’s investment adviser for investment portfolio management, any other management fees payable to the fund’s investment adviser or its affiliates, and
administrative fees payable to the investment adviser that are not included in the "Other Expenses" category. They are also called maintenance fees.

ii) Account Fee: Account fees are fees that some funds separately impose on investors in connection with the maintenance of their accounts. For example, some funds impose an account maintenance fee on accounts whose value is less than a certain dollar amount.

(C). Other Operating Expenses

Transaction Costs: These costs are incurred in the trading of the fund's assets. Funds with a high turnover ratio or investing in illiquid or exotic markets usually face higher transaction costs. Unlike the Total Expense Ratio these costs are usually not reported.

Loads: Load funds exhibit a "Sales Load" with a percentage charge levied on purchase or sale of shares. A load is a type of Commission (remuneration). Depending on the type of load a mutual fund exhibits, charges may be incurred at time of purchase, time of sale, or a mix of both. The different types of loads are outlined below.

(a) Front-end load: Also known as Sales Charge, this is a fee paid on shares

(b) Level load / Low load: It's similar to a back-end load in that no sales charges are paid when buying the fund. Instead a back-end load may be charged if the shares purchased are sold within a given time frame. The distinction between level loads and low loads as opposed to back-end loads is that this time frame where charges are levied is shorter.

(c) No-load Fund: As the name implies, this means that the fund does not charge any type of sales load. But, as outlined above, not every type of shareholder fee is a "sales load." A no-load fund may charge fees that are not sales loads, such as purchase fees, redemption fees, exchange fees, and account fees.
2.13 Association of Mutual Fund in India (AMFI)

With the increase in mutual fund players in India, a need for mutual fund association in India was generated to function as a non-profit organization. Association of Mutual Funds in India (AMFI) was incorporated on 22nd August, 1995. AMFI is an apex body of all Asset Management Companies (AMC) which has been registered with SEBI. Till date all the AMCs are that have launched mutual fund schemes are its members. It functions under the supervision and guidelines of its Board of Directors. Association of Mutual Funds India have brought down the Indian Mutual Fund Industry to a professional and healthy market with ethical lines enhancing and maintaining standards. It follows the principle of both protecting and promoting the interests of mutual funds as well as their unit holders.

AMFI has submitted a proposal for gradually moving towards becoming a Self Regulatory Body. AMFI plans to achieve SRO status by 2014-15.

2.13.1 The Objectives of Association of Mutual Funds in India:

The Association of Mutual Funds of India works with 30 registered AMCs of the country. It has certain defined objectives which juxtaposes the guidelines of its Board of Directors. The objectives are as follows:

1. This mutual fund association of India maintains high professional and ethical standards in all areas of operation of the industry.

2. It also recommends and promotes the top class business practices and code of conduct which is followed by members and related people engaged in the activities of mutual fund and asset management. The agencies who are by any means connected or involved in the field of capital markets and financial services also involved in this code of conduct of the association.

3. AMFI interacts with SEBI and works according to SEBI's guidelines in the mutual fund industry.
4. Association of Mutual Fund of India does represent the Government of India, the Reserve Bank of India and other related bodies on matters relating to the Mutual Fund Industry.

5. It develops a team of well qualified and trained Agent distributors. It implements a program me of training and certification for all intermediaries and other engaged in the mutual fund industry.

2.14 Asset Management Companies of Mutual Funds

Some of the AMCs Operating Currently in India are given in the Table given on the next page:

<table>
<thead>
<tr>
<th>Name of the AMC</th>
<th>Nature of ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alliance Capital Asset Management (I) Private Limited</td>
<td>Private foreign</td>
</tr>
<tr>
<td>Birla Sun Life Asset Management Company Limited</td>
<td>Private Indian</td>
</tr>
<tr>
<td>Bank of Baroda Asset Management Company Limited</td>
<td>Banks</td>
</tr>
<tr>
<td>Bank of India Asset Management Company Limited</td>
<td>Banks</td>
</tr>
<tr>
<td>Can bank Investment Management Services Limited</td>
<td>Banks</td>
</tr>
<tr>
<td>Cholamandalam Cazenove Asset Management Company Limited</td>
<td>Private foreign</td>
</tr>
<tr>
<td>Dundee Asset Management Company Limited</td>
<td>Private foreign</td>
</tr>
<tr>
<td>DSP Merrill Lynch Asset Management Company Limited</td>
<td>Private foreign</td>
</tr>
<tr>
<td>Escorts Asset Management Limited</td>
<td>Private Indian</td>
</tr>
<tr>
<td>First India Asset Management Limited</td>
<td>Private Indian</td>
</tr>
<tr>
<td>GIC Asset Management Company Limited</td>
<td>Institutions</td>
</tr>
<tr>
<td>IDBI Investment Management Company Limited</td>
<td>Institutions</td>
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<tr>
<td>Indfund Management Limited</td>
<td>Banks</td>
</tr>
<tr>
<td>ING Investment Asset Management Company Private Limited</td>
<td>Private foreign</td>
</tr>
<tr>
<td>J M Capital Management Limited</td>
<td>Private Indian</td>
</tr>
<tr>
<td>Jardine Fleming (I) Asset Management Limited</td>
<td>Private foreign</td>
</tr>
<tr>
<td>Kotak Mahindra Asset Management Company Limited</td>
<td>Private Indian</td>
</tr>
<tr>
<td>Kothari Pioneer Asset Management Company Limited</td>
<td>Private Indian</td>
</tr>
<tr>
<td>Jeevan Bima Sahayog Asset Management Company Limited</td>
<td>Institutions</td>
</tr>
</tbody>
</table>
Chapter 2 - Conceptual and Regulatory framework of Mutual funds in India

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Ownership Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Morgan Stanley Asset Management Company Private Limited</td>
<td>Private foreign</td>
</tr>
<tr>
<td>Punjab National Bank Asset Management Company Limited</td>
<td>Banks</td>
</tr>
<tr>
<td>Reliance Capital Asset Management Company Limited</td>
<td>Private Indian</td>
</tr>
<tr>
<td>State Bank of India Funds Management Limited</td>
<td>Banks</td>
</tr>
<tr>
<td>Shriram Asset Management Company Limited</td>
<td>Private Indian</td>
</tr>
<tr>
<td>Sun F and C Asset Management (I) Private Limited</td>
<td>Private foreign</td>
</tr>
<tr>
<td>Sundaram Newton Asset Management Company Limited</td>
<td>Private foreign</td>
</tr>
<tr>
<td>Tata Asset Management Company Limited</td>
<td>Private Indian</td>
</tr>
<tr>
<td>Credit Capital Asset Management Company Limited</td>
<td>Private Indian</td>
</tr>
<tr>
<td>Templeton Asset Management (India) Private Limited</td>
<td>Private foreign</td>
</tr>
<tr>
<td>Unit Trust of India</td>
<td>Institutions</td>
</tr>
<tr>
<td>Zurich Asset Management Company (I) Limited</td>
<td>Private foreign</td>
</tr>
</tbody>
</table>

Source: Mutual funds India.com

2.15 Regulatory Framework of Mutual Funds in India

The Regulatory framework was designed to ensure that the Mutual funds are managed for the benefit of their investors. The Mutual fund must not become instrument for benefiting the promoters or the government and the privileged public sector institutions. Another objective of the regulatory system was to ensure that Mutual funds do not exploit their privileged position to gain an unfair advantage over individual investor’s who choose to manage their portfolio themselves.  

The ministry of finance, Govt. of India issued guidelines on June 28 (1990) which required approval of Mutual funds by controller of capital issues and their regulation with securities and exchange board of India. However SEBI role was minimized under these guidelines and it was only required to prescribe the accounting and disclosures requirements. Mutual funds focused the problems of compliance and monitoring due to the very existence of two set of guidelines. Thus in the year 1992, Securities and exchange Board of India (SEBI) Act was passed, which provided the regulations for all the mutual funds except UTI and became operational on January 1993.
Chapter 2  Conceptual and Regulatory framework of Mutual funds in India

2.15.1 Basic Guidelines of SEBI Regulation 1996

The fast growing industry is regulated by the Securities and Exchange Board of India (SEBI) since inception of SEBI as a statutory body. SEBI initially formulated SEBI regulation "1993" Providing detailed procedure for establishment, registration, constitution, management of Trustees, Asset Management Company, about schemes/products to be designed, about investment of funds collected, general obligation of MFs, about Inspection, audit etc. Based on experience gained and feedback received from the market SEBI revised the guidelines of 1993 and issued fresh Guidelines in 1996 titled "Securities and Exchange Board of India (mutual funds) regulations, 1996". The said regulations as amended from time to time are in force even today. The SEBI Mutual Fund Regulations contain ten chapters and twelve schedules. These guidelines are applicable to all the mutual funds that invest in the capital market.

(a) Establishment of mutual funds:

To develop Mutual funds, sponsorship is required. An application for registration of a mutual fund shall be made to the Board in Form A by the sponsor. The Board may require the sponsor to furnish such further information or clarification as may be required by it. An applicant proposing to sponsor a mutual fund in India must submit an application in Form A along with a fee of Rs.25, 000. The application form is examined and once the sponsor satisfies the prescribed eligibility criteria the registration certificate is issued in form B subject to the payment of registration fees of Rs.25.00 lakh.

(b) Constitution of the Mutual Fund

A mutual fund shall be constituted in the form of a trust and the instrument of trust shall be in the form of a deed, duly registered under the provisions of the Indian Registration Act, 1908 (16 of 1908) executed by the sponsor in favour of the trustees named in such an instrument.
(c) Appointment of Trustee

"The mutual fund is required to have an independent Board of Trustees, i.e. two thirds of the trustees should be independent persons who are not associated with the sponsors in any manner whatsoever. An AMC or any of its officers or employees is not eligible to act as a trustee of any mutual fund. In case a company is appointed as a trustee, then its directors can act as trustees of any other trust provided that the object of such other trust is not in conflict with the object of the mutual fund. Additionally, no person who is appointed as a trustee of a mutual fund can be appointed as a trustee of any other mutual fund unless he is an independent trustee and prior approval of the mutual fund of which he is a trustee has been obtained for such an appointment."62

Rights and Obligations of the Trustees: As per the regulation 1996, trustees are made more responsible for the action of AMC. The provisions given in Annexure 1 highlight their responsibilities.

(d) Appointment of an Asset Management Company

"The sponsor or the trustees are required to appoint an AMC to manage the assets of the mutual fund. Under the Mutual Fund Regulations, the applicant must satisfy certain eligibility criteria in order to qualify to register with SEBI as an AMC:

a. The sponsor must have at least 40% stake in the AMC;

b. The directors of the AMC should be persons having adequate professional experience in finance and financial services related field and not found guilty of moral turpitude or convicted of any economic offence or violation of any securities laws;

c. The AMC should have and must at all times maintain, a minimum net worth of Rs. 100 million;
Chapter 2  Conceptual and Regulatory framework of Mutual funds in India

d. The board of directors of such AMC has at least 50% directors, who are not associate of, or associated in any manner with, the sponsor or any of its subsidiaries or the trustees;

e. The Chairman of the AMC is not a trustee of any mutual fund.

f. In addition to the above eligibility criteria and other ongoing compliance requirements laid down in the Mutual Fund Regulations, the AMC is required to observe the following restrictions in its normal course of business:

i. Any director of the AMC cannot hold office of a director in another AMC unless such person is an independent director and the approval of the board of the AMC of which such person is a director, has been obtained;

ii. The AMC shall not act as a trustee of any mutual fund;

iii. The AMC cannot undertake any other business activities except activities in the nature of portfolio management services, management and advisory services to offshore funds, pension funds, provident funds, venture capital funds, management of insurance funds, financial consultancy and exchange of research on commercial basis if any of such activities are not in conflict with the activities of the mutual fund;. However, the AMC may, itself or through its subsidiaries, undertake such activities if it satisfies the Board that the key personnel of the asset management company, the systems, back office, bank and securities accounts are segregated activity wise and there exist systems to prohibit access to inside information of various activities.

iv. The AMC shall not invest in any of its schemes unless full disclosure of its intention to invest has been made in the offer. However, an AMC shall not be entitled to charge any fees on its investment in that scheme.

The AMC is required to take all reasonable steps and exercise due diligence to ensure that the investment of funds pertaining to any scheme are not contrary to the provisions of the Mutual Fund Regulations and the trust deed. An AMC cannot, through any broker associated with the sponsor, purchase or sell
Chapter 2 Conceptual and Regulatory framework of Mutual funds in India

securities, which is an average of 5% or more of the aggregate purchases and sale of securities made by the mutual fund in all its schemes. However, the aggregate purchase and sale of securities excludes the sale and distribution of units issued by the mutual fund and the limit of 5% shall apply only for a block of any three months. The duties and Obligation of AMC is given in Annexure 2

(e) Appointment of Custodian

(1) The mutual fund shall appoint a custodian to carry out the custodial services for the schemes of the fund and sent intimation of the same to the Board within fifteen days of the appointment of the custodian.

(2) No custodian in which the sponsor or its associates hold 50% or more of the voting rights of the share capital of the custodian or where 50% or more of the directors of the custodian represent the interest of the sponsor or its associates shall act as custodian for a mutual fund constituted by the same sponsor or any of its associate or subsidiary company.

(f) Schemes of Mutual funds

Under the Mutual Fund Regulations, a mutual fund is allowed to float different schemes. Each scheme has to be approved by the trustees and the offer document is required to be filed with the SEBI. Launch of different schemes depend on capital adequacy. Fund house are required to raise 50 Crores in open ended schemes and Rs 20 Crores in close ended schemes. It is mandatory that close ended schemes should be listed in some recognized stock exchange.

(g) Disclosures in the Offer Document

The offer document shall contain disclosures which are adequate in order to enable the investors to make informed investment decision including the disclosure on maximum investments proposed to be made by the scheme in the listed securities of the group companies of the sponsor. The trustees shall be bound to make such disclosures to the unit holders as are essential in order to
keep them informed about any information, which may have an adverse bearing on their investments. The current guidelines on portfolio disclosures make it mandatory for the funds to disclose their top ten holdings in the portfolio on a monthly basis. The SEBI Mutual funds regulation 1996 mandate completes portfolio disclosure once in a quarter. Going beyond the regulatory stipulation all AMC’s is disclosing the complete portfolio every month.

(h) Advertisement Material

Advertisements in respect of every scheme shall be in conformity with the Advertisement Code as specified in the Sixth Schedule and shall be submitted to the Board within 7 days from the date of issue.

(i) Investment and borrowing restrictions

The Mutual Fund Regulations has set down certain investment criteria that the mutual funds are required to observe. The money collected by a mutual fund under any scheme shall be invested only in transferable securities in the money market or in the capital market or in privately placed debentures or securitized debts. However, in the case of securitised debts, such fund may invest in asset backed securities and mortgaged backed securities. In addition to this, the mutual fund having an aggregate of securities which are worth Rs.100 million (approximately USD 2.15 million) or more shall be required to clear up their transactions through dematerialized securities.

Furthermore, mutual funds are not permitted to borrow money from the market except to meet provisional liquidity needs of the mutual funds for the purpose of repurchase, redemption of units or payment of interest or dividend to the unit holders. Still such borrowing cannot exceed 20% of the net asset of a scheme and the duration of such a borrowing cannot exceed a period of six months. Likewise, a mutual fund is not allowed to advance any loans for any purpose. A mutual fund is permitted to lend securities in accordance with the Stock Lending Scheme of SEBI. The funds of a scheme are prohibited from being used in option trading or in short selling or carry forward transactions. However, SEBI has
allowed mutual funds to go into derivative transactions on a recognized stock exchange for the reason of hedging and portfolio balancing and such investments in derivative instruments have to be made in accordance with SEBI Guidelines issued in this regard.

(j) Pricing of Units

The price at which the units may be subscribed or sold and the price at which such units may at any time be repurchased by the mutual fund shall be made available to the investors.

I. The mutual fund, in case of open ended scheme, shall at least once a week publish in a daily newspaper of all India circulation, the sale and repurchase price of units.

II. While determining the prices of the units, the mutual fund shall ensure that the repurchase price is not lower than 93% of the Net Asset Value and the sale price is not higher than 107% of the Net Asset Value.

a. Provided that the repurchase price of the units of a close ended scheme shall not be lower than 95% of the Net Asset Value.

b. Provided further that the difference between the repurchase price and the sale price of the unit shall not exceed 7% calculated on the sale price.

III. The price of units shall be determined with reference to the last determined Net Asset Value as mentioned in sub-regulation (3) unless,

a. The scheme announces the Net Asset Value on a daily basis; and

b. The sale price is determined with or without a fixed premium added to the future net asset value which is declared in advance.
(k) Investor protection and educating investor

Although several corrective reforms have been taken by the SEBI, it needs to be noted that both the regulator and market participants find it very difficult to restore the faith of the investors in the market. This is manifest from the fact that less than 5% of the total household savings is channelised into the securities market. Astonishingly, even well-qualified professionals like medical practitioners and engineers consider the equity market a ‘legalised Casino’.

Due to this backdrop, as a part of budgetary provisions SEBI has decided to set up an Investor Protection and Education Fund (IPEF). The regulator has recently issued a draft Securities and Exchange Board of India (Investor Protection and Education Fund) Regulation, 2008.

SEBI has clearly stated the main aim of the fund is to protect the interest of the investors and create awareness among them. It is not the lone advocate of investor education. The Association of Mutual Funds in India (AMFI), the Financial Planning Standards Board, India (FPSB) and market participants have also started embarking on investor education programmes. The need of the hour is to make investors awake about the functioning of the equity market. They must be explained the basics of both fundamental and technical issues. The influencing global and domestic factors like inflation and interest rate movements on the market should also be explained to the investors clearly. Investor safety is very important for the restoration of their faith in the market. A proper utilization of the IPEF will help in creating awareness among investors, which, in turn, can create a win-win situation not only for investors but also for the markets and the regulator.²¹

2.15.2 Further regulatory measures

The 1993 Regulations have been revised on the basis of the recommendations of the Mutual Funds 2000 Report prepared by SEBI. The revised regulations strongly emphasize the governance of mutual funds and increase the responsibility of the trustee in overseeing the functions of the asset management
company. Mutual funds are now required to obtain the consent of investors for any change in the "fundamental attributes" of a scheme, on the basis of which unit holders have invested. The revised regulations require disclosures in terms of portfolio composition, transactions by schemes of mutual funds with sponsors or affiliates of sponsors, with the asset Management Company and trustees, and also with respect to personal transactions of key personnel of asset management companies and of trustees.\(^2\)

In financial year 2000-01, SEBI issued code of conduct for advertisement banning mutual funds from making assurance or claims based on past performance that might mislead the investors. They were asked to disclose the non-performing assets (NPAs) and illiquid portfolio every six months. The Mutual funds were asked to disclose also the benchmark indices in case of equity-oriented schemes in order to enable the investor to compare the performance of the scheme with the given benchmark.

In financial year 2001-02, SEBI asked the AMCs to maintain records of each decision of investment in equity and debt securities and made it mandatory to launch the scheme within six months of its approval. In order to bring uniformity in the calculation of NAV of unlisted equity shares, it issued guidelines for the valuation of schemes.

During 2002-03 a uniform method was evolved to calculate the sale and repurchase price of the units. The SEBI mutual funds regulations were amended requiring that the trustees should meet at least six times a year and also to include the modalities for payment to, and recovery from, investors in case of discrepancy in calculation of NAV due to non-recording of transactions. A risk management system was evolved to be followed on a mandatory basis in the area of fund management, operations, and disaster recovery and business continuity etc. that was primarily based on existing industry practices.\(^3\) The union budget had abolished the distribution tax of on Mutual Funds on the dividends or income distributed by them.
The financial year 2003-04 provided that dividends are tax free in the hands of the shareholders or unit holders. Correspondingly, there will be 12.5 dividend distribution taxes on domestic companies and MFs. It is noticed that the government is changing the tax policy in respect of MFs too often.  

Securities Exchange Board of India (SEBI) announced the game changer policy of 'No entry load' on all mutual funds from August 1, 2009. This step is aimed at driving more transparency and service orientation from the advisors.  

Exit load is to be uniform across-the-board w.e.f. August 24, 2009 and can be imposed for exit by investor's up to one year. SEBI has stipulated that of the exit load or CDSC charged to the investor, a maximum of 1 per cent of the redemption proceeds should be maintained in a separate account, which could be used by the AMC to pay commissions to the distributors and to take care of the marketing and selling expenses, and any balance should be credited to the scheme immediately.  

In accordance with SEBI letter dated June 19, 2009 addressed to AMFI and subsequent guidelines issued by AMFI in this regard, investments through SIPs up to Rs 50,000 per year per investor shall be exempted from the requirement of PAN, with effect from August 1, 2009. The exemption shall be applicable for SIPs where aggregate of investments in a rolling 12 months period or in a financial year i.e. April to March does not exceed Rs 50,000.  

With effect from August 10, 2009, mutual funds will have to disclose inter scheme transfers of corporate bonds on stock exchanges where they are traded on a daily basis. Earlier, mutual funds used to disclose this data once in six months. Compliance department of most fund houses had already asked fund managers to curb inter scheme transfers.  

2.16 Conclusion  

In the present chapter the researcher has examined in detail about the Mutual Fund Industry, their working and their regulatory framework. Mutual funds are funds that pool the money of several investors to invest in equity or debt markets.
Mutual Funds could be Equity funds, Debt funds or balanced funds. The mutual fund industry started in India in a small way with the UTI. Over the years, this grew fairly successfully and gave investors a good return, and therefore in 1989, as the next logical step, public sector banks and financial institutions were allowed to float mutual funds and their success emboldened the government to allow the private sector to foray into this area. The advantages of mutual fund are professional management, diversification, and economies of scale, simplicity, and liquidity. The disadvantages of mutual fund are high costs, over-diversification, possible tax consequences, and the inability of management to guarantee a superior return. In the next chapter the researcher has worked on objective of studying in detail the role played by the Mutual Fund Industry after liberalisation in the development of Indian capital market.
Chapter 2 Conceptual and Regulatory framework of Mutual funds in India

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