Chapter No. 06

Mutual Fund Regulations and Government Policy

- Introduction.
- Financial Regulatory Bodies.
- Ministry of Finance.
- Securities and Exchange Board of India (SEBI).
- Reserve Bank of India.
- Association of Mutual Funds in India (AMFI).
- Self-Regulatory Organization (SRO).
- Procedure for registering a mutual fund with SEBI.
- State Monopoly on Mutual Funds.
- Regulation of Mutual Funds.
- Government Efforts in Establishment of Mutual Funds.
- Regulatory Aspects of Schemes of a Mutual Fund.
- Regulator of Mutual Funds.
- Computerization of Stock Exchange.
- Investment Company Act of 1940.
Introduction:

The development of mutual fund industry in Indian financial system evolved in such a way that there was social and economic justice with consideration of political and economic growth and development of the country. Since there was no strong financial mechanism in the operation of mutual fund in the country, chaotic conditions prevailed. It has a vital role in promoting efficiency and growth of economy. It increases the flow of funds from those who want to save a part of their income and form those who want to invest in productive assets. The effective operation of this mechanism for channelizing the savings of the community into investment in productive facilities, that is for allocating the country’s capital resources among alternative uses, done through capital market. The crucial role played by the capital market in shaping the pattern and growth of real output imparts a social significance to individual investment and portfolio decisions.

However, the mutual fund industry develops and attains a stage of maturity only after enactment of some uniform standards and rules. It is a widely accepted fact that it required concerted efforts and time to evolve standard regulations and procedures aiming at ensuring an orderly development of any activity. It is being increasingly believed that the role of the government should be restricted to the financial sector, and that the liberalization of the financial sectors is necessary to allocate efficiency. The structural
operation in practical field witnessed the process of dismantling of regulations and restrictions and the removal of control in the financial market. In this line, the process of liberalization has not always ensured optimum allocation of resources or been able to protect investors from market failures. This has raised doubts regarding uncontrolled liberalization and its impact on the economy in general and investors in particular. The debate about the utility, extent and quality of regulation in a free market economy is an ongoing one. The liberalization of the Indian financial market ensures competition in the market place. But any type of investment activity ensured optimum allocation of resources or been able to protect investors from market failures. In order to subdue the prevalence of risk associated with the regulatory measures it is necessary to play a vital role for attaining twin objectives of connecting market failures and protecting investors from potential loss.

In India under the present framework, the regulation of all participants in the securities market is the responsibility of SEBI with the exception of issuer’s capital. There is a considerable debate about the appropriate structure of regulation to be adopted by a country to regulate its financial services in general and investment business in particular. But there is always application of trial and error method for reaching at a solution for a complicated problem. The instances of regulatory structure can be either as statutory or legislative as in the USA or Self-Regulatory Organization as in the U.K., in practice, each of these is not free from limitations. The self-regulatory organization may not create enough public confidence although it is a less
bureaucratic and more collective and more practitioner oriented mechanism. On the other hand, Statutory Regulation may create more public confidence, but it is bureaucratic and may be unrealistic and costly. A suitable regulatory structure would be one, which is backed by legislative action and supported by industry practitioners.

Soon after introduction of liberalization of economic policy by reformations in 1991 the Indian economy witnessed a revolutionary change following SEBI is judicially fully empowered as the main regulator of all aspects of the securities in market and investor protection in India. SEBI’s basic objective, as the prime regulator of capital market activities in India, is to protect the interest of investors. This objective has been states in the preamble of the Securities and exchanges Board of India Act, 1991, to protect the interests of investors in securities and to promote the development of and to regulate, the securities market and for matters connected therewith or incidental thereto. Accordingly all the capital market activities including that of mutual funds are covered under the above objectives so far as investors’ protection is concerned.

Financial Regulatory Bodies:

Financial sector in India has experienced a better environment to grow with the presence of higher competition. The financial system in India is regulated by independent regulators in the field of banking, insurance, mortgage and capital market.
Ministry of Finance (MoF):

Government of India plays a significant role in controlling the financial market in India. Ministry of Finance, Government of India controls the financial sector in India. Every year the finance ministry presents the annual budget on 28th February. The Reserve Bank of India is an apex institution in controlling banking system in the country. Ministry of Finance is the supervisor of both the RBI & SEBI. Aggrieved parties can make appeals to the MOF on the SEBI ruling relating to the mutual funds.

Securities and Exchange Board of India (SEBI):

Securities and Exchange Board of India (SEBI) was first established in the year 1988 as a non-statutory body for regulating the securities market. It became an autonomous body in 1992 and more powers were given through an ordinance. Since then it regulates the market through its independent powers with the objectives of-

- It tries to develop the securities market.
- Promotes Investor’s Interest.
- It makes rules and regulations for the securities market.

Functions of SEBI:

- Regulates Capital Market
- Checks Trading of securities.
• It enhances investor’s knowledge on market by providing education.
• It regulates the stockbrokers and sub-brokers.
• It promotes Research and Investigation.
• Registers & regulates the working of venture capital funds & collective investing schemes, including Mutual Funds.
• It controls all the mutual funds both in private and public sector in India.

The Mutual Funds are regulated under the SEBI (MF) Regulations, 1996. All the MFs have to be registered with SEBI. The regulations have laid down a detailed procedure for launching of schemes, disclosures in the offer document, advertisements, listing and repurchase of close-ended schemes, offer period, transfer of units, investments, among others. In addition, RBI also supervises the operations of bank-owned MFs while SEBI regulates all market related and investor related activities of the bank/FI-owned funds, any issue concerning the ownership of the AMCs by banks falls under the regulatory ambit of the RBI.

**Reserve Bank of India:**

Reserve Bank of India is the apex monetary Institution of India. It is also called as the central bank of the country. The bank was established on April 1, 1935 according to the Reserve Bank of India act 1934. It acts as the apex monetary authority of the country. The Central Office of the Reserve Bank has been in
Mumbai since inception. The Central Office is where the Governor sits and is where policies are formulated. Though originally privately owned, since nationalization in 1949, the Reserve Bank is fully owned by the Government of India.

The preamble of the reserve bank of India is as follows:

RBI regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage. RBI is the monetary Authority and the Regulator of the banking system. Bank sponsored mutual funds were under the dual control of RBI & SEBI. Presently RBI is only the regulator of Bank sponsored mutual funds. SEBI is the regulator of all mutual funds. Mutual funds are affected by the RBI stipulations on structure, issuance, pricing & trading of Govt. securities.

Association of Mutual Funds in India (AMFI):

Association of Mutual Funds in India (AMFI) incorporated in Aug 1995 is the Umbrella body of all the mutual fund registered with SEBI. It is non-profit organization committed to develop the Indian mutual fund industry on professional, healthy & ethical lines & to enhance and maintain standards in all areas with a view to protecting & promoting the interests of Mutual Funds and their unit holders. AMFI is an industry association, incorporated in 1995,
is not an SRO, so it can just issue guidelines to members. It cannot enforce regulations.

**Objectives of AMFI:**

- To promote the interests of mutual funds and unit holders.
- To set ethical, commercial and professional standards in the industry.
- To increase public awareness of the mutual fund industry.
- AMFI is governed by a board of directors elected from mutual funds and is headed by a full-time chairman.
- AMFI has therefore prepared guidelines for intermediaries called AMFI Guidelines & Norms for Intermediaries.

**Self-Regulatory Organization (SRO):**

A self-regulatory organization (SRO) is an organization that exercises some degree of regulatory authority over an industry or profession. The regulatory authority could be applied in addition to some form of government regulation, or it could fill the vacuum of an absence of government oversight and regulation. The stock exchanges are regulated by SEBI, but they are registered SRO’s. It means SEBI is a frontline regulator & SRO is a sub regulator that reduces the burden of SEBI.
**Objectives of SRO:**

- Promote the investor protection & insure the market operate in a fair manner.

- Treat its entire member & any prospective person who applies for membership in a fair manner.

- Manage any possible conflict of interest that may arise by virtue of the role & function carried out by the SRO.

- Promote healthy competition in the market.

- Ensure that his member & officers duly complied with securities law, regulations, & guideline issued by SEBI.

SEBI will revisit rules on self-regulatory organizations and AMFI may be appointed as the first self-regulatory organization in India.

**Procedure for registering a mutual fund with SEBI:**

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 is examined and once the sponsor satisfies certain conditions such as being in the financial services business and possessing positive net worth for the last five years, having net profit in three out of the last five years and possessing the general
reputation of fairness and integrity in all business transactions, it is required to complete the remaining formalities for setting up a mutual fund. These include inter alia, executing the trust deed and investment management agreement, setting up a trustee company/board of trustees comprising two-thirds independent trustees, incorporating the asset management company (AMC), contributing to at least 40 per cent of the net worth of the AMC and appointing a custodian. Upon satisfying these conditions, the registration certificate is issued subject to the payment of registration fees of Rs.25.00 lacs.9

**State Monopoly on Mutual Funds:**

Mutual funds have been a significant source of investment in both government and corporate securities. It has been for decades the monopoly of the state with UTI being the key player. The state-owned insurance companies also hold a portfolio of stocks. Presently, numerous mutual funds exist, including private and foreign companies. Banks; mainly state-owned too have established Mutual Funds. Foreign participation in mutual funds and asset management companies is permitted on a case by case basis. In 1995, the RBI permitted private sector institutions to set up Money Market Mutual Funds (MMMFs). They can invest in treasury bills, call and notice money, commercial paper, commercial bills accepted by banks, certificates of deposit and dated government securities having unexpired maturity up to one year.
All MFs are allowed to apply for firm allotment in public issues. SEBI regulates the functioning of mutual funds, and it requires that all MFs should be established as trusts under the Indian Trusts Act. The actual fund management activity shall be conducted from a separate asset management company (AMC). The minimum net worth of an AMC or its affiliate must be Rs. 50 million to act as a manager in any other fund. MFs can be penalized for defaults including non-registration and failure to observe rules set by their AMCs. MFs dealing exclusively with money market instruments have to be registered with RBI. All other schemes floated by MFs are required to be registered with SEBI.

**Mutual Fund Investor’s Environment:**

Mutual fund; it is an institution that sells shares to the public and uses the proceeds to buy a selection, or portfolio, of various types of stocks, bonds, or both stocks and bonds. Though there are many financial intermediaries banking sector in India has been contributing to a major portion of total credit lending to various sectors and in resource mobilization it has been playing a main role which is because of cumulative effects. Assured rate of return on assets of depositors in banks. Easy, costless access to services through the large branch network of banks. Virtually zero risk on the investments in banks unlike other non-banking sectors which pose greater risks. GOI and RBI policies supported the cause of banks through their policies like, Interest rate ceiling on deposits with NBFC & Ceiling on quantum deposits in these companies.
Mutual funds in India have come of age to cater to the needs of investors. SEBI, which also controls the stock market operations, is the regulatory body of the Indian mutual fund industry. Mutual funds can be classified into open-ended funds, close-ended funds, and interval funds, based on the fund structure. Based on the investment objectives, they are divided into growth funds, income funds, balanced funds, and money-market funds. Based on the specific purpose of use, mutual funds are classified into tax savings schemes, index funds, and theme-based funds. Many fund marketers have come out with innovative and customer friendly products that aim at satisfying the investors' financial goals. Systematic Investment Plan (SIP) is an innovation in payment option for mutual fund investors. It is designed for those who are interested in gradually accumulating wealth in a disciplined manner over a long term. Mutual funds are priced based on their net asset value, which the fund houses declare on a daily basis. Investors can sell their units back to the fund at the prevailing NAV.

Some funds attract entry and exit loads. Such loads are used to recover the costs spent on distribution and other marketing costs.

Mutual funds are distributed through five channels of distribution, namely, direct channel, advice channel, retirement plan channel, fund supermarket channel, and institutional channel. Apart from these channels, mutual banking is also adopted, where cross-selling is used in association with banks to sell the fund schemes through the banks' branches. Mutual fund marketers use advertising, sales promotions, brand communications, and public relations to
attract investors and to increase their sales. Advertising includes print and electronic media, including the Internet. Fund marketers give away incentives and gifts to the investors for investing in their funds and such incentives and gifts may act as a catalyst for attracting more sales. They also give incentives to their trade partners and their representatives. Further, the fund houses have started the process of overhauling their brand image to promote themselves more effectively to the customers. AMFI, the industry association, has been actively involved in public relations (PR), by promoting the mutual fund industry, both at the domestic level and in the international arena.

**Regulation of Mutual Funds:**

The monopolistic role of UTI comes to an end in 1987 with the setting up of mutual funds by Nationalized Banks. So the Government of India amended the Banking Regulations Act to enable commercial banks in the public sector to set up subsidiaries operating as trusts to perform the functions of mutual funds. However, in this connection, neither was the UTI Act suitably amended, nor was a separate Mutual Fund Act passed to govern the incorporation, operation and regulation of all the mutual funds. Another major flaw in the regulatory set up was the absence of any single regulatory body to enact appropriate legislation for monitoring mutual fund operations. Since UTI Act applied to UTI the bank sponsored mutual funds were expected to adhere to the guidelines issued from time to time by the various government bodies, i.e. Reserve Bank of India and Ministry of
Finance. All these guidelines indicate that there is some sort of clarity of imagination and systematic planning in respect of the regulation of mutual fund operations in our country.

In order to monitor the operations of Bank sponsored mutual fund RBI issued a set of regulations in 1987. These are:

1. Mutual fund should be constituted as a trust under the Indian Trust Act and at least two outside trustees should be there.

2. Mutual funds should have a full time executive for the day-to-day management.

3. There must be an arm’s length relationship between the mutual fund and the sponsor bank.

4. Every sponsor bank should contribute at least Rs. 25 Lakhs.

5. A clear statement of objectives and policies for the fund must be laid down and published.

6. Operations must be restricted to capital market instruments and mutual funds are not to undertake direct or indirect lending, underwriting bills discounting and money market operations.
7. Restrictions must be placed on the last of managing any scheme.

8. A Management Information System should be evolved to maintain data and to submit various reports.

**Government Efforts in Establishment of Mutual Funds:**

The mutual fund industry has been in India for a long time. This came into existence in 1963 with the establishment of Unit Trust of India, a joint effort by the Government of India and the Reserve Bank of India. The next two decades from 1986 to 1993 can be termed as the period of public sector funds with entry of new public sector players into the mutual fund industry namely, Life Insurance Corporation of India and General Insurance Corporation of India. The year of 1993 marked the beginning of a new era in the Indian mutual fund industry with the entry of private players like Morgan Stanley, J.P Morgan, and Capital International. This was the first time when the mutual fund regulations came into existence.

SEBI was established under which all the mutual funds in India were required to be registered. SEBI was set up as a governing body to protect the interest of investor. By the end of 2008, the number of players in the industry grew enormously with 462 fund houses functioning in the country. With the rise of the mutual fund industry, establishing a mutual fund association became a prerequisite. This is
when Association of Mutual Funds India was set up in 1995 as a non-profit 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.

The mutual fund industry is considered as one of the most dominant players in the world economy and is an important constituent of the financial sector and India is no exception. The industry has witnessed startling growth in terms of the products and services offered, returns churned, volumes generated and the international players who have contributed to this growth. Today the industry offers different schemes ranging from equity and debt to fixed income and money market. The market has graduated from offering plain vanilla and equity debt products to an array of diverse products such as gold funds, exchange traded funds (ETF’s), and capital protection oriented funds and even thematic funds. In addition investments in overseas markets have also been a significant step. Due credit for this evolution can be given to the regulators for building an appropriate framework and to the fund houses for launching such different products. All these reasons have encouraged the traditional conservative investor, from parking fund in fixed deposits and government schemes to investing in other products giving higher returns.
Regulatory Aspects of Schemes of a Mutual Fund:

- The asset management company shall launch no scheme unless the trustees approve such scheme and a copy of the offer document has filed with the Board.

- Every mutual fund shall along with the offer document of each scheme pay filing fees.

- 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 make by the scheme in the listed securities of the group companies of the sponsor a close-ended scheme shall fully redeemed at the end of the maturity period. Unless a majority of the unit holders otherwise decide for its rollover by passing a resolution.

- The mutual fund and asset management company shall be liable to refund the application money to the applicants,-
  - If the mutual fund fails to receive the minimum subscription amount referred to in clause (a) of sub-regulation (1);

  - If the moneys received from the applicants for units are in excess of subscription as referred to in clause (b) of sub-regulation (1).
• **Rules Regarding Advertisement:** The offer document and advertisement materials shall not be misleading or contain any statement or opinion, which are incorrect or false.

• **General Obligations:**
  
  o The financial year for all the schemes shall end as of March 31 of each year. Every mutual fund or the asset management company shall prepare in respect of each financial year an annual report and annual statement of accounts of the schemes and the fund as specified in Eleventh Schedule.

  o Every mutual fund shall have the annual statement of accounts audited by an auditor who is not in any way associated with the auditor of the asset management company.

• **Restrictions on Investments:** A mutual fund scheme shall not invest more than 15 per cent of its NAV in debt instruments issued by a single issuer, which are rated not below investment grade by a credit rating agency authorized to carry out such activity under the Act. Such investment limit may be extended to 20 per cent of the NAV of the scheme with the prior approval of the Board of Trustees and the Board of asset Management Company.
Regulator of Mutual Funds:

Mutual funds collect money from the public and they need to follow several rules and regulations. Securities Exchange Board of India (SEBI) is the prime regulator of mutual fund industry in India. SEBI, established in 1992 in accordance with Securities and Exchange Board of India Act, 1992, has the mandate to protect the interests of investors in securities and to promote the development of, and to regulate the securities market. SEBI provides the regulatory framework and oversees the functioning of mutual fund industry in order to ensure the protection of public interest.16

After the regulator, let’s look at the structure of fund itself. A mutual fund is set up in the form of a trust, which has sponsor, trustees, Asset Management Company (AMC) and custodian. The trust is established by a sponsor who is like promoter of a company. The trustees of the mutual fund hold its property for the benefit of the investors in the fund. The trustees have the oversight on the AMC and give it the direction to meet the fund objectives. They monitor the performance and compliance of SEBI Regulations by the mutual fund. Asset Management Company approved by SEBI manages the funds by making investments in various approved securities and financial instruments. Custodian, who is registered with SEBI, holds the investments of the fund in its custody. SEBI regulations require that at least two thirds of the directors of trustee company or board of trustees must be independent i.e. they should not be associated with the sponsors. All mutual funds are required to be registered with SEBI before they launch any scheme.
Computerization of Stock Exchange:

The Stock Exchange business operations are equipped with modern communication systems. Online computerization for simultaneously carrying out the trading transactions, monitoring functions have been introduced at this Exchange since 1988 and the Settlement and Delivery System has become simple and easy to the Exchange members. The HSE On-line Securities Trading System was built around the most sophisticated state of the art computers, communication systems, and the proven VECTOR Software from CMC and was one of the most powerful SBT Systems in the country, operating in a WAN environment, connected through 9.6 KBPS 2 wire Leased Lines from the offices of the members to the office of the Stock Exchange, where the Central System CHALLENGE-L DESK SIDE SERVER made of Silicon Graphics (SGI Model No. D-95602-S2) was located and connected all the members who were provided with COMPAQ DESKPRO 2000/DESKTOP 5120 Computers connected through MOTOROLA 3265 v. 34 MANAGEABLE STAND ALONE MODEMS for carrying out business from computer terminals located in the offices of the members. The HOST System enabled the Exchange to expand its operations later to other prime trading centers outside the cities.

Investment Company Act of 1940:

Investment companies (mutual funds) are regulated by the Investment Company Act of 1940. The roots of government
regulation of investment companies are found in the great stock market crash of 1929, which caused to begin an extensive investigation of the U.S. securities industry. The bulk of federal powers over the activities of investment companies are contained in the Investment Company Act of 1940, which provides for the registration and regulation of companies primarily engaged in the business of investing in securities.\textsuperscript{17} The major provisions of the Act are summarized as follows:

- The Act provides for registration, ‘full’ disclosure and regulation of investment companies to prevent fraudulent abuses.

- Generally, not more than 60 percent of the board of directors may be affiliated with the fund, its banks or brokers.

- Management (advisor) contracts must be approved by shareholders and the funds outside directors.

- A company must redeem shares duly offered by shareholders within seven calendar days at per share net asset value.

- Open-end companies (mutual funds) may borrow from a bank and use the proceeds for investment purposes (leverage); such debt must be collateralized three to one.

- Shareholders must be sent complete financial reports at least semiannually, and the SEC must see such reports.
• To qualify as a regulated investment company, the fund must have at least 75 percent of its total assets invested in securities, with not more than 5 percent of its assets invested in the securities of any one issuer and not holding more than 10 percent of the voting securities of any one corporation.

• A prospectus must be given to a prospective fund investor before sales can be solicited.

• Securities and cash must be kept by either a bank or a broker who is a member of a national securities exchange.

• In addition to federal registration, a mutual fund must register in and abide by the laws and regulations of each state in which its shares are sold. In other words, unless a fund is registered in your state of residence, it cannot legally sell its shares to you.

The Indian mutual fund industry is passing through a transformation. On one side it has seen a number of regulatory developments while on the other the overall economy is just recovering from the global crisis of 2008. The regulatory changes have been made keeping in mind the best interests of the investors. However, like all changes these changes will take time to be adapted by industry, intermediaries and the investing public at large. The industry is looking forward to early resolution of certain inter-regulatory issues requiring Government intervention. Market
participants are waiting to see how the industry adapts to these changes, while trying to maintain its pace of growth. Mutual funds are restructuring their business models to provide for increased efficiencies and investor satisfaction. The industry also faces a number of issues which are characterized by lack of investor awareness, low penetration levels, high dependence on corporate sector and spiralling cost of operations. The Growth rate of the industry therefore needs to be seen from this perspective. Though, it is commendable to note, that, Assets Under Management have managed to record a compounded growth of 28 per cent over 2006-2010, however, the AUM of Equity Funds and Balanced Funds where retail investors invest have only grown by 20 per cent in the same period. The net sales of Equity/Balanced funds in 2009-10 have been one of the lowest in recent years.¹⁸

India has vast growth potential backed by a resilient economy, commensurate with an accelerated GDP growth rate of 7.4 per cent, high rate of household savings and investments. This seeks to outline the current state of the industry, with its growth drivers and continuing challenges. It also seeks to draw a comparison with other global economies, the business and regulatory trends which have been impacting this industry with a snapshot of some of the regulatory changes anticipated around the corner.
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