MUTUAL FUND CONCEPTS AND WORKING

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Mutual Fund Concepts and Working

Chapter III

MUTUAL FUND CONCEPTS AND WORKING

2.0 Introduction

Financial markets have become more complex and sophisticated. In order to be successful, investors need an intermediary who provides the required knowledge and professional expertise. The concept of mutual fund emerged to play this role of intermediary. In the previous chapter, we have reviewed the available literature on mutual funds and mobilisation of savings. In continuation of that chapter, in this chapter, an attempt is made to explain the fundamental concepts of mutual funds in general and its working and regulation in the Indian context. This chapter has two parts, Part A and Part B. Part A is comprised of the mutual fund basics like the concept, types, advantage and disadvantages. Part B is meant to explain the working of mutual funds and its underlying rules and regulations. This is considered essential for getting a clear picture of the environment in which the mutual funds are working.

Part A: Mutual fund concepts

2.A.1 Concept of mutual fund

A mutual fund is a trust that pools the savings of a number of investors who share a common financial goal[1]. The money thus collected is then invested in capital market instruments such as shares, debentures and other securities. [The combined holdings of shares, debentures and securities and assets the fund owns are known as its portfolio.[2]] Thus, the fund is owned jointly by all of the unit-holders. The income earned through these investments and the capital appreciation realised are shared by them in proportion to the number of units owned by them. The word 'mutual' in a 'mutual fund' signifies that such benefits accrue pro rata to all the investors in proportion to their investment; they share mutually the benefits arising there from. 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.

2.A.2 Definitions

Different scholars have defined Mutual Fund differently. Frank K. Reilly has defined mutual fund as an investment company, which pools funds belonging to many individuals that is used to acquire a collection of individual investments such as stocks, bonds, other publicly traded securities.[3] John A. Halin defines it as a major type of investment-company that pools the funds of investors who are seeking some general investment objective and invest them in a number of frequently traded different types of securities.[4] Mutual fund is the institution, which collectively manages the funds from different small investors. It mobilises savings from the public and provide them attractive returns, security and liquidity by investing in capital market. It is a fund established in the form of a Trust by a sponsor to raise monies by the Trustees through the sale of units to the public under one or more schemes for investing in securities.[5] It is a diversified portfolio of stocks, bonds, or other securities run by a professional money manager or, in some cases, a management team.[6] It provides instant diversification in a given area within objectives laid. These offer a variety of diversified options for investments looking into varied risks and returns.[7] Regulation 2(q) of the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 defines a mutual fund as a "fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments". Thus a mutual fund is an institutional device or an investment vehicle through which, the investors pool their funds under the direction of an investment manager. These funds are invested in wide variety of portfolios of securities in such a way as to minimise risk, while ensuring safety and steady return.[8]

2.A.3 Principles

There are four time-honoured principles of mutual fund investing which are (1) broad diversification, (2) professional management, (3) liquidity, and (4) convenience.[9]

Diversification is essential to eliminate risk. It reduces and can even eliminate the specific risk that comes with the ownership of just a few individual shares and securities. Mutual funds provide two types of diversification: diversification within a portfolio and diversification among portfolios. The second principle of mutual fund investing is professional management. Managing an investment portfolio means selecting and supervising the funds in accordance with the fund's investment objectives and policies. The fund managers have the obligation to add value over and above the returns generally received from the markets. The third principle of mutual fund investing is liquidity. The mutual fund units may be purchased or sold at a moment's notice at the fund's net asset value without incurring any cost or loss. The fourth basic principle provides for simplicity and convenience for the mutual fund transactions. A major reason for the remarkable growth in the mutual fund industry has been the diverse classes of financial assets to which its principles have been successfully applied.

2.A.4 Types of Mutual Fund Schemes

There are a variety of mutual fund products coming to the market so as to cater to the requirements of different classes of investors. Figure 3.1 depicts the classification. These schemes can be classified on the basis of

1. Structure/constitution:	a) Open – ended schemes b) Close – ended schemes
2. Charges on investors:	a) Load fund schemes b) No-load fund schemes
3. Investment Objectives:	a) Income schemes b) Growth schemes c) Balanced schemes d) Tax saving schemes or ELSS e) Index fund schemes f) Sector fund schemes g) Assured Return schemes h) Miscellaneous schemes
4. Nature of investment	a) Financial asset fund schemes b) Physical asset fund schemes
5. Geography:	a) Domestic schemes b) Offshore schemes or Global schemes

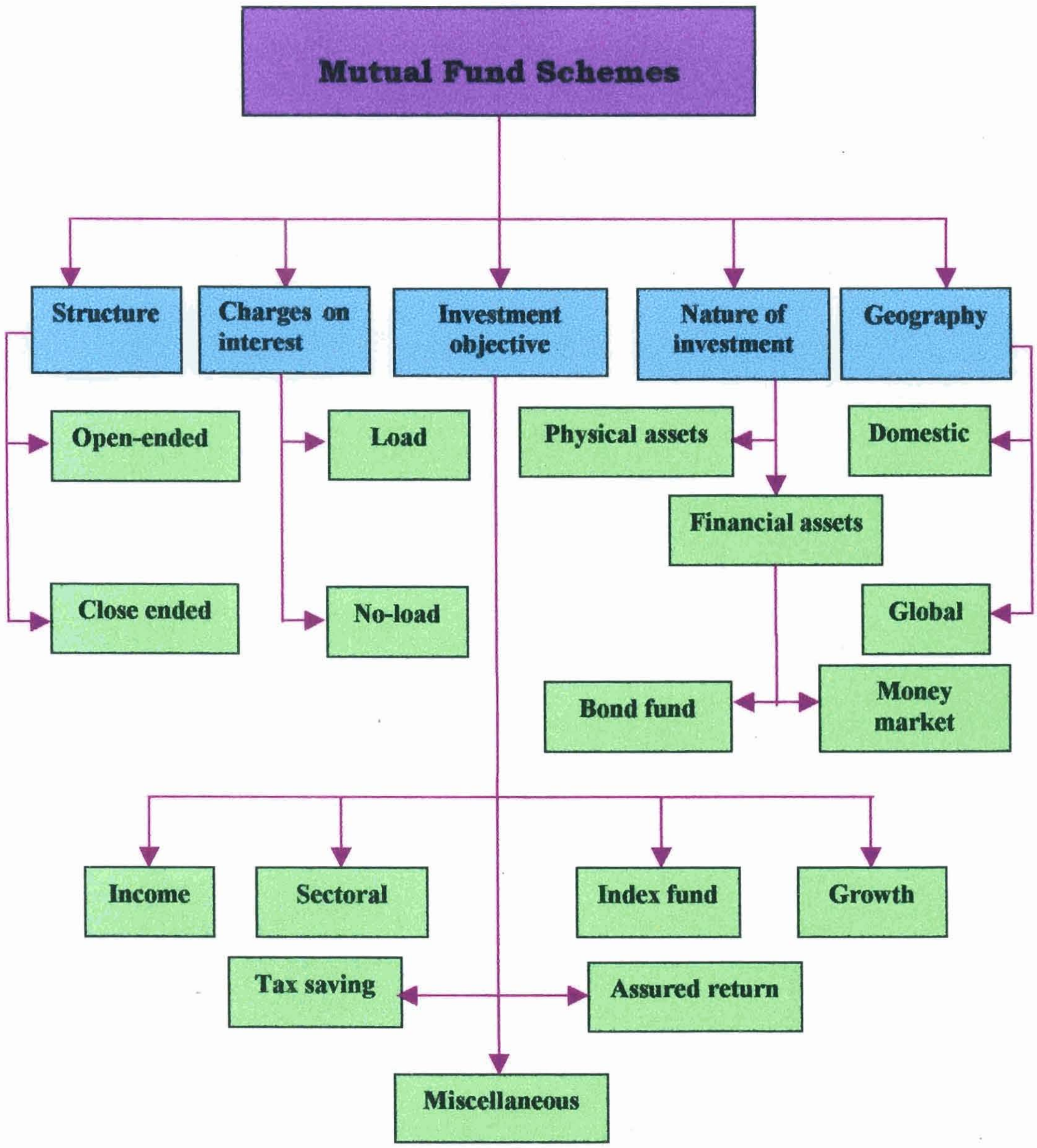
2.A.4.1 Open-ended Schemes

Funds available for subscription all the year round excluding the period of book closing are open-ended schemes. These schemes do not have a fixed maturity and the units can be sold or bought on any day at a price calculated based on the NAV (Net Asset Value). NAV is the per unit market value of the assets of the scheme minus its liabilities. The most popular example is Unit 64 of the UTI. SBI Magnum, Birla Tax Plan, Reliance Growth, Sundaram Tax Saver, LIC Dhanasahayog, etc are other examples.

2.A.4.2 Close-ended Schemes

Schemes have a stipulated maturity period are close ended schemes. Direct investment in such schemes can be done at the time of the initial issue and thereafter buying or selling can be done through the stock exchanges where the scheme is listed. The maturity period may range between 2 to 15 years. The market prices are expected to be equal to the NAV, but for obvious reasons they are seldom equal to the NAV, and most of the units are quoted much below to the NAV. Kothari Pioneer Taxshield, UTI Market Equity Plan 99, Morgan Stanley Growth Fund, Sundaram Tax Saver etc are examples of close-ended schemes.

Figure 3.1 Classification of mutual funds



2.A.4.3 Load fund schemes

Mutual fund schemes that collect charges from the investors at the time of entry, exit or both are called load fund schemes. If the charge is collected at the time of entry it is front -end load and if it is collected at the time of exit it is called repurchase or back-end load.

2.A.4.4 No-load fund schemes

Schemes that do not collect any such charges are no-load fund schemes.

2.A.4.5 Income Schemes

Income schemes seek to provide regular and steady returns in the form of dividends. These schemes invest in fixed debt securities as well as money market instruments. These schemes are ideal for investors who need some regular income to supplement their earnings. Alliance Monthly Income Plan, HDFC Income Fund, Escorts Income Plus, Kothari Income Builder, Templeton India Income Fund etc are examples.

2.A.4.6 Growth Schemes

Growth schemes aim to provide capital appreciation over the period of investment. These schemes normally invest a majority of its funds in equities and convertible debentures. These schemes are meant for investors seeking growth over the long term. Can Expo, Franklin India Growth Fund, HDFC Growth Fund, ING Growth Portfolio, Kotak Mahindra K 30, Zurich Capital Builder, etc are examples.

2.A.4.7 Balanced Schemes

These schemes aim to provide both growth and income by periodically distributing a part of the income and capital gains they earn. They invest in both shares and fixed income securities in the proportion stated in their offer documents. These schemes are ideal for investors looking for a combination of income and moderate growth. Cantriple, DSP Merill Lynch Balance Fund, Dundee Balance Fund, Kothari Balanced Fund, Tata Balance Fund, etc are examples.

2.A.4.8 Tax Saving Schemes or ELSS

These schemes offer tax incentives to the investors under the Income Tax Act, 1961. Previously deduction of income under Section 80CCB were allowed in respect of the investment made in ELSS. However, various pension schemes, unit-linked insurance schemes, etc are other schemes, which can be categorised under this category. Alliance Tax Relief, BOB ELSS 96, Escorts Tax Plan, Kothari Pioneer Taxshield, Tata Tax Savings, UTI Equity Tax Savings Plan etc. are examples.

2.A.4.9 Index Funds

Schemes that attempt to replicate the performance of a particular stock market index such as the BSE Sensex or the NSE 50. The returns offered are linked with the changes in the index. These schemes are ideal for investors who are satisfied with an equivalent return that of an index. These schemes gather importance now a days due the present capital market position. UTI Master Index Fund, UTI Nifty Index Fund, Franklin India Index Fund etc are examples.

2.A.4.10 Sector funds

These schemes invest in securities of a specified sector of an industry or market. The risk and potentiality of the specific sector would be reflected in these funds. Sector fund schemes are ideal for investors who have already decided to invest in a particular sector or segment. Alliance Basic Industries, Kothari Pioneer Infotech, Kothari Pioneer FMCG Fund, Tata Life Sciences and Technologies, Internet Opportunities Fund, UTI Growth Sectors Fund, etc are some examples.

2.A.4.11 Assured Return Schemes

SEBI allows only those mutual funds that have a track record of 5 years to launch guaranteed return funds. The guarantee of return can be given only for one year at a time with post-dated cheques.

2.A.4.12 Financial asset fund schemes

Generally mutual funds are investing their funds in the financial assets like shares, bonds and government securities. The broad classifications are equity funds, bond funds and money market funds.

2.A.4.13 Bond Fund or Gilt Fund Schemes

Schemes to pass the advantages of debt markets to the investors by investing in a variety of bonds and debentures are Bond Schemes. These carry less risk as compared to funds that have equity shares in their portfolio. Magnum Bond Fund, UTI Bond Fund, Birla Gilt Plus, etc are examples.

2.A.4.14 Money Market Schemes

Funds invest wholly in money market instruments such as treasury bills, certificates of deposits, commercial papers and bill discounting. These funds aim to provide easy liquidity, preservation of capital and moderate income. These schemes are meant for corporate and individual investors to invest their surplus funds for a short period. IDBI Principal Money Market Fund, Kothari Pioneer MMF, UTI Money Market Fund, etc are examples.

2.A.4.15 Physical asset or commodity fund schemes

Mutual Funds can also invest the funds in physical assets, which specialise in investing in different commodities directly or through shares of commodity companies or through commodity futures contracts. Common examples are gold funds, other precious metals or real estates funds.

2.A.4.16 Domestic Mutual Fund Schemes

Schemes launched with a view to mobilise savings of citizens of the country are domestic schemes. Almost all the schemes offered by the mutual funds other than the offshore schemes are domestic schemes.

2.A.4.17 Offshore Schemes

Mutual fund schemes launched with a view to mobilise the savings of foreign countries for the purpose of investment in the Indian securities are offshore securities. The amount shall be mobilised in foreign currencies. These schemes are the doors to the Indian capital market to the foreign investors. India Fund of UTI, Morgan Stanley India Investment Fund, Jardine Fleming India Fund, LG India Fund, etc are examples.

The list of schemes offered by different mutual funds as on March 31,2000 is given as Appendix IV.

2.A.5 Advantages of mutual funds

A mutual fund is generally seen as a portfolio manager, managing the funds of the unit holders. An investor of mutual fund scheme can automatically reap the benefits of research and a wider range of low cost information services. The major advantages of investing in mutual funds are as follows:

2.A.5.1 Professional Management

One of the most important benefits is the availability of low cost, highly professional management services. Mutual funds are managed by highly skilled mangers with sound knowledge of the market and wide experience in investment. Further the cost to the investor is proportionate to investment because management fees are distributed pro rata basis, with smaller investors have to pay less than big investors.

2.A.5.2 Portfolio Diversification

Individual investors have to face company-related risks and market-related risks. Company-related risks arise due to wrong selection of investments, non-performance of the company, lack of monitoring of the performance, etc. Market related risk arise due to the volatility of the market caused by economic and political factors. Higher returns, however, depend on the higher level of risk. This risk can be dispersed and reduced through diversification of portfolio. For a small investor appropriate portfolio diversification may not be possible due to shortage of minimum required funds, but when a small investor invests in mutual fund, his portfolio automatically gets diversified.

2.A.5.3 Higher return

Mutual funds have the potential to provide a comparative higher return as they invest in a diversified portfolio.

2.A.5.4 Easy Liquidity

Liquidity is an important consideration for any investor. Mutual fund investment offers enough liquidity to investors. In the case of open-ended schemes money invested can be received back from the mutual fund itself at NAV related prices. In the case of listed close-ended schemes the units can be either sold at the prevailing market prices or avail of the facility of direct repurchase at NAV related prices fixed by the mutual fund.

2.A.5.5 Transparency

Regular and periodical information on value of investment can be received by the investors in addition to disclosure on the specific investments made by the scheme, the proportion invested in each class of assets and the fund manager's investment strategy and outlook.

2.A.5.6 Flexibility

Many mutual funds allow investors to switch from one fund to another. Investors can switch from growth to income funds and vice versa, and accordingly their objective from capital gains to income and vice versa. The investor can also systematically invest or withdraw funds through the facilities like regular investment plans and dividend reinvestment plans.

2.A.5.7 Choice of schemes

Mutual funds are floating different schemes with a variety of investment objectives. This creates an opportunity among investors to choose the schemes on the basis of their objectives, motivations, and requirements.

2.A.5.8 Investment Protection

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 from the reports submitted by the mutual funds. Funds must publish details of their operations for public information. However, no guarantee of investment or return can be provided by SEBI or any similar agencies.

2.A.5.9 Tax Benefits

Mutual funds as well as investors can enjoy certain tax benefits. Any income of a notified mutual fund is fully exempt from tax under Section 10 (23D) of the Income Tax Act, 1961. Income of mutual funds by way of dividends, interests, etc on investment or capital gains will be exempt from payment of Income Tax. The UTI is also not liable to pay any tax is respect of any income, profits or gains. The tax benefits enjoyed by the mutual funds will be automatically passed on to the investors. The investors of mutual fund schemes can enjoy income tax benefits both in the form of deduction from income under

Section 80 L and as tax relief under Section 88. Income received on units of mutual funds are qualified for a deduction up to Rs.12000 along with other specified securities and deposits under Sec. 80L. Further an additional deduction of Rs.3000 is also available on dividends from mutual funds investments. Twenty percent of the amount invested in mutual funds along with other investments is deductible from the tax payable subject to a maximum of Rs.2000.

2.A.5.10 Convenient Administration and Record keeping

Record keeping is simplified and is handled by the fund, which avoid many problems such as bad deliveries, delayed payments and unnecessary follow-up with brokers and companies. Hence, time is saved and made investing easy and convenient.

2.A.5.11 Reduced transaction costs

Investors have to bear all the costs of brokerage and custodian charges. Through mutual funds advantages of economies of scale can be enjoyed. Mutual funds need to pay a lesser cost than individual investors.

2.A.6 Disadvantages of mutual funds

Mutual funds have certain disadvantages also. The main among them are as follows:

2.A.6.1 Higher risk

All mutual funds are subject to risks and those that depend primarily to stock markets have higher risks. Of course the potential for higher returns is also higher than in funds that invest in debt markets and government securities, where there is lower risk profile with steady income.

2.A.6.2 Our fund managed by others

An investor in a mutual fund has any type of control over the portfolio management. Investor looses the right of building his own portfolio of shares and securities as it is delegated to the fund managers and just rely on the due diligence of the fund managers.

2.A.6.3 No control over costs

Investors absolutely have no control over the overall costs of investing. Besides, they have to pay investment management fees and fund distribution costs only for the sake of obtaining the mutual fund services.

2.A.6.4 Difficulty of choosing from

As a large number of mutual fund schemes are available the investor has to make a correct choice. He may need advice of experts on how to select a fund, which satisfies his investment objectives, which is quite similar in the case of direct investing in the share market.

2.A.7 Conclusion

In this part, we made an attempt to review the basic concepts of mutual funds. In the succeeding part an effort is made to explain the structure and legal structure in which mutual funds work in India.

Part B: Working and regulation of mutual funds in India

2.B.0 Introduction

The structure of mutual funds differs from country to country. The structure followed in countries like the USA, the UK, Japan and India differ in its workings and structures. The regulatory environment also differs from country to country. The structure, working and the regulatory environment of the mutual funds specific to India are discussed in this part.

2.B.1 Structure of mutual funds in India

Mutual funds have a special structure unlike a joint stock company or a partnership firm. All the mutual funds (except money market mutual funds, foreign financial institutions and the UTI) are regulated by the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, which is given as Appendix II (the annexure part is excluded). As per the regulations a mutual fund is comprised of four separate participants or constituents, namely the sponsor, the mutual fund trust, the asset management company (AMC) and the custodian. There are some more additional entities like depository participant, bankers, brokers and registrars or transfer agents. The structure of the UTI is quite unique where the activities of the trustee, the AMC and the custodian are combined. The pictorial representation of the structure is given in Figure 3.2.

2.B.1.1 Sponsor

The sponsor can be any person who, acting alone or in combination with another body corporate, establishes the mutual fund and gets it registered with SEBI[10]. He must have a sound track record and general reputation of fairness and integrity and is required to contribute at least 40% of the net worth of the asset management company.

2.B.1.2 Mutual fund

The mutual fund shall be constituted in the form of a registered trust under the Indian Trusts Act, 1882. It is the Board of Trustees who manages the mutual fund[11]. The Board of Trustees may be either a body of individual or a corporate body. Most of the funds in India are managed by Boards of Trustees. While Board of Trustees are governed by the provisions of the Indian Trusts Act, where the Trustee is a corporate body, it is required to comply with the provisions of the Companies Act, 1956.

2.B.1.3 Asset Management Company (AMC)

The Board or the Trustee Company protects the investors' interests. Instead of managing by them, Trustees appoint an Asset Management Company (AMC) to manage the portfolio of securities as per the defined objectives, Trust Deed and SEBI Regulations. AMC is required to be approved and registered with SEBI. Chapter IV of the SEBI (MF) Regulations, 1996 contains the regulations regarding the appointment, obligations, and the related aspects of an AMC. The Trust is created by the execution of the Trust Deed. The sponsor does the execution of the deed in favour of the Trustees. The Trust Deed should be stamped and registered under the provisions of the Indian Registration Act and registered with the SEBI.

Trust Deed contains clauses relating to the establishment of the trust, the appointment of Trustees, their powers, duties and obligations, etc. [12]

2.B.1.4 Custodian

The custodian is responsible for safe keeping of assets of the fund, which may mainly be in large volumes of securities. He has to get a certificate of registration to carry on the business of custodian of securities under the SEBI (Custodian of Securities) Regulations, 1996[13]. The Board of Trustees appoints the custodian and enters into a custodian agreement[14].

2.B.1.5 Depository Participant

Instead of having physical certificates of securities they can be dematerialised with a depository. It is through a Depository Participant mutual funds hold its dematerialised securities.

2.B.1.6 Bankers

Financial dealings of mutual funds like buying and selling units, paying for investments made, receiving the proceeds on sale of investments and paying the operational expenses are done through banks.

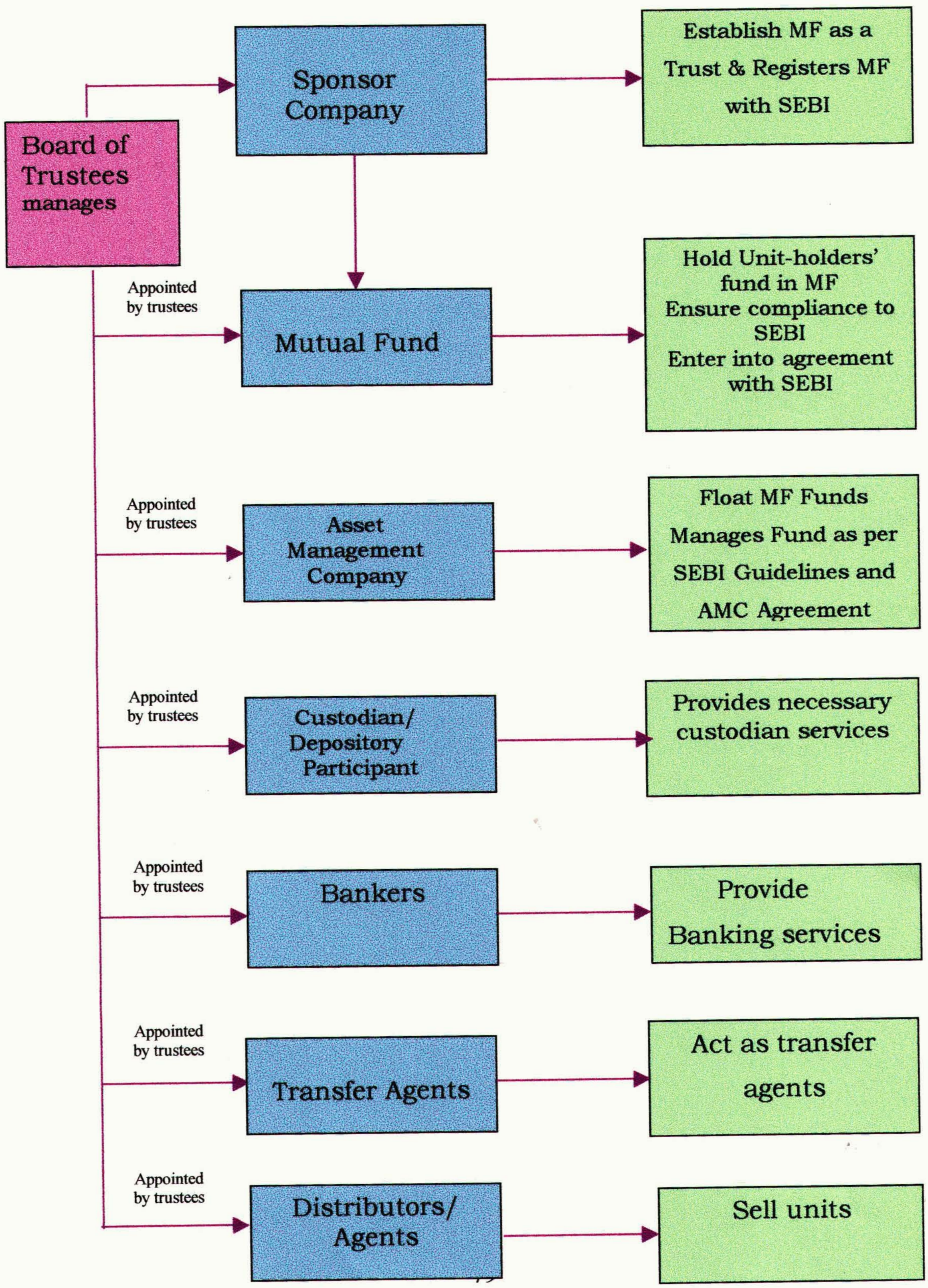
2.B.1.7 Brokers

It is through brokers, agents and distributors the units of mutual funds are sold. A broker usually acts on behalf of several mutual funds simultaneously and may have several sub-brokers and agents under him.

2.B.1.8 Registrar/ transfer agent

The registrar/ transfer agent's duty is to handle the registry related work of the unit holders. They are responsible for issuing and redeeming units of mutual funds and other related services.

Figure 3.2[15] Structure of Mutual Funds



2.B.2 Working of Mutual Funds

The mutual fund raises money through sale of units under one or more schemes abiding the SEBI guidelines. The trustees see that the schemes floated and managed by the AMC are in accordance with the trust deeds and SEBI guidelines. The trustees have the right to obtain relevant information and quarterly reports from the AMC. They can also dismiss the AMC under specific conditions. The trustees are required to submit half yearly reports to SEBI on the activities of the mutual fund. The AMC is appointed by the trustees to float the mutual fund schemes and manage the funds raised by selling units under a scheme. The AMC must act as per SEBI guidelines, the trust deeds and the management agreement between the trustees and the AMC.

2.B.3 Procedures and functions

The various functional procedures, in detail, like registration of mutual funds, registration of trust deed, appointment of trustees, AMC, custodian etc. are discussed here.

2.B.3.1 Registration of mutual fund[16]

For registering a mutual fund the sponsor has to submit an application to the SEBI in the prescribed form (Form A) accompanied by the prescribed fee of Rs.25000. On receipt of such an application SEBI can require the sponsor to furnish any further information or clarifications as may be required by it. Incomplete applications can be rejected only after giving an opportunity to complete the required formalities. SEBI may register the mutual fund and a certificate in the prescribed form (Form B) will be issued only if the applicant pays the registration fee of Rs.25,00,000 and fulfils all of following eligibility criteria:

1. The sponsor should have not less than five years' experience in carrying on business in financial services with positive net worth in all the years and profit for the last three years including the last year.
2. The sponsor should have contributed at least 40% to the net worth of the asset management company.

3. The sponsor or any of its directors should not have been guilty of fraud or has not been convicted of any economic offence or any offence involving moral turpitude.
4. The modes of appointing trustees and asset managing company should be in accordance with the provisions of the Regulations.
5. The trustees should have authorised the appointment of the custodian and the custodian activities.

A registered mutual fund is of the obligation

1. To comply all the provisions of the Regulations, and
2. To pay the yearly service fee of Rs.2,50,000.

Besides, mutual fund has to make a filing fee for offer documents of Rs.25,000 along with the lounging of every new scheme.

2.B.3.2 Registration of Trust Deed[17]

Mutual fund shall be constituted in the form of a trust and the Trust Deed should be registered under the provisions of the Indian Registration Act, 1908. Such a trust deed should contain all the clauses mentioned in the Third Schedule annexure to the Regulations.

2.B.3.3 Appointment of Trustees[18]

Trustees of mutual funds can be appointed only with the prior approval from the SEBI and in accordance with the provisions of the Regulations. The eligibility criteria to be fulfilled for getting appointed as a trustee are as follows:

1. A person should be of ability, integrity and standing
2. He has not been found guilty of moral turpitude
3. He has not been convicted of any economic offence or violation of any securities laws
4. He has furnished all particulars as specified in Form C, and
5. He should not be an officer or employee of the asset management company.

An appointed trustee of any other mutual fund can be appointed as a trustee only if such a person is an independent trustee and has obtained prior approval from the mutual fund of which he is a trustee. Two thirds of the trustees should be independent persons and should not be related or associated with the sponsors. A company can also be appointed as a trustee and in that case the directors of the company can act as trustees.

The trustees and the asset management company, with the prior approval from SEBI, then enter into an investment management agreement. Such an agreement should contain all the clauses mentioned in the Fourth Schedule of the Regulations. The trustees can enjoy all the rights and are liable for the obligations as per the Regulation 18.

2.B.3.4 Appointment of an AMC[19]

It is the sponsor who appoints an AMC, which has been approved by SEBI under sub-regulation (2) of regulation 21. The trustee can also appoint the AMC if the trust deed so authorises. The application for approval of the AMC should be made in Form D. The eligibility criteria for getting the appointment as an AMC are as follows:

1. In case the AMC is an existing AMC it should have a sound track record, general reputation and fairness in transactions.
2. The AMC should be a fit and proper person.
3. The directors of the AMC must 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.
4. The key personnel of the AMC have not been found guilty of moral turpitude or convicted of economic offence or violation of securities laws or worked for any AMC or mutual fund or any intermediary during the period when its registration has been suspended or cancelled at any time by SEBI.
5. The board of directors of such AMC should have 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.

6. The chairman of the AMC must not be a trustee of any mutual fund.

7. The AMC should have a net worth of not less than Rs.10 crores.

The approvals of AMCs are granted on the following conditions:

1. Any director of the AMC shall not hold the office of the director in another AMC unless such person is an independent director referred to in clause (d) of sub-regulation (1) of regulation 21 and approval of the board of AMC of which such person is a director, has been obtained.

2. The AMC shall forthwith inform SEBI of any material change in the information or particulars previously furnished, which have a bearing on the approval granted by it.

3. No appointment of a director of an AMC shall be made without prior approval of the trustees.

4. The AMC must undertake to comply with the SEBI (MF) Regulations.

5. Any change in the controlling interest of the AMC shall be only with the prior approval of trustees, SEBI and the unit holders (in the case of close ended schemes), and

6. The AMC shall furnish such information and documents to the trustees as and when required by the trustees.

There are certain restrictions on business activities of the AMC, which are as follows:

1. The AMC should not act as a trustee of mutual fund

2. It should not undertake any other business activities except activities in the nature of portfolio management services 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, and

3. It should not invest in any of its schemes unless full disclosure of its intention to invest has been made in the offer documents.

The obligations of an AMC are varied which are as follows:

1. It should take all reasonable steps and exercise due diligence to ensure that the investment of funds pertaining to any scheme is not contrary to the provisions of these regulations and the trust deed.
2. It should exercise due diligence and care in all its investment decisions as would be exercised by other persons engaged in the same business.
3. It should be responsible for the acts of commissions or omissions by its employees or the persons whose services have been procured by the AMC.
4. It should submit to the trustees quarterly reports of each year on its activities and the compliance with these regulations.

5. The trustees at the request of the AMC may terminate the assignment of the AMC at any time, provided that such termination shall become effective only after the trustees have accepted the termination of assignment and communicated their decision in writing to the AMC.

6. Notwithstanding anything contained in any contract or agreement or termination, the AMC or its directors or other officers shall not be absolved of liability to the mutual fund for their acts of commission or omissions, while holding such position or office.

7. An AMC, should not through any broker associated with the sponsor, purchase or sell securities, which is average of 5% or more of the aggregate purchases and sale of securities made by the mutual fund in all its schemes.

8. It should not utilise the services of the sponsor or any of its associates, employees or their relatives, for the

purpose of any securities transaction and distribution and sale of securities.

9. It should file with the trustees the details of transactions in securities by the key personnel of the AMC in their own name or on behalf of the AMC and should also report to SEBI, as and when required by SEBI.

10. In case the AMC enters into any securities transactions with any of its associates a report to that effect should be sent to the trustees at its next meeting.

11. In the case any company has invested more than 5% of the net asset value of a scheme, the investment made by that scheme or by any other scheme of the same mutual fund in that company or its subsidiaries should be brought to the notice of the trustees by the AMC and be disclosed in the half yearly and annual accounts of the respective schemes with justification for such investment provided the latter investment has

been made within one year of the date of the former investment calculated on either side.

12. It should file with the trustees and SEBI detailed bio-data of all its directors along with their interest in other companies within fifteen days of their appointment and any change in the interests of directors every six months. A quarterly report must also be submitted to the trustees giving the details and adequate justification about the purchase and sale of the securities of the group companies of the sponsor or the AMC as the case may be, by the mutual fund during the said quarter.

13. A statement of holdings in securities of the directors of AMC should be filed with the trustees with the dates of acquisition of such securities at the end of each financial year.

14. It should not appoint any persons as key personnel who has been found guilty of any economic offence or involved in violation of securities laws.

15. It should appoint registrars and share transfer agents who are registered with the SEBI.

16. It should abide by the Code of Conduct as specified in the Fifth Schedule.

2.B.3.5 Appointment of Custodian[20]

A mutual fund can appoint a custodian to carry out the custodial services for the schemes of the fund and sent intimation of the same to SEBI within 15 days of the appointment of the custodian. 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 should act as custodian for a mutual fund constituted by the same sponsor or any of its associate or subsidiary company. The mutual fund should enter into a custodian agreement, which should contain the clauses, which are necessary for the efficient and orderly conduct of the affairs of the custodian.

2.B.3.6 Procedure for launching of schemes[21]

AMC can launch a scheme only after getting approval for the scheme from the trustees and after having filed a copy of the offer document along with the filing fee of Rs.25,000 with SEBI. The offer document should 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. Advertisements in respect of every scheme should be in conformity with the Advertisement Code as specified in the Sixth Schedule and should be submitted to SEBI within 7 days from the date of issue. The offer document and advertisement materials should not be misleading or contain any statement or opinion, which are incorrect or false.

2.B.3.7 Listing of close-ended schemes[22]

Every close-ended scheme should be listed in a recognised stock exchange within six months from the closure of the subscription. Listing is not mandatory in the following cases:

1. If the scheme provides for periodic repurchase facility to all the unit-holders with restriction, if any, on the extent of such re-purchase, or
2. If the scheme provides for monthly income or caters to special classes of persons like senior citizens, women, children, widows or physically handicapped or any special class of persons providing for repurchase of units at regular intervals, or,
3. If the details of such repurchase facility are clearly disclosed in the offer document, or
4. If the said scheme opens for repurchase within a period of six months from the closure of subscription.

2.B.3.8 Repurchase of close-ended schemes

The AMC can at its option repurchase or reissue the repurchased units of a close-ended scheme. The units of close-ended scheme can also be converted into open-ended scheme if the offer document of such scheme discloses the option and the period of such conversion or the unit-holders are provided with an option to redeem their units in full. It can also be redeemed at the end of the maturity period.

2.B.3.9 Allotment of units[23]

The AMC should issue to the applicant whose application has been accepted, unit certificates or a statement of accounts specifying the number of units allotted to the applicant as soon as possible but not later than six weeks from the date of closure of the initial subscription list and from the date of receipt of the request from the unit holders in any open-ended scheme. The maximum period for which an initial offer can be kept open is 45 days.

2.B.3.10 Transfer of units[24]

Unless and otherwise restricted or prohibited under the scheme, all unit certificates are freely transferable. Within 30 days of receipt of the application the AMC should register the transfer and return the unit certificate to the transferee.

2.B.3.11 Guaranteed return[25]

Guaranteed return can be provided in a scheme only if the following conditions are satisfied:

1. Such returns are fully guaranteed by the sponsor or the AMC.
2. A statement indicating the name of the person, who will guarantee the return, is made in the offer document.
3. The manner in which the guarantee to be met has been stated in the offer document.

2.B.3.12 Winding up procedure[26]

The following are the occasions in which mutual fund schemes are wound-up:

1. A closed-ended scheme can be wound up on the expiry of duration fixed in the scheme on the redemption of the units unless it is rolled-over for a further period under sub-regulation (4) of regulation 33.
2. A scheme of mutual fund can be wound up, after repaying the amount due to the unit-holders on the happening of any event which, in the opinion of the trustees, requires the scheme to be wound, if 75% of the unit holders of a scheme pass a resolution that the

scheme be wound up, or if SEBI so directs in the interest of the unit-holders.

3. Where a scheme is to be wound up under sub-regulation (2), the trustees should give notice disclosing the circumstances leading to the winding up of the scheme to SEBI and in two daily newspapers having circulation all over India, a vernacular newspaper circulating at the place where the mutual fund is formed.

On and from the date of the publication of the notice the trustee or the AMC, as the case may be, may cease to carry on any business activities in respect of the scheme so wound up, cease to create or cancel units in the scheme and cease to issue or redeem units in the scheme.

The procedure and manner of winding up are as follows:

1. The trustees should call a meeting of the unit holders to approve by simple majority of the unit holders present and voting at the meeting resolution for authorising the trustees or any other person to take

steps for winding up of the scheme, provided that a meeting of the unit holders should not be necessary if the scheme is wound up at the end of maturity period of the scheme.

2. The trustees or the person authorised should dispose of the assets of the scheme concerned in the best interest of the unit holders of that scheme.

3. The proceeds of sale realised should be first utilised towards discharge of such liabilities as are due and payable under the scheme and after making appropriate provision for meeting the expenses connected with such winding up, the balance should be paid to the unit holders in proportion to their respective interest in the assets of the scheme as on the date when the decision for winding up was taken.

4. On completion of the winding up, the trustee should forward to SEBI and the unit holders a report on the winding up containing particulars such as circumstances leading to the winding up, the steps

taken for disposal of assets of the fund before winding up, expenses of the fund for winding up, net assets available for distribution to the unit holders and a certificate from the auditors of the fund.

After the receipt of the report, if SEBI is satisfied that all measures for winding up of the scheme have been complied with, the scheme shall cease to exist.

2.B.4 Regulatory Environment of Mutual Funds of India

The business of mutual funds are regulated by a number of legal bodies such as SEBI, RBI, Ministry of Finance, CLB, DCA, Registrars of Companies, Office of the Public Trustees, and the Unit Trust of India and some self-regulatory bodies such as stock exchanges and the AMFI.

2.B.4.1 SEBI

SEBI was constituted in 1992 as the apex capital market regulator. It requires all mutual funds to be registered with it. It issues guidelines for all mutual fund operations like where they can invest, limits and restrictions of investments, how they should account for income and expenses and how they should make disclosures of information to the investors. It acts as the protector of the investors' interests. SEBI also controls the other mutual fund constituents, custodians, bankers, stock exchanges, brokers, etc.

2.B.4.2 RBI

RBI being the money market regulator of the country governs the bank-owned mutual funds and money market mutual funds. The bank-owned mutual funds, thus, come under the joint control of the SEBI and the RBI. All the market-related and investor-related activities are supervised by the SEBI and the RBI looks after issues concerning the ownership of the AMC. Money market mutual funds are regulated by the RBI guidelines dated 23-11-1995.

2.B.4.3 Ministry of Finance

Being the executive body of the government Ministry of Finance controls both the SEBI and the RBI. It is the supreme policy making and supervising body of the mutual funds in

India. It also acts as the Appellate Authority for any disputes over any of the guidelines.

2.B.4.4 CLB, DCA and Registrars of Companies

Since the asset management companies and corporate trustees are come under the purview of the Companies Act of 1956, mutual funds are under the control of the authorities like Registrars of Companies, the DCA the CLB and the Ministry of Law and Justice. All the companies are primarily answerable to the Registrars of Companies. The Registrars of Companies are supervised by the DCA, which is a part of the CLB under the Ministry of Law and Justice of the Government of India.

2.B.4.5 Office of the Public Trustees

Mutual funds registered as public trusts, which are governed by the Indian Trust Act, 1882 and accountable to the Office of the Public Trustees.

2.B.4.6 The UTI

The UTI was set up by a special enactment, the Unit Trust of India Act, 1963. All the schemes and the functioning of the

UTI had being controlled by the provisions of the Act until recently. Now, all schemes except US 64 have brought under the purview of SEBI (MF) Regulations, 1996.

2.B.4.7 Self-regulatory bodies

An entity, which is empowered to exercise authority over the regulation of their members, is called a self-regulatory body. A stock exchange can regulate its member-brokers under the overall regulatory supervision of SEBI. The Association of Mutual Funds in India (AMFI) was incorporated in 1995 so as to assume the role of a self-regulatory body gradually by promoting the interests of both the funds and investors.

2.B.5 Conclusion

In this chapter we made an attempt to understand the theoretical and legal framework in which the mutual funds of India work. In the succeeding chapters an effort is made to evaluate the mutual fund industry in terms of its mobilisations and investor acceptance both in the country as a whole and in the state of Kerala.

Notes:

[1] www.amfiindia.com

[2] www.sec.gov

[3] Reilly, Frank K, *Investments,* The Dryden Press, The USA, 1982,pp 525-526.

[4] Halin, John A, *Investors' Guide to Mutual Funds,* The Prentice-Hall, The UK, 1985, p.3.

[5] Krishnamurthy, S, *Mutual Funds in India,* The Institute of Cost & Works Accountants of India,

Calcutta, 1996, p 1

[6] Fredman, Albert J and Russ Wiles, *How Mutual Funds Work,* Prentice-Hall of India, New Delhi, 1997,p 6

[7] Agrawal, Peeush Ranjan, *Mutual Funds: A Comprehensive Approach,* Orient Law House, New Delhi, 1996, p1.

[8] Rao, P. Mohana, *Working of Mutual Fund Organisations in India,* Kanishka Publishers, New Delhi, 1998, p 31.

[9] Bogle, John C, *Mutual Funds: New Perspectives for the Intelligent Investor,* Dell Publishing, New York, 1994, p 50.

[10] Regulations 2(x) and 7 of the SEBI (MF) Regulations, 1996.

[11] Regulation 2(q) of the SEBI (MF) Regulations, 1996.

[12] Third Schedule to the SEBI (MF) Regulations, 1996 stipulates the contents of a trust deed.

[13] Regulation 2(h) of the SEBI (MF) Regulations, 1996.

[14] Regulation 27of the SEBI (MF) Regulations, 1996.

[15] Sadhak, H, Mutual Funds in India: Marketing Strategies and Investment Practices, Response Books, New Delhi, 1997.

[16] Regulations 3 –13 of the SEBI (MF) Regulations,1996.

[17] Regulation 14 of the SEBI (MF) Regulations,1996.

[18] Regulations 16-18 of the SEBI (MF) Regulations,1996.

[19] Regulations 19-25 of the SEBI (MF) Regulations,1996.

[20] Regulations 26-27 of the SEBI (MF) Regulations,1996.

[21] Regulations 28-31 of the SEBI (MF) Regulations,1996.

[22] Regulation 32 of the SEBI (MF) Regulations,1996.

[23] Regulations 35-36 of the SEBI (MF) Regulations,1996.

[24] Regulation 37 of the SEBI (MF) Regulations,1996.

[25] Regulation 38 of the SEBI (MF) Regulations,1996.

[26] Regulations 39-42 of the SEBI (MF) Regulations,1996.