iii. Mutual Funds and Other Schemes

Mutual funds

In consultation with the Association of Mutual Funds of India, a number of policy decisions were taken during the year and regulations were amended accordingly. The necessary guidelines and details issued to the mutual funds are given below:

Prudential investment norms

Prudential investment norms were prescribed to ensure that the investment portfolios of the mutual funds are diversified to reduce the inherent risk associated with such investments. Investments in equity related instruments of a single company have been restricted to 10 per cent of the NAV of a scheme with an exception for index funds and sector/ industry specific schemes

Investment in investment grade rated debt instruments issued by a single issuer, should not exceed 15 per cent of NAV of the scheme. This limit may be extended to 20 per cent of the NAV of the scheme with the prior approval of the Boards of AMC and trustees. In case of unrated debt instruments, the investment in a single issuer shall not exceed 10 per cent of the NAV of the scheme and in case of such debt instruments of all the issuers in a scheme shall not exceed 25 per cent of NAV subject to approval of Boards of AMC and trustee company. However, these restrictions for debt instruments will not be applicable to government securities and money market instruments.

As investment in unlisted shares is less liquid, such investments have been restricted to a maximum of 10 per cent of the NAV of a scheme in case of close ended scheme. In case of open-ended schemes the limit is made more stringent to 5 per cent of the NAV of the scheme as there is continuous repurchase by investors in such schemes and there is need of liquidity.

Investment for ADRs /GDRs

With a view to expand the spectrum of investment opportunities available to mutual funds, measures have been taken to permit mutual funds to enter the global securities market. In consultation with Reserve Bank of India and the Government of India, the mutual funds have now been permitted to invest in overseas securities. Initially this facility has been extended to ADRs/GDRs issued by Indian companies with an overall cap of US$ 500 million with a sub ceiling of 10 per cent of the net assets managed by individual mutual funds and a maximum limit of US$ 50 million for each mutual fund. The proposals of three mutual funds who showed interest in making such investments, have been cleared.

Permitting derivatives trading

Mutual funds have been allowed to enter into derivatives transactions for the purpose of hedging and portfolio balancing. Detailed guidelines on the procedures to be followed while entering into derivatives trading, have been issued.

Exit option for unit holders

With a purpose to give more flexibility to the mutual funds for the operation of their schemes and to streamline the procedures, the present requirement of consent of 3/4th of the unitholders for any change in controlling interest of AMC or fundamental attributes of a scheme has been done away with. Instead, in such cases, the unitholders shall be informed by way of individual communication as well as through advertisements in the newspapers of the proposed modifications and the unitholders shall be given option to exit at the prevailing NAV without paying any exit load.

Advertisement code

With a purpose to ensure that the advertisements issued by the mutual funds are not misleading, the advertisement code has been amended so that the advertisement on performance is supported by relevant figures and such figures of NAV, yields or returns are given for the past three years wherever applicable. The practice of selectively reproducing extracts from the offer document which could be misleading in the advertisement is not allowed. Celebrities cannot be displayed in advertisements.

Portfolio management activities

As the Asset management companies have expertise in funds management and as they represented to SEBI, they have been permitted to carry out portfolio management activities subject to certain conditions.

Improvement of disclosure standards

With a view to make unit holders aware of the securities in which the funds have been invested by the mutual fund and to enable them to take well informed investment decisions, it has been made mandatory that the mutual funds should send to all unitholders a complete statement of the scheme portfolio before the expiry of one month from the close of each half year.

For easy assessment of the transactions of the mutual funds with the associates of the sponsor, it has been made mandatory for the mutual funds to disclose at the time of declaring half-yearly and yearly result (i) any underwriting obligations undertaken by the schemes of the mutual funds with respect to issue of associate companies, (ii) devolvement, if any, (iii) subscription by the schemes in the issues lead managed by associate companies (iv) subscription to any issue of equity or debt on private placement basis where the sponsor or its associate companies have acted as arranger/ manager.

Code of conduct

The code of conduct has been elaborated to include certain clauses pertaining to integrity, due diligence, fairness in dealings etc which should be adhered to by the AMC and the Trustees.

Implementation of P.K.Kaul committee recommendations

The committee recommended the manner of discharging responsibilities by the trustees. The views of AMFI (Association of Mutual Funds in India) and the trustees of mutual funds were taken into consideration before implementing the same. Board of Directors of the AMCs will now have to play more important role in the compliance process and reporting to trustees periodically in this regard. The manner in which due diligence shall be carried out by the Trustees in fulfillment of the various obligations as required under the Regulations, has been specified. Trustees can appoint independent auditors or can have separate full fledged administrative set up to give them support in discharging their duties in accordance with the SEBI Regulations.

Trustees shall now be required to meet more frequently, at least once in every three months and four such meetings to be held in a year. Also the quorum for such meetings shall require the presence of at least one independent trustee / director who is not associated with the sponsor.

Mutual funds advisory committee

During the year 1999-2000, a standing committee chaired by Shri B.G.Deshmukh was set up to examine the emerging trends in the mutual fund industry and propose suitable amendments to the Mutual Funds Regulations for promoting healthy growth of the mutual fund industry. The committee met twice and made various recommendations.

Collective investment schemes (CIS)

The Government of India, vide its press release dated November 18, 1997, directed that schemes through which instruments like agro-bonds, plantation bonds etc. are issued would be treated as "Collective Investment Schemes" coming under the provisions of Sec.11 (2)c of the SEBI Act.

Pursuant to the Government directions, the SEBI vide its press release dated November 26, 1997 and its public notice dated December 18, 1997 directed under the provisions of Sec. 11B read with Proviso to Section 12(1)(B) of the SEBI Act prohibited the entities from launching any fresh schemes till such time as the regulations for collective investment schemes are notified. The existing entities were also directed to file with the SEBI the details of their schemes. The SEBI had received information from 642 entities who had reportedly raised about Rs. 2681 crore. Based on the information received from investors and government agencies, it had come to the notice of the SEBI that 137 entities may be operating Collective Investment Schemes without filing information with it.

In order to frame the regulations for collective investment schemes, a committee was appointed under the Chairmanship of Dr. S.A. Dave. The committee comprised representations from various ministries like the Ministry of Finance, Ministry of Agriculture, Ministry of Forestry, Regulatory bodies like Reserve Bank of India and Department of Company Affairs, Professional representation from Institute of Chartered Accountants of India, Association of Merchant Bankers and Mutual Funds, Investor Association and representation from the Industry.

After due deliberations, the Committee submitted its interim report and the draft Regulations of Collective Investment Schemes alongwith the recommendations of the accounting sub committee to SEBI on December 31, 1998. These were made available for public discussion and comments/suggestions of investors and the entities operating collective investment schemes were invited. The Association of Agri Plantation Companies of India was also invited to make a presentation before the Committee on the Industries' views on the draft regulations. The Committee considered the suggestions received from all concerned and thereafter, submitted its final report to SEBI on April 5, 1999.

The SEBI Board approved the Regulations for Collective Investment Schemes in its meeting held on August 17, 1999.

The SEBI (Collective Investment Schemes) Regulations, 1999 were notified on October 15, 1999. Henceforth, no person other than a Collective Investment Management Company which has obtained a certificate of registration under the SEBI (Collective Investment Schemes) Regulations, 1999, can carry on or sponsor or launch a collective investment scheme. Also, no existing collective investment scheme can launch any new scheme or raise money from the investors even under the existing schemes, unless a certificate of registration is granted to it under the said regulations.

The Securities Laws (Second Amendment) Act, 1999 had defined "Collective Investment Scheme" by inserting a new section 11AA in the SEBI Act, 1992. On January 25, 2000 the SEBI Board approved amendment to the SEBI (Collective Investment Schemes) Regulations, 1999 by adopting the definition of collective investment scheme as introduced by the said Securities Amendment Act. Further, to remove doubt or technicalities, if any, the Board also adopted the CIS Regulations as the Regulations made under the Amended Act. On February 14, 2000 the SEBI (Collective Investment Schemes) (Amendment) Regulations, 2000 were notified in the Gazette of India.

Venture capital funds

Keeping in view the crucial role played by the venture capital in promoting innovation research, scientific ideas and knowledge based enterprises, proper focus was given to the area of venture capital regulation. The SEBI convened a meeting of the key persons and professionals associated with venture capital industry in India on May 19, 1999. The deliberation of the meeting was to identify regulatory and other issues hampering the venture capital industry in India. It was decided that a Committee would be set up to study in detail all the issues concerning venture capital industry and suggest policy formation at the level of Government.

The SEBI set up a committee under the chairmanship of Shri K B Chandrasekhar of Exodus communication Inc., USA. The committee comprised of industry participants, professionals, representatives from financial institutions and RBI. Four working groups were formed to look into the following areas :

Articulation of vision for venture capital industry in India including creating the environment, research and industry linkage, support services and awareness.

Structuring of venture capital fund and fund raising including regulatory and legal aspects

Investment process and related issues and

Exit related issues including possibility of trading in Unlisted securities, IPO route and valuation aspects.

The working groups deliberated the issues and submitted their recommendations for consideration of the committee. Overseas participants interacted in the deliberations of the committee through tele-conferencing and exchange of E-mails. Draft recommendations of the committee were submitted to SEBI on December 8, 1999 and were immediately published for public comments. Based on the feedback received, the report of the committee was finalised in the meeting held on January 8, 2000.

The recommendations of the committee were widely appreciated and found acceptance by the Government also. A high level meeting consisting of officials from MoF, DCA, RBI, SEBI was held on January 21,2000 at the Ministry in New Delhi to discuss the recommendations of the committee particularly regarding the harmonisation of the regulatory framework for the venture capital funds and the taxation issues.

The Board of SEBI, on January 25, 2000, approved in principle the recommendations of the committee. The main recommendations of the committee are as under:

1. **Multiplicity of regulations – need for harmonisation and single regulator:**

   Presently there are three set of Regulations dealing with venture capital activity i.e. SEBI (Venture Capital Regulations) 1996, Guidelines for Overseas Venture Capital Investments issued by Department of Economic Affairs in the MOF in the year 1995 and CBDT Guidelines for Venture Capital Companies in 1995 which were modified in 1999. The need is to consolidate and substitute all these with one single regulation of SEBI to provide for uniform, hassle free single window clearance.

2. Tax pass through for venture capital funds:

Once registered with SEBI, Venture Capital Funds should be entitled to automatic tax pass through at the pool level while maintaining taxation at the investor level without any other requirement under Income Tax Act.

3. **Mobilisation of global and domestic resources:**

(A) Foreign venture capital investors (FVCIs):

FVCIs should be allowed to register with SEBI and having once registered, they should have the facility of hassle free investments and disinvestments without any requirement for approval from FIPB / RBI.

(B) Augmenting the domestic pool of resources:

Banks, mutual funds and insurance companies should also be permitted to invest in Venture Capital Funds upto a prudential limit.

4. Flexibility in investment and exit:

   A. *Allowing multiple flexible structures:*

   Eligibility for registration as venture capital funds should be neutral to firm structure. The government should consider creating new structures, such as limited partnerships, limited liability partnerships and limited liability corporations.

   B. ***Flexibility in the matter of investment ceiling and sectoral restrictions:***

   According to the committee recommendations, 75 per cent of a venture capital fund's investible funds must be invested in unlisted equity or equity-linked instruments, while the rest may be invested in other instruments. Sectoral restrictions for investment by VCFs could be put by specifying a negative list which could include areas such as finance companies, real estate, gold-finance, activities not legally permitted and any other sectors which could be notified by the SEBI in consultation with the Government. Investments by VCFs in associated companies should also not be permitted. Further, not more than 25 per cent of a fund's corpus may be invested in a single firm.

   C. ***Changes in buy-back requirements for unlisted securities:***

   A venture capital fund incorporated as a company/ venture capital undertaking should be allowed to buyback upto 100 per cent of its paid up capital out of sale proceeds investments and assets and not necessarily out of its free reserves and share premium account or proceed of fresh issue. Such purchases will be exempt from the SEBI takeover code. A venture-financed undertaking will be allowed to make an issue of capital within 6 months of buying back its own shares instead of 24 months as at present. Further, negotiated deals may be permitted in Unlisted securities where one of the party to the transaction is VCF.

D. ***Relaxation in IPO norms:***

The requirement of a 3 year track record should be relaxed provided the issuer company has received at least 10 per cent of its capital as funding from a registered venture capital fund similar to existing provision of funding by banks or financial institutions.

A. **QIB market for unlisted securities:**

A market for trading in unlisted securities by QIBs be developed.

B. **NOC requirement :**

In the case of transfer of securities by VCF to any other person, the requirement of obtaining NOC from joint venture partner or other shareholders should be dispensed with.

(G) RBI pricing norms:

At present, investment/disinvestment by FVCI is subject to approval of pricing by RBI which curtails operational flexibility and needs to be dispensed with.

1. Global integration and opportunities:

A. ***Incentives for employees:***

The limits for overseas investment under the Employee Stock Option Scheme of a foreign company should be raised from present ceilings of US$10,000 over 5 years, and US$50,000 over 5 years for ADRs/GDRs, to a common ceiling of US$100,000 over 5 years. Foreign employees of an Indian company may invest in the Indian company to a ceiling of US$100,000 over 5 years.

B. ***Incentives for shareholders:***

The shareholders of an Indian company that has venture capital funding and is desirous of swapping its shares with that of a foreign company should be permitted to do so.

C. **Global investment opportunity for domestic venture capital funds (DVCF):**

DVCFs should be permitted to invest higher of 25 per cent of the fund's corpus or US $10 million or to the extent of foreign contribution in the fund's corpus in unlisted equity or equity-linked investments of a foreign company. Such investments will fall within the overall ceiling of 70 per cent of the fund's corpus. This will allow DVCFs to invest in synergistic startups offshore and also provide them with global management exposure.

In the meeting of High Level Committee on Capital Markets held at RBI on January 31, 2000 recommendations related to RBI were discussed.

The Hon'ble Finance Minister in his budget speech for the year 2000-2001 announced that SEBI would be single point nodal regulator for registration and regulation of both domestic and overseas venture capital fund/company. He also stated that no approval of Venture Capital Funds by tax authorities would be required and that the principle of "pass through" would be applied in tax treatment of Venture Capital Funds.

The SEBI is now in the process of amending the Venture Capital Fund regulations in the light of K B Chandrasekhar Committee report and also the budget announcements where some important recommendations have been accepted by the government.

Derivative trading

The Securities Law (Amendment) Act 1999, was passed by the Parliament and notification was issued on December 16, 1999, 'derivatives' are now included in the definition of "securities" under SC(R) Act. "Derivatives" has been defined as contracts which derives value form prices, or index of prices of underlying securities.

In-principle approval was granted on January 17, 2000 to the Futures & Options segment of NSE, its clearing house i.e. Futures & Options Segment of NSCCL and the Derivative Segment of BSE. The in-principle approval was subject to compliance with the conditions of eligibility recommended by Dr. L.C Gupta Committee.

On February 1, 2000 SEBI issued guidelines for participation by Mutual Funds in trading in derivative contracts for the purpose of hedging and portfolio balancing.

The Central Government has withdrawn CIRCULAR NO S.O. 2561 DATED JUNE 27, 1969 on forward trading in securities vide its notification dated March 01, 2000. The SEBI has issued notification dated March 01, 2000 permitting trading in Exchange traded derivatives.

All the necessary infrastructure to start derivative trading are in place with NSE & BSE. SEBI has already prescribed regulatory framework for Derivative trading in India. Derivative trading would therefore start very soon.