

SECURITIES AND EXCHANGE BOARD OF INDIA

Memorandum to the Board

Review of certain policies relating to mutual funds – Amendment to SEBI (Mutual Funds) Regulations, 1996

1.0 Objective

1.1 This memorandum seeks approval of the Board to review certain policies relating to mutual funds and carry out consequential amendment to SEBI (Mutual Funds) Regulations, 1996.

2.0 Issues for Consideration

Committee for examining the recommendations given by AMFI

2.1 In order to address the concerns raised by Mutual Fund industry and others, and to encourage the growth of Mutual Fund industry and foster more retail participation especially in the smaller towns, Securities and Exchange Board of India (SEBI) had constituted a Committee to examine the recommendations given by Association of Mutual Funds of India (AMFI) and advise SEBI on the recommendations.

2.1.1 The Committee was chaired by Shri Prashant Saran, Whole Time Member, SEBI and had the following members:

1. Shri H N Sinor, CEO, AMFI
2. Shri Dharendra Kumar, CEO, Value Research
3. Prof.G Sethu, In charge, NISM
4. Shri Narendra Mehta, Investors Grievance Forum, Mumbai
5. Shri V Ganesh, CEO, Karvy Computershare Pvt Ltd

2.1.2 The terms of reference of the Committee were to review the recommendations given by AMFI on the following matters:

- i. Transaction cost and single cheque by investors
- ii. Distributors Regulations
- iii. Simplification of processes and transparency of information.
- iv. Total Expense Ratio
- v. Any other matter relevant to the Mutual Fund Industry with the permission of the Chair.

2.1.3 The committee crystallized its views on the recommendations given by AMFI on the aforesaid issues and based on its recommendations the following proposals are placed.

2.2. Transaction charges

Introduction

2.2.1 SEBI, vide circular dated June 30, 2009 abolished entry load and mandated that the upfront commission to distributors will be paid by the investor directly to the distributor, based on his assessment of various factors including the service rendered by the distributor. This was also designed to meet concerns on high portfolio churn and mis-selling.

2.2.2 Apart from empowering investors to decide the amount of fee payable to the distributor, another important outcome was reduction in the number of New Fund Offers and increase in inflows to the existing schemes. This was in the interest of the desired objective of infusing scale and consolidation in the industry.

2.2.3 It has been represented by the industry that it is the objective of the government and SEBI that mutual funds should expand to the smaller towns and cities to effectively channelize the savings to Capital Market. Mutual funds offer Systematic Investment Plans (SIPs) with the monthly amount as small as Rs.100/- to enable people with smaller saving potential in urban areas and smaller towns access the capital market. The role of distributors is vital in this process. Distributors incur minimum expenditure on traveling and incidentals for reaching to such investor and procuring business for mutual funds. Moreover, for a SIP application, he may not be able to charge investor directly since the investment will happen in future every month. Intermediaries are also required to set up appropriate infrastructure for servicing investors as well as incur certain expenses while marketing the units of mutual funds.

2.2.4 Recommendation of committee for examining the recommendations given by AMFI

The committee has made the following recommendations:

- i. For existing investors in a mutual fund, the distributor would be allowed to charge Rs. 100/- as transaction charge per subscription of Rs.10,000/- and above.
- ii. As an incentive to attract new investors, the distributor would be allowed to charge Rs. 150/- as transaction charge per subscription to an investor investing in any scheme of mutual fund for the first time.
- iii. Mutual Funds shall carry out an exercise of de-duplication of folios across all mutual funds within a period of 6 months.
- iv. There would be no transaction charge on subscription below Rs.10,000/-
- v. In case of SIPs, transaction charge will be applicable only on the first installment (irrespective of the amount of investment through SIP).
- vi. There would be no transaction charge on transactions other than purchases/ subscriptions relating to new inflows.
- vii. There would be no transaction charge on direct transactions with the

mutual fund.

viii. The transaction charge would be subject to the following:

- The above terms and conditions would be part of the application form in bold print.
- The transaction charge would be deducted by the AMC from the subscription amount and paid to the distributor; and the balance would be invested.
- The charge should be prominently displayed on the statement of account of the investor as gross subscription less transaction charge, net investment with units allotted against that.
- Distributors would be able to choose to opt out of charging the transaction charge. However, the 'opt-out' would be at distributor level and not investor level i.e. a distributor cannot charge one investor and choose not to charge another investor.
- The AMCs would be responsible for any malpractice/mis-selling by the distributor while charging transaction costs.

It is also clarified that as per the June 30, 2009 Circular, upfront commission to distributors will continue to be paid by the investor directly to the distributor by a separate cheque based on his assessment of various factors including the service rendered by the distributor.

One of the members has not agreed with the aforesaid recommendations and suggested that "No entry load in any form be stipulated as we totally oppose the same, even in the name of transaction fees. This transaction fees shall not be helpful to bring business as thought by other members of the committee. This in any case will not encourage the growth of the mutual fund industry considering the past when the entry load was in existence. Hence we strongly feel that any type of fees should not be charged to the investor. Please also note that the example of all developed countries has been given without considering the situation if the transaction fee is paid by MF and being considered the same in

over all limit of expenses. In short it will not be deducted from the subscription made by the investors.”

The other members of the committee, however, felt that a component of entry load was ‘transaction charge’. With the abolition of entry load, Independent Financial Advisors (IFAs) found it non remunerative to embark on any transaction, as they would incur out-of-pocket costs on travel and incidental for sourcing mutual fund investors. Thus, instead of rewarding distributors on an ad valorem basis which was the feature of the earlier entry load regime, it would be pertinent to enable distributors to recover such minimum costs as they may reasonably incur in this process.

There also needs to be a system to remunerate distributors bringing new investors into a mutual fund, in the interest of spreading the culture of mutual fund investments.

Proposals:

- 2.2.5 In view of the above, we may accept the aforesaid recommendations of the committee except that in case of SIPs, it is proposed that the transaction charge will be applicable only if the total commitment through SIPs amounts to Rs.10,000/- and above. In such cases the transaction charge can be recovered in 3-4 installments.

2.3 Permissible activities to be carried out by AMC

Introduction

- 2.3.1 Present regulation allows AMCs to undertake activities in the nature of asset management and advisory services provided that the key personnel of the AMC, the systems, back office, bank and securities accounts are segregated activity-wise and there exist systems to prohibit access to inside information of various activities.

Recommendation of committee for examining the recommendations given by AMFI

- 2.3.2 The committee deliberated that though, we have created Chinese walls across “products “or “businesses” within the same investment management team (e.g. Chinese walls/verticals for Mutual funds, PMS, offshore funds and advisory services etc), the actual conflict of interest has not been addressed by merely creating Chinese walls as conflicts may also arise due to the different fee structure received by MF vis-à-vis the other products.
- 2.3.3 Further, even in activities of core competency of mutual funds, or the PMS and Advisory services, there is an inherent conflict of interest as one set of investor may get a favorable treatment vis-à-vis other set of investors.
- 2.3.4 A drawback of having many Chinese walls is that by requiring separate investment teams, back office, systems and personnel, segregation between other activities of AMC, it adds to the cost of AMC. This will translate into higher costs to the ultimate investors as well. Further, regulations mandate to have separate fund manager for each activity and thus investors are not in a position to enjoy the benefits of the cumulative experience of the investment team.
- 2.3.5 In the markets of UK, USA and Hongkong there are no segregation amongst PMS, domestic fund and offshore fund management. The Fund managers or team of professionals can manage different portfolios or funds including segregated accounts of institutional clients and portfolios of retail mutual funds provided disclosure about the potential conflicts of interest is made to the investor.

For ex. under FSA UK regulations, a scheme can belong to either the domestic version i.e. UCITS or a non UCITS retail scheme. So, in UK, when funds by AMC are allowed to manage outside UCITS, retail orientation to outside funds is pre requisite. Thus, in overseas jurisdictions, AMCs manage pooled assets. On the same grounds, we may propose that in India, when mutual fund AMCs manage

other funds, the entity should be on broad based criteria.

2.3.6. Under Indian mutual funds, broad based criteria is 20/25 rule (20 investors, single investor < 25%). Thus other domestic or foreign funds that Indian AMCs may want to manage need to satisfy 20/25 criteria.

2.3.7. The basic conflict of differing remunerations across different businesses can be addressed by requiring AMC to restrict itself to management of funds of other 'broad based' entities and other activities currently undertaken by the AMC like PMS and advisory services shall be undertaken by a separate entity without sharing any resources with that of the AMC.

2.3.8. A potential conflict may manifest themselves in front running, insider trading, and unfair treatment to select investors. To address potential conflicts, compliance in asset management is about ensuring that management to prevent potential conflict of interest and it does not become real conflict of interest.

For example in UK, provision is for disclosure of conflict of interest to clients and potential clients and Conflict policy prescribes that person engaged in business activities involving conflict should be independent .

In USA, time of trade monitoring by investment compliance forms a second line of defense against trade errors and portfolio managers required to treat each of their accounts "fair and equitably in the allocation of Investment ideas".

2.3.9 Thus managing conflict of interest needs to be addressed in 3 pronged manner i.e. between client and AMC, client Vs client and between clients and AMC employees. Principle based approach of fair treatment is prescribed under AMC section. But taking cue from UK FSA and HK SFC, a few broad guidelines on how to address conflict situations may be prescribed.

2.3.10 In view of the above, the committee made the following recommendations:

- i. There should be disclosure in SID that there exists no material conflict of interest across activities, if any.

- ii. AMCs to manage and advise only pooled assets including offshore funds, insurance funds, pension funds, provident funds, etc that are broad based provided there is no conflict of interest due to differential fee structure. The absence of conflict of interest should be demonstrated through appropriate disclosures to the trustees and unit holders (in the SAI). Here, broad based fund would mean that the fund should have at least 20 investors; and no single investor should account for more than 25% of the corpus of the fund.
- iii. Activities such as PMS and private advisory services shall be undertaken by a separate entity without sharing any resources including research with that of the AMC. The existing mutual funds may be given a one year time to comply with this.
- iv. There should be one fund manager for every unique strategy followed by the MFs/ AMCs. SEBI may indicate a proper timing/schedule for implementation of this.
- v. Mutual Funds to ensure fair treatment of investor/s across different products that shall include but not limited to, an asset management company to carry out simultaneous buy and sell in the same equity security only through market mechanism and a written down trade order management system.
 - a. Provided that there are stated disclosure documents that there exist no material conflict of interest across activities, if any
 - b. Provided that if there are unavoidable conflict of interest situations, asset management company shall satisfy itself that disclosures are made of source of conflict, potential 'material risk or damage' to investor interests and detailed parameters for the same .
 - c. That independence be provided to key personnel handling the relevant conflict of interest through removal of direct link between remuneration to relevant AMC personnel and revenues generated by that activity.

Proposals:

- 2.3.11. SEBI is working on regulations for alternate investment vehicles (including PMS) and hence it is proposed that the proposals in para 2.3.10 be approved except para 2.3.10 (iii).

2.4 Transparency of information

2.4.1 Disclosures through Advertisement:

Introduction

The SEBI (Mutual Funds) Regulations, 1996 and various circulars issued thereafter have elaborate prescriptions regarding various kinds of advertising like tombstone, product and performance advertising. Though the regulations and circulars give very prescriptive guidelines, the Committee felt that the same can be enhanced by giving additional disclosures and to standardize the content in the advertisements.

Performance measurement of a scheme is used to assess how well the investment has done in comparison to the market and even its peers. While the objectives or strategies adopted by schemes may be different, the benchmark indices provide the simplest medium for the investors to assess the performance of the scheme. Mutual Funds should select appropriate benchmarks for a scheme after a proper assessment of its investment objective, investment universe and proposed asset allocation. Earlier, Mutual Funds used to provide only the returns obtained by a scheme over various time periods while providing the performance. Vide our circular no. MFD/CIR/16/400/02 dated March 26, 2002, the Mutual Funds were asked to disclose the benchmark returns as well in the performance disclosure.

A study by CRISIL on performance of Mutual funds in 2009 brought out that 55% of the large cap equity funds underperformed the S&P CNX Nifty. Also 70% of the large cap funds underperformed the S&P CNX Nifty over the last 5 year period. However, the same may not reflect when the funds publish their results as many schemes use their own customized benchmarks which are paid for by the AMCs.

2.4.2 Disclosure of AUM

Data like AUM and folios of various mutual funds is routinely disclosed on the AMFI website and in the fact sheets of the mutual funds which are also uploaded on the individual websites of mutual funds. However, further bifurcation of the AUM into equity and debt, retail and wholesale and by city, which would present a clearer picture on the concerned mutual fund, is not provided.

2.4.3 Disclosure of commissions

In the interests of greater transparency, it is desirable that the total commission paid by AMCs to distributors and the amount paid to leading distributors by AMCs be disclosed.

2.4.4 Recommendation of committee for examining the recommendations given by AMFI

- i. As the current disclosure of CAGR does not provide ease of understanding to retail investors, point-to-point return on a standard investment of Rs. 10,000/- may also be shown in addition to CAGR for a scheme that is existent for at least three years since inception.
- ii. Where scheme has been in existence for more than three years, performance advertisement shall be provided since inception and for as many twelve month periods as possible for the last 3 years, such periods being counted from the last day of the calendar quarter preceding the date of advertisement, along with benchmark index performance for the same periods.
- iii. Where scheme has been in existence for less than three years, performance advertisement of scheme(s) shall be provided for as many as twelve month periods as possible, such periods being counted from the last day of the calendar quarter preceding the date of advertisement, alongwith benchmark index performance for the same periods.
- iv. Where investment track record is for less than one year, past performance shall not be provided.

- v. The return may be expressed in INR and percent.
- vi. For the sake of standardization, a similar return in INR and percent and CAGR must be shown for the following apart from the scheme benchmarks:

| Scheme Type | Benchmark |
|-----------------------|----------------------------|
| Equity scheme | Sensex or Nifty |
| long term debt scheme | 10 year dated Gov security |
| short-term debt fund | 1 year T-Bill |

These disclosures shall form a part of the SAI and all advertisements of mutual funds.

- vii. Other performance data-for quarter/half year may be shown as at calendar quarter/half year ends only.
- viii. When the performance of a particular mutual fund scheme is advertised, the advertisement should also include the performance data of all the other schemes managed by the fund manager of the scheme.
- ix. SEBI may also consider revisiting the existing regulations and circulars on advertisements and come out with a comprehensive set of guidelines in regard.

AUM disclosure

- x. Wherever the mutual funds discloses the AUM figures for the fund, disclosure on bifurcation of the AUM into debt/equity/ balanced etc, and Percentage of AUM by geography (i.e. top 5 cities, next 10 cities, next 20 cities, next 75 cities and others). The mutual funds to disclose the figures on their respective websites and AMFI to disclose industry wide figures on the AMFI website.

Commission disclosure

- xi. There should be disclosure of total expenses paid to distributors along with the names and amount of commission paid to Top 10 distributors of each Asset management company. Mutual funds will disclose the aforesaid disclosures at their

respective websites and submit the same to AMFI. AMFI shall disclose the consolidated disclosure on their website.

Proposal

2.4.5 In view of above, it is proposed that the aforesaid recommendations of the committee may be accepted. However with regard to disclosure of commissions as stated at para 2.5.4.xi above in order to cover those distributors who cater to non-institutional category, it is proposed that in the initial stage disclosure of commissions paid to such distributors who satisfy one or more of the following conditions may be mandated with respect to non-institutional (retails and HNI) investors :

- 1 Multiple point presence (More than 20 locations)
- 2 AUM raised over Rs.100 crore across industry in the non institutional category but including high networth individuals (HNIs).
- 3 Commission received of over Rs. 1 crore p.a. across industry
- 4 Commission received of over Rs. 50 lakh from a single mutual fund

2.4.6 The review of other provisions of SEBI (Mutual Funds) Regulations, 1996 and circulars issued by SEBI on advertisement will be carried out in due course.

2.5. Simplification of processes

Common Account Statement

2.5.1. SEBI has enabled asset management companies to issue a common statement across the mutual funds in respect of mutual fund accounts maintained by respective Registrars and in the event of investor choosing to retain mutual fund units in demat account, investor should receive single statement of holdings covering mutual fund units. This will result in the following advantages:

- The investor gets a single view of all his/her investments across fund houses.

- Cost incurred by fund houses in dispatch of individual account statements ultimately results in increased cost to the fund / investors. Common Account Statement would reduce this cost.

2.5.2. Currently common account statement is available via email, to investors who have registered an email, through Mailback, by private arrangement between three RTAs – Karvy, CAMS and FT. This is not mandatory but an added convenience to the Investors and the common statement needs to be initiated by the investor. The current model aggregates based on email id of investors.

2.5.3 Regulation 36 of SEBI (Mutual Funds) Regulations, 1996 regarding statement of accounts or unit certificates which reads as under:

“36. (1) The asset management company shall issue to the applicant whose application has been accepted, a statement of accounts specifying the number of units allotted to the applicant as soon as possible but not later than five working days from the date of closure of the initial subscription list and/or from the date of receipt of the request from the unitholders in any open ended scheme:

Provided that if an applicant so desires, the asset management company shall issue the unit certificates to the applicant within five working days of the receipt of request for the certificate.”

2.5.4. It was pointed out by the registrars to the mutual funds that once they switch over to proposed monthly frequency of common statements, given that extraction of data, aggregation across funds based on the defined logic, printing and dispatch would take about 10 days. Therefore, it was requested by the industry to review and consider issuing a communication to the effect that "Consolidated account statements may be dispatched to the transacted folios / investors every calendar month on or before the 10th of succeeding month".

2.5.5 Recommendation of committee for examining the recommendations given by AMFI

- 1 RTAs will dispatch one common account statement every month for investors who have transacted in any of his folios. The format of the common account statement shall be standard across all AMCs and shall contain disclosure regarding investor's holdings across all mutual funds. In this respect financial transactions will include purchase, redemption, switch, dividend payout, dividend reinvestment, SIP, STP, SWP and bonus transactions. The statement of account shall also contain the disclosure related to the transaction charge paid to the distributor.
- 2 RTAs will dispatch one common account statement every half year (September/March) for all non-transacted folios.
- 3 These dispatches of common account statement shall start from October 1, 2011.
- 4 RTAs will identify common investors across Fund houses by their PAN Number.

Proposal

2. 5. 6 The aforesaid recommendations of the committee may be accepted.

2.6. Distributors of mutual fund products

Introduction

- 2.6.1. Currently SEBI does not regulate the distributors of mutual fund product. It is felt that there is need to regulate these distributors in the interest of the investors in the long term by way of a regulation. However, in the interim period (till the time the regulations are notified) it is proposed that we may regulate the distributors through AMCs by putting in place the due diligence process to be conducted by AMCs.

2.6.2. Recommendation of committee for examining the recommendations given by AMFI

- i. The due diligence process may be initially applicable for distributors satisfying one or more of the following criteria:

- 1 Multiple point presence (More than 10 locations)
- 2 AUM raised over Rs.100 crore across industry
- 3 Commission received of over Rs. 1 crore p.a. across industry
- 4 Commission received of over Rs. 10 lakh from a single mutual fund

It is understood from data collected from an RTA that these parameters would be covering around 600 distributors. The basic premise is that beginning of regulation of distributors should be a smaller, manageable number of distributors with a future move to a larger number.

- ii. At the time of empanelling distributors and during the period review process, mutual funds shall undertake a due diligence process to satisfy 'fit and proper' criteria that incorporate, amongst others, the following factors:

- a. Business model, experience and proficiency in the business.
- b. Record of regulatory / statutory levies, fines and penalties, legal suits, customer compensations made; causes for these and resultant corrective actions taken.
- c. Review of associates and subsidiaries on above factors.
- d. Organizational controls to ensure that the following processes are delinked from sales and relationship management processes and personnel:

- 1 Customer risk / investment objective evaluation.
- 2 MF scheme evaluation and defining its appropriateness by customer risk categories.

iii. Customer relationship and transactions are categorized as:

- 1 Advisory – where the institutional distributor commits to distributing only on the principle of ‘appropriateness’ of products to that customer category. Appropriateness is defined as selling only that product categorization that is identified as best suited for investors within a defined upper ceiling of risk appetite. No exception can be made.
- 2 Execution Only – all transactions that are not booked as ‘advisory’ and, would therefore, mandatorily require:
 - o In case of “execution only” transaction where the institutional distributor has information to believe that the transaction is not appropriate for the customer, then a written communication shall be made regarding whether the product is suitable or otherwise to the investor, duly acknowledged and accepted by investor.
 - o A customer confirmation to the effect that the transaction is ‘execution only’ notwithstanding the ‘advice of appropriateness’ from that distributor, is obtained prior to the execution of the transaction.
 - o That on all such ‘execution only’ transactions, the customer is not required to pay the distributor anything other than a standard flat transaction fee, that is not ad valorem or percentage of value and is consistent across all investors irrespective of the transaction value.

3 There may be no third categorization of customer relationship / transaction

iv. Compliance and risk management functions of the institutional distributor include review of defined management processes for:

- a. The criteria to be used in review of products and the periodicity of such review.
- b. The factors to be included in determining the risk appetite of the customer and the investment categorization and periodicity of such review.
- c. Review of transactions, exceptions identification, escalation and resolution process by internal audit.
- d. Recruitment, training, certification and performance review of all personnel engaged in this business.
- e. Customer on boarding and relationship management process, servicing standards, enquiry / grievance handling mechanism.
- f. Internal / external audit processes, their comments / observations as it relates to MF distribution business.
- g. Findings of ongoing review from sample survey of investors

v. AMFI and mutual funds are encouraged to implement additional measures as deemed appropriate to help achieve greater investor protection.

Proposal

2.6.3 As per the criteria laid down by the committee AMCs would be required to do due diligence for around 600 distributors. Since this number is very high to begin with, it is proposed that the following due diligence process may be initially applicable for those distributors satisfying one or more of the criteria stated in para 2.4.5 At the time of empanelling distributors and during the period review process, mutual funds shall undertake a due diligence process to satisfy 'fit and proper' criteria that incorporate, amongst others, the factors described in para 2.6.2.

2.7. Green initiative and cost effective measures

2.7.1. There is a proposal from AMFI to allow mutual funds to send the scheme annual accounts to investors who have registered their email ids with the mutual funds, by email only. Besides being a green initiative, this would save unnecessary costs incurred in printing and dispatching the annual reports. SEBI concurs with the views of the Committee set up for examining the recommendations given by AMFI and feels that this is a good initiative and accordingly it is proposed that:

In case of unitholders whose email ids are available with the Mutual Fund, the AMCs should communicate to them stating that henceforth, the scheme annual reports would only be sent by email.

In case of unitholders whose email ids are not available with the Mutual Fund, the AMCs should communicate to the unitholders to obtain their email ids for registration of the same in their database.

- i. The communication in both the above cases should clearly mention that the scheme annual accounts would henceforth be sent to these email ids and not as physical copies.
- ii. The communication should also have an option for the investors stating that those who still wish to receive the reports as physical copies may indicate as much.

- iii. In case of any request from these unitholders as detailed above for hard copies notwithstanding their registration of email ids, AMCs should provide the same without demur.
- iv. For the rest of the investors, i.e. whose email ids are not available with the mutual fund, the AMCs shall continue to send hard copies of scheme annual reports.
- v. The AMCs shall display the link of the scheme annual reports prominently on their websites and make the physical copies available to the investors at their registered offices at all times.

3.0 PROPOSALS

3.1. It is proposed that the proposals as mentioned at 2.2.5, 2.3.11, 2.4.5, 2.4.6, 2.5.6, 2.6.3 and 2.7.1 above may be accepted.

3.2 The Board is requested to consider and approve the proposals contained in para 3.1 above and authorize the Chairman to take necessary consequent steps to give effect to the decisions.