

Amendment to SEBI (Mutual Funds) Regulations, 1996

1.0 Objective:

1.1 This Board memorandum proposes to amend various regulations of SEBI (Mutual Funds) Regulations, 1996 to provide clarity, remove redundant provisions and operational difficulties and to incorporate certain policy changes.

2.0 Background:

2.1 SEBI (Mutual Funds) Regulations, 1996 (hereinafter called as “MF Regulations”) notified in the year 1996 to regulate mutual funds have since undergone several amendments and various circulars have been issued thereunder, broadly to enhance transparency and disclosures, to address the emerging issues, to improve operational efficiency, to protect the interest of investors, to facilitate development and growth and to strengthen the regulatory framework for mutual funds in India, etc.

2.2 As no comprehensive review of MF Regulations was carried out, a need to undertake regulatory revamp exercise of MF Regulations and various Circulars issued thereunder was felt with the objective to:

- a. Remove ambiguities of language, contradictions with other Regulations and redundant provisions
- b. Suggest amendments to align with Companies Act, 2013 and Insolvency and Bankruptcy Code, 2016
- c. Suggest amendments to remove operational difficulties & consequential changes, if any

3.0 Consultative Process:

3.1 Suggestions were invited from various market participants for the regulatory revamp exercise, were deliberated internally and placed before Mutual Fund

Advisory Committee (MFAC). Based on the recommendation of MFAC, a Working Group comprising representatives from mutual fund industry, law firm and officials of SEBI was formed with the mandate to:

- a. Examine the suggestions received from the market participants.
- b. Examine the other policy suggestions received and suggest appropriate amendments.
- c. Take up any other matter referred to the Working Group.

3.2 Proposals to amend MF Regulations based on the suggestions of the Working Group were placed before MFAC.

3.3 MFAC deliberated on the suggestions of the Working Group and certain policy issues including eligibility criteria of a sponsor of a mutual fund. The recommendations of MFAC are given under Part I of Annexure A. Certain other proposals based on suggestions from market participants and internal examinations are broadly in the nature of removal of redundant provisions, ambiguity in language and alignment with existing applicable Acts and other Regulations which were not discussed in MFAC are given under Part II of Annexure A.

4.0 Proposals and Rationale:

4.1 The detailed proposals with regard to amendments to MF Regulations along with rationale are placed at Annexure A. The proposals at Annexure A are divided into the following broad categories:

4.1.1 Removal of Redundant Provisions and Ambiguity in Language

- i. Certain provisions in the MF Regulations have become redundant due to expiry of the timeline(s) provided to mutual funds for implementation or non-applicability of certain provisions subsequently, such as amortization of initial issue expenses in close ended schemes and submission of certain

periodic reports by mutual funds, abolition or phasing out of certain provisions such as applicability of entry load and provisions related to Rajiv Gandhi Equity Saving Scheme (RGESS), etc.

- ii. Further, in certain provisions of MF Regulations, grammatical correction and removal of ambiguous language were required.

In view of the above, certain amendments in MF Regulations are proposed based on the recommendations of MFAC and suggestions of market participants.

4.1.2 Addressing Operational Difficulties

- i. In MF Regulations, some terms such as “affiliates” and “controlling interest” are mentioned but not defined. Further, these terms resemble the terms “associates” and “Control” which are defined in MF Regulations. Therefore, MFAC has recommended to replace the term “affiliates” with the term “associates” and the term “Controlling interest” with the term “Control” in MF Regulations.
- ii. There are certain regulatory requirements which are consequential in the nature, but lead to duplication of the processes, and can be avoided. For example, in cases where amendment to trust deed is consequential to reflect/ record the Change in Control, MFAC has recommended that separate unitholder’s approval for amendment in trust deed may not be required, once the change in control is approved.
- iii. Timelines prescribed for issuance of Consolidated Accounts Statements to unitholders may need revision as per the industry practices and processes, therefore, MFAC has recommended that the existing timelines which are prescribed in MF Regulations may be relaxed by providing additional time and may be prescribed through a circular.

- iv. In certain cases based on the recommendations of MFAC, MF Regulations are proposed to be amended by incorporating suitable clarifications w.r.t. provisions related to auditors of mutual funds and non-applicability of issuer level investment restrictions as per seventh Schedule of MF Regulations to debt ETFs, which were issued by way of circulars.

4.1.3 Alignment with the existing applicable Acts and other SEBI Regulations.

MFAC has recommended removal of references to various Acts and other Regulations in MF Regulations, which have been repealed, abolished or phased out over the years such as Companies Act, 1956, Monopolies and Restrictive Trade Practices Act, 1969, SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 1995, etc. and alignment with new Acts, Codes and Regulations notified / enacted such as Companies Act, 2013, Competition Act, 2002, SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003, etc.

Similar amendments in MF Regulations are also proposed based on the suggestions of market participants.

4.1.4 Policy Changes

A few proposals in the nature of policy changes leading to amendments to MF Regulations are as under:

i. Eligibility Criteria of Sponsor

- a. One of the eligibility criteria for sponsoring a Mutual Fund, as laid down in Regulation 7(a) of MF Regulations, outlining 'sound track record and general reputation of fairness and integrity' is that the sponsor (applicant) should have profit after providing for depreciation, interest and tax in three out of the immediately preceding five years, including the fifth year, while making application. Over the years, the role of

technology in financial services industry has increased manifold. For enhancing geographical outreach of mutual funds beyond top 30 cities (B-30 cities), there is a need to encourage setting up of Mutual Funds by entities that can facilitate enhanced reach to more and more investors at a faster pace though they may yet not be profitable due to their business models. This may also be reasonable as the profitability of the sponsor is not an ongoing requirement post registration of mutual fund. In view of the above, MFAC has recommended:

In case the applicant is not complying with only the requirement of profitability, the applicant may be considered to sponsor a mutual fund subject to having a net worth of not less than INR 100 crores for the purpose of contribution towards networth of Asset Management Company (AMC) and the AMC should maintain the net worth of not less than Rs.100 crores till it has profits for five consecutive years.

b. As of now the sponsor can apply for mutual fund registration only if it fulfills the criteria to have networth more than its capital contribution to AMC in the previous financial year. In case the sponsor is not fulfilling the networth requirement in the previous financial year but fulfills anytime during the current financial year, the sponsor has to wait till the financials of the current year gets audited to fulfill the criteria. In order to facilitate such sponsors to make application, MFAC has recommended:

1. While making application, the networth shall be more than the proposed capital contribution of the sponsor in the AMC (in case of setting up of a new mutual fund). A latest net worth certificate from the statutory auditor to this effect shall be provided along with the application.

2. Further, in case of acquisition of shares of an existing AMC of a mutual fund leading to change in control, the networth of the sponsor

shall be more than the aggregate par value or market value of the shares so acquired, whichever is higher.

ii. Definitions

With a view to bring greater robustness, clarity and uniform interpretation across the industry, MFAC has recommended to define certain terms and modify certain existing definitions which, inter-alia, includes the following:

a. Networth

Currently, as per the extant provisions of MF Regulations, "networth" means the aggregate of the paid up capital and free reserves of the asset management company after deducting therefrom, miscellaneous expenditure to the extent not written off or adjusted or deferred revenue expenditure, intangible assets and accumulated losses. In this regard, MFAC has recommended:

1. To bring the definition of networth in the definition section of the MF Regulations for making it applicable for both AMC & Sponsors.
2. To make computation of networth of AMCs more robust, loans and advances given by AMC to either sponsor, associates or group company of sponsor and associates or group company of asset management company shall be excluded while computing the networth of the asset management company.

b. Associate

1. As per current definition of 'associate' if the independent director of a company is an independent director of an AMC or Trustee Company, that company is considered as an associate of the AMC as per the existing provisions, which may not be desirable. Further,

the term associate of sponsor though used, is not defined in MF Regulations.

2. Therefore, MFAC has recommended to exclude companies with common independent directors from the ambit of the term “associate” and to expand the definition of ‘associate’ to cover associates of sponsor.

iii. Networth of AMC on a continuous basis

As per the extant provisions of MF Regulations, the trustees review the networth of the AMC on quarterly basis and in case of any shortfall, they need to ensure that the AMC makes up for the shortfall. MFAC has recommended that the requirement of maintaining the minimum networth should be mandatory on a continuous basis.

iv. Board of Directors of Trusteeship Company

Currently, MF Regulations do not explicitly mention whether the term “Trustees” also refers to directors of the Board of Trustees, in case the trusteeship of the mutual fund is with a trustee company. Therefore, MFAC has recommended that wherever the context requires applicability of the provisions of MF Regulations to individual trustees, the provisions shall be made applicable to directors of the Board of Trustees of such trustee company.

v. Disclosure by Trustees with respect to details of their transactions of dealing in securities

Currently trustees are required to file the details of their transactions of dealing in securities with the Mutual Fund on a quarterly basis. However, timelines for filing the quarterly reports are not prescribed. Further, currently,

trustees are required to report to Mutual Funds only those transactions in securities that exceed INR one lakh in value. The existing guidelines regarding the aforementioned threshold was prescribed in January, 2000.

MFAC has recommended to prescribe the timelines for quarterly filing and to enhance the threshold value of transaction in securities for the purpose of reporting from the existing INR one lakh to INR five lakh.

vi. Segregation and ring- fencing of assets and liabilities of mutual fund schemes

The extant MF Regulations require that mutual fund schemes should have scheme-wise segregation of bank accounts and securities accounts. Since the interest of investors of each scheme of a mutual fund are distinct, MFAC has recommended that assets and liabilities of each scheme are segregated and ring-fenced from other schemes of the mutual fund.

vii. Exit Load

As per existing MF Regulations, there is a cap of seven percent on exit load. Generally, mutual fund schemes charge one to two percent as exit load, however some long term schemes such as retirement schemes have exit load of around five percent. Accordingly, MFAC has recommended to amend MF Regulations to reduce the existing seven percent cap on exit load to five percent for all mutual fund schemes which can charge exit load.

viii. Issuance of Physical Unit Certificate

There is an existing provision in MF Regulations for issuance of physical unit certificate on request of the unitholders. Since, demat is a safe way of recording the holding of investments as compared to unit certificates, MFAC has recommended that, going forward, only statement of accounts and units

in dematerialized form may be issued by AMCs to unitholders for all mutual fund schemes.

ix. Mode of despatch of payments (for both dividend and redemption) by AMCs to unitholders and timeline for despatch of dividend payments

To streamline all modes of despatch of payment of dividend and redemption proceeds to mutual fund investors and to reduce the timeline for dividend payments, MFAC has, inter-alia, recommended that:

- a. To reduce the timeline for payment of dividends to unitholder from the existing 30 days from the date of declaration of dividend to 15 days from the record date.
- b. To permit other modes of despatch, apart from registered post with acknowledgement due and to allow, in addition to dividend warrants, cheque or demand draft, other modes of payment such as electronic modes of payment which may be specified through a circular.

x. Interest chargeable and penalty on delay of dividend payments

For delay in payment of redemption proceeds to unitholders, there are provisions in MF Regulations for payment of interest and penalty for such delays by AMCs. However, there is no specific mention with respect of liability of AMCs towards payment of interest and penalty in case of delay in dividend payments to unitholders. Therefore, MFAC has recommended to amend the extant provisions of MF Regulations for providing clarity with respect to the liability of the AMC with respect to payment of interest and penalty in case of delay in dividend payments.

- 4.2 It is proposed that the recommendations of MFAC and the proposals based on the suggestions received from market participants may be accepted. In this

regard, the draft notification for amendments to MF Regulations vetted by legal department is placed at Annexure B.

4.3 Further MFAC has recommended certain changes such as giving option to unitholders for their consent / approval through postal ballot wherever required, requirement of approval from the Board in case of fundamental attribute changes in mutual fund schemes, exit period with respect to exit options to be given to unitholders under various provisions, etc. These changes and the consequential changes pursuant to amendments in MF Regulations as proposed at paragraph 4.2 above may be issued through circular(s).

5.0 Proposals for consideration and approval of the Board:

5.1 The Board may consider and approve the proposals and draft amendments to MF Regulations at paragraph 4.2 above.

5.2 The Board may authorize the Chairman to take steps to implement the proposals with consequential and appropriate changes, as may be required in this regard.

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