Subject: Norms for Shareholding and Governance in Mutual Funds

1. Objective

1.1. The objective of this memorandum is to place a proposal to restrict sponsor of a mutual fund, its associate and/or its group company or any shareholder holding 10% or more stake in an Asset Management Company ("AMC") / Trustee Company of a mutual fund operating in India, from having significant stake and/or representation in the board of AMCs / Trustee Companies of other mutual funds operating in India.

2. Background

2.1. The SEBI (Mutual Funds) Regulations, 1996 ("MF Regulations") prescribes a legal structure with inbuilt checks and balances in the form of independent agencies viz. Trustees, AMC, Custodian, Sponsor etc. Eligibility criteria has been prescribed in the MF Regulations for the sponsor for grant of certificate of registration. A Mutual Fund has to be constituted in the form of a Trust, created through a Trust Deed and executed by the sponsor in favour of the Trustees who hold the property of the Mutual Fund in trust for the benefit of the unit holders. As per the MF Regulations sponsor means any person who, acting alone or in combination with another body corporate, establishes a mutual fund and contributes at least 40% to the net worth of the AMC.

2.2. In order to prevent conflict of interest in the working of Trustees, it has inter-alia been prescribed in Regulation 16 (4) of MF Regulations that "No person who is appointed as a trustee of a mutual fund shall be eligible to be appointed as a trustee of any other mutual fund…". Further, Regulation 16(3) of MF Regulations provides restriction on AMC or its directors, officers or employees to be appointed as a Trustee of any Mutual Fund.

Further, in order to prevent conflict of interest in the working of AMC directors, it has inter-alia been prescribed in Regulation 22 (a) of MF Regulations that "…any director of the asset management company shall not hold the office of the director in another asset management company 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 asset management company of which such person is a director, has been obtained…".

3. Definitions as per MF Regulations

3.1. *Sponsor has been defined in Regulation 2(x) as "…any person who, acting alone or in combination with another body corporate, establishes a mutual fund".*

Further, Regulation 7(c) of MF Regulations inter-alia states that "..any person who holds 40% or more of the net worth of an asset management company shall be deemed to be a sponsor..."

3.2. *As per Regulation 2(c) of MF Regulations, "associate" includes a person,—*

3.2.1. *who directly or indirectly, by himself, or in combination with relatives, exercises control over the asset management company or the trustee, as the case may be, or*

3.2.2. *in respect of whom the asset management company or the trustee, directly or indirectly, by itself, or in combination with other persons exercises a control, or*

3.2.3. *whose director, officer or employee is a director, officer or employee of the asset management company;*

3.3. *As per Regulation 2(g) of MF Regulations, "control" means—*

3.3.1. *in the case of a company any person or combination of persons who directly or indirectly own, control or hold shares carrying not less than 10% of the voting rights of such company; or*

3.3.2. *as between two companies, if the same person or combination of persons directly or indirectly, own, control or hold shares carrying not less than 10% of the voting rights of each of the two companies; or*

3.3.3. *majority of the directors of any company who are in a position to exercise control over the asset management company;*

4. Issue under consideration

4.1. *For sponsor / its associate / its group company:*

4.1.1. *While appropriate restrictions are in place in the MF Regulations to avoid conflict in appointment and functioning of the Trustees, the MF Regulations are silent with regard to the sponsor having stake or representation in the board of AMCs / Trustee Companies* *of other mutual funds operating in India. When sponsor files an application for setting up of mutual fund with SEBI, it is seen whether the sponsor is already running a mutual fund or has control over AMC of any other mutual fund. Such situations are not desirable as there would be inherent conflict of interest in case a sponsor is same for more than one AMC which may compete with each other in the domestic as well as international markets.*

Further, there could be a possibility that a mutual fund sponsor may have representation, with or without having any shareholding, on the board of AMC / Trustee Company (or board of Trustees) of other mutual funds and thus have influence over such AMC / Trustee Company. This may not be desirable as there would be conflict of interest.

4.1.2. Regulation 21 (1) (d) of MF Regulations states that "the board of directors of such asset management company has at least fifty per cent directors, who are not associate of, or associated in any manner with, the sponsor or any of its subsidiaries or the trustees". Thus, upto 50% directors in the board of AMC can be associated with the sponsor.

Similarly, regulation 16 (5) of MF Regulations states that "Two-thirds of the trustees shall be independent persons and shall not be associated with the sponsors or be associated with them in any manner whatsoever". Thus, upto 1/3rd of the trustees of a mutual fund can be associated with the sponsor.

4.1.3. If sponsor of a mutual fund, its associate and/or its group company takes significant stake or appoints representative on the board of AMCs / Trustee Companies of other mutual funds, following potential conflicts may arise:-

- *Sponsor with its associate directors / representative on the board of other AMC and Trustee Company (or Board of Trustees) may influence the economic and business decisions of that mutual fund.*
- *Also, it would be privy to information or developments in the other mutual fund, which may be used for its own competitive advantage.*

- *As a shareholder, it may influence the strategic initiatives which require shareholder's approval e.g. allotment of ESOP, change in Memorandum of Association and Article of Association etc.*

Further, Statement of additional information (SAI) which forms part of offer documents of Mutual funds contains details of sponsors along with the details of their financial performance. In SAI, the appearance of the name of sponsor of other mutual fund may create confusion among investors.

4.1.4. Further, para 2 of Seventh Schedule of MF Regulations on Restrictions on Investments inter-alia states that "…No mutual fund under all its schemes should own more than ten per cent of any company's paid up capital carrying voting rights…".

A mutual fund through its scheme can acquire shares of AMC of other mutual funds either by subscribing shares or transfer of shares from another shareholder. Further, Mutual Funds can also acquire shares of listed AMCs through stock exchanges. One of the AMCs is already listed and few other AMCs are also planning for listing in the near future.

Hence, a sponsor both directly or through the schemes of its mutual fund may take stake in other AMC/ Trustee Company and thus may get to exercise voting rights corresponding to such holding. So a need is felt to restrict the sponsor from acquiring shares of other AMCs through the scheme of its mutual fund as well.

In view of the possible conflicting issues as enumerated under para 4.1.3 and para 4.1.4, it may not be desirable that a sponsor of a mutual fund, its associate and/or its group company, and its AMC through the schemes, collectively, to have 10% or more stake or have representation in the board of AMCs / Trustee Companies of other mutual funds operating in India.

4.2. <u>For shareholders other than sponsor having 10% or more stake:</u>

4.2.1. As stated in para 3.3 above, MF Regulations have defined the controlling interest. At the time of giving registration to a mutual fund, SEBI conducts due diligence of all the entities holding 10% or more stake each in the mutual fund. Moreover, in case of any subsequent change in controlling interest of 10% or more in an AMC, prior approval of *the trustees and SEBI is required; and the unitholders are required to be given an option to exit on the prevailing Net Asset Value without any exit load.*

In view of the above, it is not desirable that any shareholder holding 10% or more stake in an AMC / Trustee Company of a mutual fund operating in India, to have 10% or more stake or have representation in the board of AMCs / Trustee Companies of other mutual funds operating in India.

5. ***Discussion in Mutual Funds Advisory Committee ("MFAC")***

A proposal to restrict sponsor / shareholder of a mutual fund from having stake in another mutual fund was taken to MFAC in the meeting held on December 23, 2016 to deliberate on the issue. The issue was discussed by the committee members and the committee principally agreed to the proposal that sponsor / shareholder of a mutual fund operating in India should be restricted from holding any stake in AMC / Trustee Company of other mutual fund operating in India. However, the modalities in this regard would be formulated by SEBI addressing all the relevant concerns. The committee also agreed to the proposal that sponsors or any shareholder of existing mutual funds operating in India, having stake in AMCs / Trustee Companies of other mutual funds operating in India, should be given a reasonable time, say 1 year, to offload their shareholding in such other AMCs / Trustee Companies.

Subsequent to the recommendations of MFAC, during the course of further examination the following came to light:

i. *there could be a possibility that a mutual fund sponsor may have representation, with or without having any shareholding, on the board of AMC / Trustee Company (or board of Trustees) of other mutual funds and may have influence over the other AMC / Trustee Company.*

ii. *A shareholder (including sponsor of mutual fund) holding minor stake (less than 10%) in AMCs / Trustee Companies of other mutual funds operating in India may not raise any conflict issue; and*

iii. *Sponsors through its mutual funds schemes may acquire upto 10% stake of AMC/ Trustee Company of another Mutual Fund, as permitted under MF Regulations.*

Accordingly, efforts have been made to address the aforesaid concerns as well.

6. "(para has been excised for the reasons of confidentiality)"

7. Impact Analysis

Absence of any restriction on holding of shares of AMCs / Trustee Companies of multiple mutual funds by a single entity may lead to a situation of conflict of interest. This conflict of interest would ultimately affect the functioning and performance of the mutual fund industry as a whole. Thus, removal of such possible causes of conflict of interest would benefit not only the affected fund houses but also the entire mutual fund industry.

8. Proposal

8.1. In view of the need to avoid the potential conflict, the following is proposed:

8.1.1. A sponsor of a mutual fund, its associate and/or its group company, and its AMC through the schemes, or otherwise collectively, may not be allowed to:

a. have 10% or more stake in AMCs / Trustee Companies of any other mutual funds operating in India,

b. have representation on the board of the AMC / Trustee Company (or board of Trustees) of any other mutual funds operating in India

8.1.2. Any shareholder holding 10% or more stake in an AMC / Trustee Company of a mutual fund operating in India, may not be allowed to:

a. have 10% or more stake in AMCs / Trustee Companies of any other mutual funds operating in India,

b. have representation on the board of the AMC / Trustee Company (or board of Trustees) of any other mutual funds operating in India

8.1.3. In case of any existing non-conformity with the positions mentioned above in sub para 8.1.1 & 8.1.2, a reasonable time, say one year, may be given for compliance with the above mentioned positions.

9. *The Board may consider and approve the proposals made at Para 8 above and authorize the Chairman to take steps to implement the proposal by amending the SEBI (Mutual Funds) Regulations, 1996 and/or issuance of circulars, wherever necessary, with consequential and appropriate changes, as may be required, and to notify the necessary regulations and issue guidelines and circular in this regard.*