

Subject: Board Memorandum for bringing clarity on the roles and responsibilities of Trustees and Board of Asset Management Companies of Mutual Funds and amendment to SEBI (Mutual Funds) Regulations, 1996.

1. Objective

1.1. This Board Memorandum proposes for providing clarity on the roles and responsibilities of the Trustees and Asset Management Company (AMC) of the Mutual Funds in India and to amend the provisions of SEBI (Mutual Funds) Regulations, 1996 (“MF Regulations”).

2. Background

2.1. Mutual funds in India are 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 and such other assets and instruments as may be specified by SEBI from time to time. Mutual Funds in India have a three-tiered structure comprising of the Mutual Fund, the Trustees and AMCs. The role of the Trustees and AMC is governed by the MF Regulations.

2.2. As per the extant regulatory framework, the Trustees hold the property of the Mutual Fund in trust for the benefit of the unit holders. The Trustees appoint an AMC to float schemes for the Mutual Fund and manage the funds mobilised under various schemes, in accordance with the investment objectives and asset allocation pattern of each scheme.

2.3. “Trustees” is defined in the MF Regulations as the Board of Trustees or Trustee Company who hold the property of the Mutual Fund in trust for the benefit of the unit holders. Thus, the Trustees are expected to exercise supervisory oversight over AMC and its activities so as to ensure that AMC acts in the interest of the unitholders.

2.4. In view of the increasing scale and reach of the Mutual Fund industry, Trustees’ role in respect of unitholders’ protection assumes even greater significance. As envisaged under extant regulatory framework, the primary role of the Trustees is to ensure that AMCs act in the best interests of the unitholders.

2.5. Accordingly, any conflict between interest of unitholder and that of AMC's stakeholders needs to be addressed by the Trustees. While the MF Regulations provide for some restrictions to address certain scenarios of conflict of interest, there are areas of conflict which require Trustees to pay specific attention. Few such potential conflicts are as under –

- a. Investment by MF Schemes in public issues of the AMC's Sponsor, its associates and/or group companies.
- b. Investment by MF schemes for fund raising activities by companies through Initial Public Offer, Follow-on Public Offer etc. where its Sponsor, associates or group companies are appointed as merchant banker.
- c. MF availing services of its Sponsor, associates and group companies at terms which are not at arm's length.
- d. Investment by MF schemes in an independent company's securities which in turn finances either such Mutual Fund's Sponsor, associates or group companies.
- e. Sponsor Group Companies indulging in Insider Trading/ Front running by taking advantage of access to MF scheme personnel/ systems/ processes/information.
- f. Sponsor influencing voting by MF schemes in companies in which sponsor has interest.

2.6. In order to enable Trustees to carry out due diligence independently, SEBI vide circular dated August 10, 2020, enabled the Trustees to appoint a resource person who would provide administrative assistance to the Trustees.

2.7. At the same time, given that the AMC manages the funds of the schemes, it needs to be reiterated and emphasized that the Board of the AMC is accountable to ensure that the interests of the unitholders are protected.

2.8. SEBI had constituted a Working Group with a view to address these issues and streamline the responsibilities at the level of Trustees and AMCs; to deliberate and make recommendations for ensuring that Trustees can devote attention to the fiduciary obligations and supervisory role cast upon them, rather than being burdened with operational responsibilities.

3. Public Consultation

- 3.1.** The recommendations of the Working Group were placed before Mutual Fund Advisory Committee. Based on deliberations in MFAC and further analysis, SEBI placed a consultation paper along with proposed amendments to MF Regulations (**Annexure I**) on February 09, 2023 on its website, seeking public comments on the proposals made therein inter-alia for identifying the core responsibilities of Trustees, enhancing the accountability of the Board of AMC and other proposals.
- 3.2.** In response, more than 20 comments have been received from public including various stakeholders. Further there were various media articles on the proposals in the consultation paper. The consolidated comments received as on February 27, 2023, are placed at **Annexure II**.

4. Regulatory changes pursuant to consultation paper

Taking into consideration the comments received on the consultation paper from various market participants including media comments and recommendations of the MFAC, the following regulatory changes are proposed: -

4.1. Core responsibilities of Trustees

A. Suggestion in the Consultation Paper

- i.* While exercising oversight over the activities of AMC, the Trustees are expected to ensure that the AMCs act in a manner which is not skewed in favour of AMC's stakeholders. While the MF Regulations over a period of time have cast various responsibilities over the Trustees, there are certain key areas which should be the focus for the Trustees and can be considered as their "core responsibilities". These key areas may include -
- a. Fairness of fees and expenses charged by the AMC.
 - b. Performance of the AMC in its schemes vis-a-vis performance of peers or the appropriate benchmarks.
 - c. Misconduct including market abuse / misuse of information by the AMC / AMC employees / distributors etc.
 - d. Undue influence by Sponsor/associates/other stakeholders of AMC.

- e. Undue or unfair advantage by AMC to any of its associates/group entities.
 - f. Conflict of interest between shareholders/stakeholders/associates of the AMC and unitholders
 - g. Misselling to increase asset under management (AUM) and valuation of the AMC.
- ii.* Presently, the Trustees primarily rely on the AMCs for ensuring compliance with the applicable Regulations and to confirm compliances under periodic reporting to SEBI. However, it is crucial that the Trustees and their resource persons independently evaluate the extent of compliance by AMCs vis-à-vis the identified key areas and not merely rely on AMCs submissions /external assurances. For an objective due diligence, it is imperative that relevant information and data should be examined / analysed by Trustees to satisfy themselves in this regard.
- iii.* Considering the above, AMCs should submit to Trustees exception reports / analytical information that add value to the process of meaningfully exercising their oversight role. Thus there is a need for implementation of suitable mechanisms/ systems at AMC's end. Accordingly, the information/ data/ reports generated through such systems, may form inputs for evaluation and effective due diligence by the Trustees. For instance, the Trustees may insist on alert based automated reports based on pre-decided parameters including but not limited to evaluation of each of the areas referred to in para **4.1.A.i** above. The Trustees should also evaluate the nature and adequacy of the alerts and the manner of dealing with such alerts by AMCs.
- iv.* Further, from the data available, it is observed that in a significant number of folios either the bank account details are not available or the bank account number provided is less than 15 or 16-digit account numbers (i.e. Non CBS account number). Such folios are exposed to vulnerabilities/risk related to fraudulent transactions. Therefore, in addition to the above, the Trustees should also be responsible for periodically reviewing the steps taken by AMCs for the folios which do not contain all KYC attributes/ updated KYC attributes

and take remedial steps necessary for updating the KYC attributes especially pertaining to bank details, PAN, mobile phone number (for OTP). Further, the Trustees should be responsible for taking steps to ensure that there are system level checks in place to prevent fraudulent transactions including front running by employees, form splitting/ mis-selling by distributors etc. and such checks are reviewed periodically.

B. Public Comments

The main comments received are summarized below:

- i.* While comments are mainly received in favour of the proposal with few language change suggestions, some have commented that there may not be a need to define “core responsibilities” for Trustees. It is suggested by some that instead of being prescriptive, the guidelines may be principle based.
- ii.* Instead of identifying certain areas as core responsibilities, they can be considered key responsibilities of the Trustees which are means to the desired end viz. investor protection.
- iii.* As the AMC manages day to day affairs of providing investment management, the burden of regulatory expectation falls primarily on AMC and thus, the Trustees may continue to rely on AMC’s submissions / external assurances.
- iv.* As the AMC presents all its reports after due diligence by various auditors and third party reporting e.g. reports by RTA, custodian and internal auditors, any additional due diligence may not be required by Trustees. Expecting Trustees to perform these roles & responsibilities will have practical challenges considering their role is supervisory in nature and not operational.
- v.* It may be difficult to generate automated alerts based on predefined parameters for some of the key areas such as undue influence by Sponsor/associates/other stakeholders of AMCs, misselling, misconduct etc. and hence, guidelines/criteria for identifying such key areas may be prescribed.
- vi.* Trustees may not be able to assess fairness of fees and expenses. Trustees should be required to ensure that the expenses and fees are within regulatory limits and that there is no compromise in the measurement or allocation of expenses alongwith clear and consistent disclosures.
- vii.* Trustees may be required to have an oversight on current and emerging areas of vulnerabilities to prevent fraud and ensure investor protection.

C. Consideration of Issues

- i.* While AMCs are primarily responsible for day to day management of the affairs of a Mutual Fund, the Trustees are responsible for safeguarding of assets of the trust i.e, the Mutual Fund and the interest of the unitholders. While essaying this role, Trustees need to ensure that AMCs act in a manner which is not tilted in favour of AMCs stakeholders or its Sponsors, associates, group companies, and thus, any areas of conflicts that may exist between unitholders' interests and that of AMC stakeholders, need to be addressed by Trustees.
- ii.* To facilitate Trustees to effectively perform their role, certain areas need to be categorized as core responsibilities which require Trustees' specific attention and independent evaluation. The due diligence required to be carried out by Trustees for fulfilling core responsibilities will warrant analysis of information and/or exception reports, and should not be merely based on submissions / confirmations by AMC/third party. To enable such evaluation, AMCs would be required to implement suitable mechanisms and systems at their end and the Trustees can in turn rely on such system generated reports / alerts for assessing AMC's compliance with various regulatory requirements and protection of investor interest, in letter as well as in spirit.
- iii.* As regards specifying guidelines / criteria for assessment of identified core responsibilities, evolving practices in the Mutual Fund industry would enable Trustees to determine parameters for assessment.

D. Proposal

- i.* The proposal at para 4.1.A may be accepted. Accordingly, the MF Regulations may be suitably amended to insert an enabling provision for specifying core responsibilities of Trustee and means to fulfill the same. The proposed enabling provisions in the MF Regulation is provided below and the detailed modalities in this regard may be specified by way of a circular -

Insert provision under Regulation 18 as under -

“The trustees shall also exercise due diligence on such matters as may be specified by the Board from time to time”

4.2. Responsibilities of Trustees for which they can rely on Third Party Assurances

A. Suggestion in the Consultation Paper

- i.* To ensure that Trustees devote time and attention to their core responsibilities, it was proposed that for fulfilling other responsibilities, Trustees may rely on professional firms such as Audit Firms, Legal Firms, Merchant Bankers. etc. (also referred to as “third party fiduciaries”) for carrying out due diligence on behalf of the Trustees.
- ii.* Some of the responsibilities for which the Trustees may require services of third party fiduciaries was given as under –
 - Policy of empanelment of stock broker by AMC.
 - AMC managing the operations of Mutual Fund schemes independently from other activities
 - To discharge their role as a custodian of assets on behalf of unitholders in accordance with MF Regulations and the trust deed.
 - Review of networth of the AMC on a periodic basis to ensure compliance with prescribed threshold.
 - To ensure transactions of the Mutual Fund are in accordance with the provisions of the trust deed.

B. Public Comments

The main comments received are summarized below:

- i.* The use of services of auditors, consultants etc., should be done on a need basis and at the discretion of the Trustee Board.
- ii.* The guideline should be made principle based and not prescriptive.

C. Consideration of Issues

- i.* To enable Trustees to focus on their core responsibilities, the services of third party fiduciaries may be relied upon for carrying out due diligence on behalf of Trustees for responsibilities other than core responsibilities.

- ii. The discretion to use services of third party fiduciaries for carrying out due diligence for responsibilities other than core areas, shall rest with the Trustees.

D. Proposal

The proposal at para 4.2 A may be accepted and prescribed in detail by way of a circular, excluding policy for empanelment of stock broker as SEBI has come across anomalies in this area as part of its inspection process.

4.3. Enhancing the accountability of Board of AMC and delegation of duties of operational nature to AMCs

A. Suggestion in the Consultation Paper

- i.* In order to clearly bring out the role, responsibility and accountability of the Board of AMC in the regulations/circular/guidelines specified for the Mutual Fund industry, it was proposed that the existing Regulation 25 of MF Regulations on AMC and its obligations may be amended to include additional clauses with respect to the obligations of the Board of AMC.
- ii.* The proposed amendment may include a clause by way of clarification, which casts an explicit obligation on the Board of AMC to ensure that all the activities of the asset management company are in accordance with the provisions of these regulations.
- iii.* Further, in line with existing Regulation 18 on rights and obligations of the Trustees, suitable clauses may be added to cast a similar explicit obligation on the Board of AMC which are currently cast on the Trustees.
- iv.* It was proposed that certain duties of the Trustees, which are operational in nature, may be delegated to the AMC, some of which were as under –
 - a. Confirmation that all systems are in place prior to launch of any scheme by the AMC
 - b. Calculation of any income due to be paid to the Mutual Fund and also of any income received in the Mutual Fund for the holders of the units of any scheme
 - c. No change in the fundamental attributes of a scheme without carrying out the necessary processes provided in the Regulations.

- d. Periodically review all service contracts such as custody arrangements, transfer agency of the securities etc.
 - e. Exercising due diligence in all operations of the AMCs.
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- v. There should be an obligation on AMCs to furnish, in a true and fair manner, reports/alerts as required by Trustees including but not limited to those outlined in para **4.1.A.iii.** above, for taking appropriate action.
 - vi. There should be a generic clause which provides powers to SEBI to specify additional matters on which the Board of AMC should exercise due diligence.

B. Public Comments

- i. The comments received were in favour of proposals for bringing clarity to the obligations of Board of AMC as well as delegation of operational duties from Trustees to AMC.
- ii. With a view to avoid duplication, obligations being added to the Board of AMC under Regulation 25 of MF Regulations may be removed from the obligations of the Trustee under Regulation 18 of MF Regulations.
- iii. Operational duties relating to change in fundamental attributes of a scheme may be delegated to the AMC while retaining prior approval from Trustees.

C. Consideration of Issues

- i. The role and accountability of the Board of AMC to safeguard unitholders' interest, across all products and services, alongwith AMC's stakeholders' interest, needs to be clarified.
- ii. Further, in order to facilitate the Trustees to focus on their fiduciary obligations and supervisory role cast upon them, it is desirable to shift duties of operational nature to AMCs who are in charge of day to day affairs of the management of a fund.

D. Proposal

The proposal at para 4.3.A may be accepted and the provisions of the Regulation 18 and 25 of MF Regulation may be suitably amended, as proposed

at **Annexure A1**. The proposal at para 4.3.A.v and other details may be prescribed by way of a circular.

4.4. Constitution of a “Unitholder Protection Committee” under the AMC Board

A. Suggestion in the Consultation Paper

- i. In order to have an independent review mechanism for the decisions of AMC from the perspective of the unit holders’ interest, across all products and services, a “Unit Holder Protection Committee” (UHPC) may be mandated to be constituted by the Board of AMC.
- ii. The UHPC shall be expected to protect interest of unit holders of Mutual Fund schemes in letter and in spirit, to review the decisions and performance of the AMC from the unitholders perspective, redress unit holder’s grievances, investor education and awareness etc.
- iii. The UHPC of AMC shall comprise of atleast three directors as members, wherein, at least two-third members of the UHPC shall be independent directors of AMC.
- iv. The UPC shall invite expert / representative of unit holders as an invitee for matters it may deem fit necessary.
- v. The details relating to the role, constitution, power and responsibilities, etc, were also suggested.

B. Public Comments

The main comments are summarized below:

- i. While most of the comments are in favour of UHPC, a few comments suggested that formation of such a committee may in practice dilute the role of AMC Board.
- ii. UHPC may not be constituted on Board level and can comprise of relevant officials of AMC, which will report Board of AMC like other committees do.
- iii. There should be a clear demarcation of the terms of reference of UHPC from the other committees of the AMC.

C. Consideration of Issues

- i. The proposal to constitute UHPC by the Board of AMC was to facilitate an independent review mechanism of the decisions and performance of AMC from the perspective of the unit holders' interest, across all products and services. Further, the UHPC may make recommendations relating to protection of interest of investors as well as monitor its implementation.
- ii. The role, powers and responsibilities of the UHPC have been proposed taking into consideration that there are no overlapping functions with other committees of the Board of AMC.
- iii. It is desirable that the UHPC is chaired by an Independent Director.
- iv. It is proposed that the UHPC shall report its findings to the Board of the AMC along with recommendations for action.

D. Proposal

The proposal at para 4.4.A and C may be accepted. Accordingly, an enabling provision may be inserted in MF Regulations for mandating constitution of UHPC by the Board of AMC in the form and manner as may be specified by SEBI. The proposed enabling provision is mentioned below and other details may be specified by way of circular –

Insert provision under Regulation 25 as under -

“The asset management company shall constitute a Unit Holder Protection Committee in the form and manner and with a mandate as may be specified by the Board.”

4.5. Structure of Trustee

A. Suggestion in the Consultation Paper

- i. Presently, there are a few Mutual Funds which have the Board of Trustees structure while the Trustees of all other Mutual Funds have adopted the structure of a Trustee Company.
- ii. In view of the need for perpetuity and financial independence, it was proposed to do away with the Board of Trustees structure and continue with only the corporate form for Trustees. Further, it was proposed to provide a

period of one year for existing Trustees with Board of Trustee structure to convert into a Trustee Company.

B. Public Comments

The main comments are summarized below:

- i. Considering the volume and pace of the Mutual Fund Industry, there is a need of corporate form of Trustee to be able to execute roles and responsibilities independently.
- ii. Corporate structure is desirable in view of perpetuity.
- iii. Regulatory exemption may be provided for meeting timelines.

C. Consideration of Issues

From a governance point of view and consistency in applicability of provisions, it is desirable to have a corporate form for Trustees of all Mutual Funds and to provide them with a year to comply with the same.

D. Proposal

The proposal at para 4.5.A may be accepted and MF Regulation may be amended as under and other consequential amendments as provided in **Annexure A1:**

Modify Regulation 2(1)(y) as under -

“trustees” mean the trustee company that holds the property of the mutual fund in trust for the benefit of the unit holders;

Insert proviso after Regulation 2(1)(y) as under –

“Provided that trustees in the form of a board of trustees shall convert to a trustee company within a period of one year from the date of notification of the provision of these amendment regulations, with the prior approval of the Board.

Explanation: In the event the trusteeship of the mutual fund is with a trustee company, wherever the context requires applicability of provisions for individual trustees, the term “trustees” under these regulations shall be deemed to mean the directors of board of the trustee company;”

4.6. Chairperson of the Trustee Company

A. Suggestion in the Consultation Paper

- i. While the existing provisions provide that the Chairperson of the Audit committee of a Trustee Company should be an Independent Director, there is no such requirement for the Chairperson to be an Independent Director.
- ii. It was therefore proposed that the Chairperson of a Trustee Company shall also be an Independent Director.

B. Public Comments

- i. The comments received are mostly in favour of the proposal of Chairperson of Trustee Company being an Independent Director.
- ii. It was suggested that currently, Chairperson of Trustee Company can be a Non-Independent Director which suffices as having Non-Executive Non-Independent Director as Chairperson helps in smooth board functioning and at the same time gives a sense of comfort to other Independent Board Members.
- iii. It was also suggested that the requirement of Chairperson should be in line with the SEBI (Listing Obligations and Disclosure Requirements) Regulations 2015.

C. Consideration of Issues

- i. As per MF Regulations, 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.
- ii. In order to facilitate independent functioning of the Trustees and also to enable the Trustees to effectively address conflicts of interest between the investors and stakeholders of an AMC, it is proposed to mandate that the Chairperson of Trustee Company shall be an Independent director.

D. Proposal

The proposal at para 4.6.A may be accepted and MF Regulations may be amended as under –

Insert provision under Regulation 16 as under –

“In case a company is appointed as the trustee of a mutual fund, the Chairperson of the board of directors of that trustee company shall be an independent director:

Provided that a trustee company, already appointed as trustee of a mutual fund shall comply with this sub-regulation within a period as may be specified by the Board from time to time.”

4.7. Meetings between the Trustee Company and the AMC

A. Suggestion in the Consultation Paper

- i. Presently the MF Regulations require that the Audit Committee of the AMC should interact with the Audit Committee of the Trustees at least once annually. However, there is no requirement of the Boards of AMC and Trustee Company to meet once annually.
- ii. It was proposed that apart from the meeting of the Audit Committee of AMCs and Trustees (which mostly comprises of independent directors), the Board of AMCs and the Board of Trustees may be mandated to meet at least once a year to discuss the issues concerning the Mutual Fund, if any, and future course of action, where required.

B. Public Comments

The comments received are largely in favour of the proposal.

C. Proposal

The proposal at para 4.7.A may be accepted. Accordingly, the requirement of mandatory meeting between Trustee Board and the Board of AMC, may be provided in the MF Regulation and the frequency of the meeting of at least once a year, may be prescribed by way of a circular.

Insert provision under Regulation 25 as under –

Meeting of the board of directors of the trustee company and the board of directors of the asset management company.

“The board of directors of the trustee company and the board of directors of the asset management company, including any of their committees, shall meet at such frequency as may be specified by the Board from time to time.”

4.8. Clarity on the role of Trustees and AMCs in provisions which cast a responsibility on the Mutual Fund

A. Suggestions in the Consultation Paper

There are certain provisions in the MF Regulations which cast responsibility on the “Mutual Funds”. It was proposed to clearly bring out the roles and responsibilities of the Trustees and the AMC in such provisions in view of the need for the Trustees to focus on their core responsibilities.

B. Public Comments

The comments received are largely in favour of the proposal.

C. Proposal

The proposal at para 4.8.A may be accepted. Accordingly, the provisions of MF Regulations may be amended to clearly bring out the relevant responsibility of AMC and/or Trustee in provisions which cast a responsibility on the Mutual Fund as at **Annexure A1**. Further other changes in the circulars issued may also be carried out separately.

5. Proposals for consideration

5.1. The Board may consider and approve the proposals at paragraphs 4.1.D, 4.2.D, 4.3.D, 4.4.D, 4.5.D, 4.6.D, 4.7.C and 4.8.C above. Draft amendments to the SEBI (Mutual Funds) Regulations, 1996, and the draft notification for the proposed amendments are placed at **Annexure A1** and **Annexure A2** respectively.

5.2. The detailed guidelines for the proposals at paragraphs 4.1.D, 4.2.D, 4.3.D, 4.4.D, 4.6.D, 4.7.C and 4.8.C may be prescribed by issuance of circular.

5.3. It is proposed to provide reasonable time for implementation to facilitate stakeholders to have required systems in place.

5.4. The Board is requested to consider and approve the proposals as in the Memorandum and authorize the Chairperson to make consequential and incidental changes and take necessary steps to give effect to the decisions of the Board.

Annexure I

The consultation paper on Review of Role and Obligations of Mutual Fund Trustees is a publicly available document and the same is placed on SEBI website under the link below:

https://www.sebi.gov.in/reports-and-statistics/reports/feb-2023/consultation-paper-on-review-of-role-and-obligations-of-mutual-fund-trustees_67946.html

Annexure II

This has been excised for reasons of confidentiality.

Annexure A1

Amendment to SEBI (Mutual Funds) Regulations, 1996 shall be notified after following the due process.

Annexure A2

Amendment to SEBI (Mutual Funds) Regulations, 1996 shall be notified after following the due process.