SECURITIES LAWS AND COMPLIANCES
PART A — SECURITIES LAWS
STUDY IX - MUTUAL FUNDS

LEARNING OBJECTIVES

The study will enable the students to understand

- Trend of mutual funds in India over a period of time, mobilization of resources by Mutual Funds.
- Various schemes of mutual funds
- Risks involved in mutual funds
- Net Asset Value of Mutual funds
- Overviews of SEBI (Mutual Fund) Regulations, 1996
- Code of conduct for Mutual funds
- Restriction on investment by mutual funds
- Gold Exchange Traded Fund Scheme/Capital protection oriented scheme

INTRODUCTION

The small investors who generally lack expertise to invest on their own in the securities market have reinforced the saying “Put not your trust in money, put your money in trust’. They prefer some kind of collective investment vehicle like, MFs, which pool their marginal resources, invest in securities and distribute the returns therefrom among them on cooperative principles. The investors benefit in terms of reduced risk and higher returns arising from professional expertise of fund managers employed by the MFs. This approach was conceived in the USA in the 1930s. In developed financial markets, MFs have almost overtaken bank deposits and total assets of insurance funds.

Experiment with MFs in India began in 1964 with the establishment of Unit Trust of India (UTI), which continues to be market leader even today with a corpus of investible funds of about Rs. 76,547 crore at the end of March 2000, accounting for 68% of total market. UTI lost its monopoly status in 1987 with the entry of other public sector MFs promoted by public sector banks and insurance companies. The industry was opened to private sector, including foreign institutions, in 1993 giving Indian investors a broader choice and increasing competition to public sector funds.

I. An Overview of Trends in Mutual Funds

As in mature markets, mutual funds in emerging markets have been among the fastest growing institutional investors. Indeed, mutual funds assets under management in emerging markets grew by 96 per cent between the end of 1997 and June 2003 and as a result, it rose from 8 per cent of GDP to 15 per cent. One key difference between mutual funds of mature and emerging markets has been the relative importance of bond and equity funds are often much larger than those of bond funds (particularly in Japan, the United Kingdom, the United States). In contrast, emerging market bond funds in a number of countries have larger assets under management than do equity funds particularly in Brazil, Mexico, Korea and Taiwan. In part, this reflects the difference in the relative development of the local markets in mature and emerging markets. This difference reflects a search for higher yield on the part of retail investors. As the nominal interest rates have declined in many emerging countries since the late 1990s, retail investors have seen an extended decline in the interest rate of traditional savings instruments. To obtain higher yields, retail investors subscribe to bond funds with investment in longer term government and corporate bonds.

Household savings play an important role in domestic capital formation. Only a small part of the household savings in India is channelised to the capital market. Attracting more households to the capital market requires efficient intermediation. The mutual funds have emerged as one of the important class of financial intermediaries which cater to the needs of retail investors. As a traditional investment vehicle, the mutual funds pool resources from the households and allocate them to various investment opportunities.

The gross mobilisation of resources by all mutual funds during 2006-07 stood at Rs. 19,38,493 crore compared to Rs. 10,98,149 crore during the previous year – an increase of 76.5 per cent over the year. Redemption also rose by 76.4 per cent to Rs. 18,44,508 crore in 2006-07 from Rs. 10,45,370 crore in 2005-06. The net mobilisation of resources by all mutual funds stood at Rs. 93,985 crore in 2006-07 was the highest ever in a single year. Reflecting large mobilisation of resources, the assets under management by all mutual funds increased to Rs. 3,26,292 crore at the end of March 2007 from Rs. 2,31,862 crore a year ago.

Mobilisation of Resources by Mutual Funds*

				(Rs. crore)
Period	*Gross Mobilisation*	*Redemption*	*Net Inflow*	*Assets at the End of Period*
1	2	3	4	5
1999-00	61,241	42,271	18,970	1,07,946
2000-01	92,957	83,829	9,128	90,587
2001-02	1,64,523	1,57,348	7,175	1,00,594
2002-03	3,14,706	3,10,510	4,196	1,09,299
2003-04	5,90,190	5,43,381	46,808	1,39,616
2004-05	8,39,708	8,37,508	2,200	1,49,600
2005-06	10,98,149	10,45,370	52,779	2,31,862
2006-07	19,38,493	18,44,508	93,985	3,26,292

The private sector mutual funds continued to dominate resource mobilization efforts during 2006-07. Of the net amount of resources mobilised by all mutual funds, the private sector mutual funds accounted for 84.1 per cent, followed by public sector mutual funds (12.1 per cent) and the UTI Mutual Fund (6.5 per cent). The shares of private sector mutual funds, public sector mutual funds and the UTI Mutual Fund in the gross mobilisation were 83.3 per cent, 10.1 per cent and 6.6 per cent, respectively during 2006-07. The share of private sector mutual funds in the gross mobilisation of resources declined

modestly in 2006-07 over the previous year. On the contrary, the shares of other two categories of mutual funds improved marginally during the same period.
Scheme-wise, resource mobilization witnessed an important shift in the pattern in the wake of strong rally in the stock markets during 2006-07. In consonance with the unusual buoyancy in the stock market, the amount of resources mobilised under growth and equity oriented schemes rose substantially in 2006-07. The net inflow of funds at Rs.35,231 crore in 2006-07 was the highest under growth/equity oriented schemes in a single year, followed by income and debt oriented schemes (Rs.16,622 crore).

Sector-wise Resource Mobilisation by Mutual Funds during 2006-07[*a]

							(Rs. Crore)			
Particulars	Private Sector MFs			Public Sector MFs			UTI MF*			Grand Total
	Open	Close	Total	Open	Close	Total	Open	Close	Total	
	ended	ended		ended	ended		ended	ended		
1	2	3	4	5	6	7	8	9	10	11
Mobilization of	14,82,588	1,17,286	15,99,874	1,85,500	10,840	1,96,340	1,32,070	10,210	1,42,280	19,38,493
Funds	(8,75,917)	(38,786)	(9,14,703)	(1,10,142)	(176)	(1,10,319)	(71,058)	(2,069)	(73,127)	(10,98,149)
Repurchase / Redemption	14,62,528	58,308	15,20,836	1,82,981	5,738	1,88,719	1,30,749	4,204	1,34,954	18,44,508
	(8,59,367)	(12,360)	(8,71,727)	(1,03,580)	(360)	(1,03,940)	(68,387)	(1,316)	(69,704)	(10,45,370)
Amount										
Net Inflow/	20,060	58,978	79,038	2,519	5,102	7,621	1,321	6,005	7,326	93,985
Outflow of	(16,550)	(26,426)	(42,977)	(6,562)	(–183)	(6,379)	(2,671)	(753)	(3,424)	(52,779)
funds										

Notes: Figures in parentheses relate to 2005-06.
Source: SEBI Annual Report 2006-07.
There were 755 mutual fund schemes as on March 31, 2007, of which, 450 were income/debt oriented schemes, 267 were growth/equity oriented

schemes and the remaining 38 were balanced schemes. Investment objective-wise classification shows dominance of the open-ended schemes in India. As on March 31, 2007, 485 schemes were open-ended and 270 schemes were close-ended. The number of close ended schemes rose substantially from 47 in 2004-05 to 129 in 2005-06 and further to 270 in 2006-07. The gross mobilization of resources by all mutual funds during the year 2006-07 stood at Rs. 19,38,493 compard to Rs. 10,98,149 crore during the previous year.
The total assets under management (AUM) of all mutual funds rose by 40.7 per cent to Rs. 3,26,292 crore as on March 31, 2007 from Rs. 2,31,862 crore a year ago. The net assets of all categories of mutual fund schemes witnessed a rise in 2006-07 over the previous year. The rise in AUM was the highest for debt oriented schemes at 55.0 per cent. This was commensurate with spurt in resource mobilisation by the debt oriented schemes. A rise of 24.3 per cent was seen in the AUM of equity oriented schemes. A negative growth of 28.1 per cent was recorded for AUM of gilt schemes. The mutual funds have traditionally been the active participants in the debt segment of Indian stock market. The heightened activity of mutual funds in the equity segment in 2005-06 did not continue at the same pace in 2006-07 save a few months of the financial year. In the first two months of the financial year, however, their inflow into the equity segment was higher, after which it declined. During 2006-07, the combined investment in debt and equity was Rs. 61,606 crore compared to Rs. 51,103 crore in 2005-06, indicating a rise of 20.6 per cent (Table 2.39). Bulk of this investment was in the debt segment. Their total inflow into the debt segment was Rs. 52,543 crore as against Rs. 36,801 crore in 2005-06. Month-wise, their inflow into the debt segment was the highest for July 2006 (Rs. 7,716 crore) followed by May 2006 (Rs. 7,612 crore) and November 2006 (Rs. 6,335 crore). The mutual fund inflow into the equity segment was the highest for May 2006 (Rs. 7,893 crore) followed by April 2006 (Rs. 3,121 crore) and December 2006 (Rs. 1,627 crore).

No. of Schemes by Investment Objectives as on March 31, 2007

	Schemes	*Classification*		*Total*
		Open-ended	*Close-ended*	
	1	2	3	4
A.	*Income/Debt Oriented Schemes*	216 (213)	234 (112)	450 (325)
	(i) Liquid/Money Market	55	0	55
	(ii) Gilt	28	0	28
	(iii) Debt (other than assured return)	133	234	367
	(iv) Debt (assured return)	0	0	0
B.	*Growth/Equity Oriented Schemes*	235 (216)	32 (15)	267 (231)
	(i) ELSS	29	11	40
	(ii) Others	206	21	227

C.	*Balanced Schemes*			
	Balanced Schemes	34 (34)	4 (2)	38 (36)
	TOTAL (A + B + C)	485 (463)	270 (129)	755 (592)

Advantages of Mutual Funds

The advantages of investing in a mutual fund are:

1. *Professional Management:* Investors avail the services of experienced and skilled professionals who are backed by a dedicated investment research team which analyses the performance and prospects of companies and selects suitable investments to achieve the objectives of the scheme.
2. *Diversification:* Mutual funds invest in a number of companies across a broad cross-section of industries and sectors.This diversification reduces the risk because seldom do all stocks decline at the same time and in the same proportion. Investors achieve this diversification through a Mutual Fund with far less money than one can do on his own.
3. *Convenient Administration:* Investing in a mutual fund reduces paper work and helps investors to avoid many problems such as bad deliveries, delayed payments and unnecessary follow up with brokers and companies. Mutual funds save investors time and make investing easy and convenient.
4. *Return Potential:* Over a medium to long term, Mutual funds have the potential to provide a higher return as they invest in a diversified basket of selected securities.
5. *Low Costs:* Mutual funds are a relatively less expensive way to invest compared to directly investing in the capital markets because the benefits of scale in brokerage, custodial and other fees translate into lower costs for investors.
6. *Liquidity:* In open ended schemes, investors can get their money back promptly at net asset value related prices from the mutual fund itself. With close ended schemes, investors can sell their units on a stock exchange at the prevailing market price or avail of the facility of direct repurchase at net asset value (NAV) related prices which some close ended and interval schemes offer periodically or offer it for redemption to the fund on the date of maturity.
7. *Transparency:* Investors get regular information on the value of their investment in addition to disclosure on the specific investments made by scheme, the proportion invested in each class of assets and the fund manager's investment strategy and outlook.

Schemes of Mutual Funds

The MFs in India offer a wide array of schemes that cater to different needs suitable to any age, financial position, risk tolerance and return expectations. These include: open-ended schemes, which provide easy liquidity; close-ended schemes with a stipulated maturity period; growth schemes, which provide capital appreciation over medium to long term; income schemes, which provide regular and steady income to investors; balanced schemes, which provide both growth and income by periodically distributing a part of income and capital gains they earn; money market schemes; which provide easy liquidity, preservation of capital and moderate income; and tax saving schemes, which offer tax rebates to investors under tax laws as prescribed from time to time.

i. *Open ended mutual funds:* An open ended mutual funds is a fund with a non-fixed number of outstanding shares/units, that stands ready at any time to redeem them on demand. The fund itself buys back the shares surrendered and is ready to sell new shares. Generally the transaction takes place at the net asset value which is calculated on a periodical basis. The net asset value (Net Asset Value per share value of the fund's is total net assets after liabilities divided by the total number of shares outstanding on a given day) of the mutual funds rises or falls as a result of the performance of securities in the portfolio and the stock exchanges.
ii. *Close ended mutual funds:* It is the fund where mutual fund management sells a limited number of shares and does not stand ready to redeem them. Primary example of such mutual fund is UTI's Master share. The shares of such mutual funds are traded in the secondary markets. The requirement for listing is laid down to grant liquidity to the investors who have invested with the mutual fund. Therefore, close ended funds are more like equity shares. The main differences between close ended and open ended funds are:

	CLOSE ENDED SCHEMES		*OPEN ENDED SCHEMS*
1.	Fixed corpus: no new units can be offered beyond the limit	1.	Variable corpus due to on going purchase and redemption
2.	Listed on the stock exchange for buying and selling	2.	No listing on exchange transactions done directly with the fund
3.	Two values available namely NAV and the Market Trading Price	3.	Only one price namely NAV
4.	Mostly liquid	4.	Highly Liquid

Besides these, there are other types of mutual funds also to meet the investment needs of several groups of investors. Some of them include the following:

a. Income Oriented Schemes: The fund primarily offer fixed income to investors. Naturally enough, the main securities in which investments are made by such funds are the fixed income yielding ones like bonds.
b. Growth Oriented Schemes: These funds offer growth potentialities associated with investment in capital market namely: (i) high source of income by way of dividend and (ii) rapid capital appreciation, both from holding of good quality scrips. These funds, with a view to satisfying the growth needs of investors, primarily concentrate on the low risk and high yielding spectrum of equity scrips of the corporate sector.
c. Hybrid Schemes: These funds cater to both the investment needs of the prospective investors - namely fixed income as well as growth orientation.

Therefore, investment targets of these mutual funds are judicious mix of both the fixed income securities like bonds and debentures and also sound equity scrips. In fact, these funds utilise the concept of balanced investment management. These funds are, thus, also known as “balanced funds”.

d. High Growth Schemes: As the nomenclature depicts, these funds primarily invest in high risk and high return volatile securities in the market and induce the investors with a high degree of capital appreciation. Aggressive investors willing to take excessive risks are the normal target group of such funds.
e. Money Market Mutual Funds: These funds invest in short- term debt securities in the money market like certificates of deposits, commercial papers, government treasury bills etc. Owing to their large size, the funds normally get a higher yield on such short term investments than an individual investor. Money market mutual funds used to be regulated by the Reserve Bank of India on the basis of specified guidelines to be laid down by the Reserve Bank of India. However, money market schemes of other mutual funds were regulated by the Securities and Exchange Board of India. But consequent upon withdrawal of guidelines by Reserve Bank of India on Money Market Mutual Funds w.e.f. March 7, 2000, the schemes of such funds, like other mutual fund schemes would exclusively be governed by SEBI (Mutual Funds) Regulations, 1996.
f. Tax Saving Schemes: These schemes offer tax rebates to the investors under tax laws as prescribed from time to time. This is made possible because the Government offers tax incentive for investment in specified avenues. For example, Equity Linked Saving Schemes (ELSS) and pensions schemes.
g. Special Schemes: This category includes index schemes that attempt to replicate the performance of particular index such as the BSE, Sensex or the NSE-50 or industry specific schemes (which invest in specific industries) or sectoral schemes (which invest exclusively in segment such as ‘A’ Group or initial public offering). Index fund schemes are ideal for investors who are satisfied with a return approximately equal to that of an index. Sectoral fund schemes are ideal for investors who have already decided to invest in particular sector or segment.
h. Real Estate Funds: These are close ended mutual funds which invest predominantly in real estate and properties.
i. Off-shore Funds: Such funds invest in securities of foreign companies with RBI permission.
j. Leverage Funds: Such funds, also known as borrowed funds, increase the size and value of portfolio and offer benefits to members from out of the excess of gains over cost of borrowed funds. They tend to indulge in speculative trading and risky investments.
k. Hedge Funds: They employ their funds for speculative trading, i.e. for buying shares whose prices are likely to rise and for selling shares whose prices are likely to dip.
l. Fund of Funds: They invest only in units of other mutual funds. Such funds

do not operate at present in India.

m. New Direction Funds: They invest in companies engaged in scientific and technological research such as birth control, anti-pollution, oceanography etc.
n. Exchange Trade Funds (ETFs) are a new variety of mutual funds that first became available in 1993. ETFs have from rapidly and now hold nearly $80 billion in assets. ETFs are sometimes described as mere “tax efficient” than traditional equity mutual funds, since in recent years, some large ETFs have made smaller distribution of realized and taxable capital gains than most mutual funds.

Bottom up Investing: This is an investment strategy which considers the fundamental factors driving individual stock performance before considering the economic prospectus which affect the industry and within which the company operates.

Top down Investing: This is an investment strategy which first takes a view on the economy and then looks at the industry scenario to assess the potential performance of a company. This is opposite to Bottom up Technique.

iii. *Equity funds* are considered aggressive in so far as higher capitalisation is sought. Investors should have a long term orientation, since companies shares give fluctuating dividends and offer benefits only in the long run through rights issue, bonus issue etc.

iv. *Balanced funds* are considered moderate since investors seek growth and stability but with moderate risk. Such funds invest both in bonds and blue chip shares. While bonds give stable interest income, the share dividends will be fluctuated though in the long run, they may give larger benefits. The exact balance between the two asset classes namely - shares and bonds depends on the fund managers ability to take risk and his priority for return. The normal ratio between stocks and bonds is 55:45 but if the fund manager is aggressive he could choose a larger equity component.

v. *Income funds* are regarded as conservative since investors want regular income and can not wait for more than short to medium term.

vi. *Money market funds* are regarded as high liquidity oriented as investors attach more value for safety and liquidity.

vii. *Sector funds* invest only in shares of companies belonging to a specific industry. These funds perform well so long as the industry or the sector is in the upswing, but the risk could be high, if the industry or the sector goes down.

Risks Involved in Mutual Funds

Mutual funds may face the following risks, leading to non-satisfactory performance:

1. Excessive diversification of portfolio, losing focus on the securities of the key segments.
2. Too much concentration on blue-chip securities which are high priced and which do not offer more than average return.
3. Necessity to effect high turnover through liquidation of portfolio resulting in large payments of brokerage and commission.
4. Poor planning of investment with minimum returns.

5. Unresearched forecast on income, profits and Government policies.
6. Fund managers being unaccountable for poor results.
7. Failure to identify clearly the risk of the scheme as distinct from risk of the market.

Calculation of Net Asset Value (NAV)

Mutual funds raise money by selling their shares to public and redeeming them at current net asset value. Net asset value is the value of the assets of each unit of the scheme. Thus if the NAV is the more than the face value of Rs. 10/-, there is an appreciation for the investment. If the NAV is less than the face value, it indicates depreciation of the investment. NAV also includes dividends, interest accruals and reduction of liabilities and expenses apart from market value of investments. Every mutual fund shall compute the NAV of each scheme by dividing the net asset of the scheme by the number of units of that scheme outstanding on the date of valuation and public the same at least in two daily newspapers at intervals not exceeding one week. However, the net asset value of any scheme for special target segment or any monthly scheme which are not mandatorily required to be listed in the stock exchange may publish the NAV at monthly or quarterly intervals as permitted by SEBI.

Mutual Fund Costs

There are two broad categories of mutual fund costs, namely - (a) Operating expenses (b) Sales charges. The latter can be sub- divided under (i) Front end loads (ii) Back end loads. These terms are explained below:

a. *Operating Expenses:* Costs incurred in operating mutual funds include advisory fees paid to investment managers, custodial fees, audit fees, transfer agent fees, trustee fees, agents commission etc. The break-up of these expenses is required to be reported in the schemes offer document. When the operating expenses are divided by the average net asset, the expense ratio is arrived at. Based on the type of the scheme and the net assets, operating expenses are determined within the limits indicated by SEBI Mutual Fund Regulations, 1996. Expenditure which is in excess over the specified limits shall be borne by the Asset Management Company, the Trustees or the Sponsors. Operating expenses are calculated on an annualised basis but are accrued on a daily basis. Therefore, an investor face expenses prorated for the time he has invested in the fund.
b. *Sales Charges:* These are otherwise called as sales loads and are charged directly to the investors. Mutual funds use the sales loads for payment of agents commission and expenses for distribution and marketing. Sales charges have no impact on the performance of the scheme as these are collected from the investor.
    i. *Front end load* is a one time fixed fee which is paid by an investor while he buys into a scheme. Printed load determines the public offer price (POP) which in turn determines how much of the initial investment gets actually invested. Front end loads decrease as the initial investment amounts increase.

Public Offer Price =	Net Asset Value
	(1-Front end load)

If an investor invests say Rs. 10,000/- in a scheme that charges a 2% Front end Load at an NAV per unit of Rs. 10/-, the Public Offer Price (POP) will be calculated as follows:

Public Offer Price =	10	= Rs. 10.20
	(1-0.02)	

ii. Back end Load: This will be a fixed fee redemption load or a contingent deferred sales charge. A redemption load exists permanently and is paid only at the time of redeeming or selling units of a load. This can be calculated as:

Net Asset Value
(1+ Back end load)

Using the formula, redemption of price can be calculated as:

10	= Rs. 9.80
(1+ 0.02)	

Contingent Deferred Sales Charges (CDSC) is a structured back end load paid when the units are redeemed during the initial of ownership. The longer the investor remains invested in the fund the lower the CDSC. As per SEBI Mutual Fund Regulations, 1996, CDSC may charge only for the first four years after purchase of units. The Regulations also stipulate the maximum CDSC that can be charged every year. The front end load or back end load in any combination shall not be higher than 7%.

It may be noted that SEBI has decided not to charge entry load for direct applications received by the Asset Management Company (AMC) i.e. applications received through internet, submitted to AMC or collection centre/ Investor Service Centre that are not routed through any distributor/agent/broker.

No Load Funds also operate in the market. Funds selling their shares directly to the public at the NAV do not collect sales charge. The expenses are borne by the fund itself. As there are no brokerage firms involved, the investor deals directly with the investment company which offers funds.

Transaction costs

Some funds impose a switch over fee as a charge on transfer of investment from one scheme to another within the same mutual fund family and also to switch over from one plan to another within the same scheme. A cost conscious investor has to consider two aspects: (i) compare a funds expense ratio with that of similar funds in the industry and find out justification based on performance (ii) compare the load with that of similar funds, since a load will reduce the investment by the amount of load. Besides these aspects the investors should carefully consider his goals, risk tolerance and investment preferences.

Judging efficiency of mutual funds is done with reference to various factors such as -

— whether the fund is stable
— whether it is liquid (listed on exchanges)
— whether it offers increase in NAV, consistent growth in dividend and

capital appreciation

— whether the investment objectives are clearly laid and implemented

— whether the issuer has a proven track record and offers assured returns or returns not less than a percentage

— whether it observes investment norms to balance risks and profits

Roll over of a scheme

A mutual fund can roll over a close ended scheme on or before the redemption of the scheme after giving an option to investors to redeem their units at NAV based price. The roll over scheme may include a fresh extension of period or continue under the same terms of the original scheme with or without modifications.

Switch over one scheme to another

A mutual fund may use its discretion to permit switching over of the investment in units from one to another of its schemes, to help the investor shift, from a high risk scheme to a low risk one or vice-versa.

Annualised Returns

Investors buy and sell mutual fund shares/units during a short period and make profits. Percentage of profits in such short periods can not be a reliable measure. The proper method is to calculate returns on an annualised basis at the compounded average rate over a year.

Asset Management Company (AMC)

Under SEBI Regulations, every mutual fund is required to have an Asset Management Company (AMC) incorporated in the Companies Act, 1956 to manage the funds of the mutual fund. The AMC should be approved by SEBI and should enter into an agreement with the trustees of the mutual fund to formulate schemes, raise money against units, invest the funds in accrued securities and after meeting the permissible costs as per norms, distribute income to the share holders of the funds.

II. SEBI (Mutual Fund) Regulations, 1996

These regulations were notified by SEBI in exercise of its powers conferred by section 30 read with section 11(2c) of SEBI Act, 1992. Some of the important definitions in these regulations are given below:

Advertisement includes every form of advertising whether in a publication by display of notices, signs, labels or by means of circulars, catalogues or other documents, by an exhibition of pictures or photographic films, by way of sound, broadcasting or television or in any other manner.

Asset Management Company means a company formed and registered under the Companies Act, 1956 and approved as such by SEBI under Regulation 21(2).

Custodian means a person who has been granted a certificate of registration to carry on the business of custodian securities under SEBI (Custodian of Securities) Regulations, 1996.

Mutual Fund means a fund 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 including money market instruments or gold or gold related instruments.

Money Market Mutual Fund means a scheme of a mutual fund set up with the objective of investing exclusively in money market instruments.

Money Market Instruments includes commercial papers, commercial bills, treasury bills, Government securities having an unexpired maturity upto one year, call or notice money, certificate of deposit, and any other like instruments as specified by RBI from time to time.

Sponsor means any person who, acting alone or in combination with another body corporate establishes a mutual fund.

Trustees mean the Board of Trustees or the Trustee Company who hold the property of the mutual fund in trust for the benefit of the unit holders.

Unit means the interest of the unit holders in a scheme which consists of each unit representing one undivided share in the assets of a scheme.

Unit Holder means a person holding one or more units in a scheme of a mutual fund.

Close-ended scheme means any scheme of a mutual fund in which the period of maturity of scheme is specified.

Open-ended scheme means a scheme of a mutual fund which offers units for sale without specifying any duration for redemption.

Gold exchange traded fund scheme means a mutual fund scheme that invests primarily in gold or gold related instruments.

Gold related instrument means such instrument having gold as underlying, as may be specified by the Board from time to time

Capital protection oriented scheme means a mutual fund scheme which is designated as such and which endeavours to protect the capital invested therein through suitable orientation of its portfolio structure.

Registration of Mutual Fund

Regulation 7 lays down the following eligibility criteria to be fulfilled by an applicant to get a certificate of registration. In the opinion of SEBI the applicant should be a fit and proper person. The other criteria are:

a. the sponsor should have a sound track record and general reputation of fairness and integrity in all his business transactions.
   The regulations provide that “Sound track record” means the sponsor -
   i. is carrying on business in financial services for a period of not less than five years; and
   ii. the networth is positive in all the immediately preceding five years; and
   iii. the networth in the immediately preceding year is more than the capital contribution of the sponsor in the asset management company; and
   iv. the sponsor has profits after providing for depreciation, interest and tax in three out of the immediately preceding five years, including the fifth year;
b. in the case of an existing mutual fund, such fund is in the form of a trust and the trust deed has been approved by SEBI;
c. the sponsor has contributed or contributes at least 40% to the networth of the asset management company;
   However any person who holds 40% or more of the net worth of an asset management company shall be deemed to be a sponsor and will be required to fulfil the eligibility criteria specified in these regulations;
d. the sponsor or any of its directors or the principal officer to be employed by

the mutual fund should not have been guilty of fraud or has not been convicted of an offence involving moral turpitude or has not been found guilty of any economic offence;

e. appointment of trustees to act as trustees for the mutual fund in accordance with the provisions of the regulations; appointment of asset management company to manage the mutual fund and operate the scheme of such funds in accordance with the provisions of these regulations;
g. appointment of a custodian in order to keep custody of the securities or gold or gold related instruments and carry out the custodian activities as may be authorised by the trustees.

Regulation 10 lays down that the registration granted to a mutual fund is subject to the following terms and conditions:

a. the trustees, the sponsor, the asset management company and the custodian comply with the provisions of these regulations;
b. the mutual fund to inform SEBI, if any information or particulars previously submitted to SEBI was misleading or false in any material respect;
c. the mutual fund to inform SEBI, of any material change in the information or particulars previously furnished, which have a bearing on the registration granted by it;
d. payment of the prescribed fees.
e. payment of service fee for each financial year before 15th April. SEBI may not permit a mutual fund to launch any scheme if it has not paid the service fee.

Constitution and Management of Mutual Fund and Operation of Trustees

Regulation 14 stipulates that a mutual fund shall be constituted in the form of a trust and the instrument of trust shall be in the form of a deed duly registered under Indian Registration Act, 1908 and executed by the sponsor in favour of the trustees named in the instrument.

Regulation 15 lays down that the trust deed shall contain clauses as prescribed in the Third Schedule to the Regulations. The trust deed shall not contain any clause which has the effect of limiting or extinguishing the obligations and liabilities of the trusts in relation to any mutual fund or the unit holders or indemnifying the trustees or the asset management company for loss or damage caused to the unit holders by their acts of negligence, commission or omission.

Contents of the Trust Deed

The Third Schedule prescribing the contents of the Trust Deed is reproduced below:

1. (i) A trustee in carrying out his responsibilities as a member of the Board of Trustees or of trustee company, shall maintain arms' length relationship with other companies, or institutions or financial intermediaries or any body corporate with which he may be associated.
   ii. No trustee shall participate in the meetings of the Board of Trustees or trustee company when any decision for investments in which he may be interested are taken.
   iii. All the trustees shall furnish to the board of trustees or trustee company

particulars of interest which he may have in any other company, or institution or financial intermediary or any corporate by virtue of his position as director, partner or with which he may be associated in any other capacity.

2. Minimum number of trustees must be mentioned in the Trust Deed.
3. The Trust Deed must provide that the trustees shall take into their custody, or under their control all the property of the schemes of the mutual fund and hold it in trust for the unit holders.
4. The Trust Deed must specifically provide that unit holders would have beneficial interest in the trust property to the extent of individual holding in respective schemes only.
5. The trust deed shall provide that it is the duty of trustees to provide or cause to provide information to unit holders and Board as may be specified by the Board.
6. The trust deed shall provide that it would be the duty of the trustees to act in the interest of the unit holders.
7. The trust deed shall provide that the trustees shall appoint an AMC approved by the Board, to float schemes for the mutual fund after approval by the trustees and Board, and manage the funds mobilised under various schemes, in accordance with the provisions of the trust deed and Regulations. The trustees shall enter into an Investment Management Agreement with the AMC for this purpose, and shall enclose the same with the Trust Deed.
8. The trust deed shall provide for the duty of the trustee to take reasonable care to ensure that the funds under the schemes floated by and managed by the AMC are in accordance with the Trust Deed and Regulations.
9. The trust deed must provide for the power of the trustees to dismiss the AMC under the specific events only with the approval of Board in accordance with the Regulations.
10. The trust deed shall provide that the trustees shall appoint a custodian and shall be responsible for the supervision of its activities in relation to the mutual fund and shall enter into a Custodian Agreement with the custodian for this purpose.
11. The trust deed shall provide that the auditor for the mutual fund shall be different from the Auditor of the AMC.
12. The trust deed shall provide for the responsibility of the trustees to supervise the collection of any income due to be paid to the scheme and for claiming any repayment of tax and holding any income received in trust for the holders in accordance with the Trust Deed Regulations.
13. Board policies regarding allocation of payments to capital or income must be indicated in the Trust Deed.
14. The trust deed shall also explicitly forbid the acquisition of any asset out of the trust property which involves the assumption of any liability which is unlimited or shall not result in encumbrance of the trust property in any way.
15. The trust deed shall forbid the mutual fund to make or guarantee loans or take up any activity not in contravention of the Regulations.

16. Trusteeship fee, if any, payable to trustee shall be provided in the Trust Deed.
17. The trust deed shall provide that no amendment to the Trust Deed shall be carried out without the prior approval of the Board or unit holders. However in case a Board of trustees is converted into a trustee company subsequently such conversion shall not require the approval of unit holders.
18. The removal of the trustee in all cases would require the prior approval of Board.
19. The trust deed shall lay down the procedure for seeking approval of the unit holders under such circumstances as are specified in the Regulations.
20. The trust deed shall state that a meeting of the trustees shall be held at least once in every two months and at least six such meetings shall be held in every year.
21. The trust deed shall specify the quorum for a meeting of the trustees. However the quorum for a meeting of the trustees shall not be constituted unless one independent trustee or director is present at the meeting.
22. The trust deed shall state that the minimum number of trustees shall be four.

Regulation 16 lays down the attributes of a person to be appointed as trustee. These attributes are:

a. he should be a person of ability, integrity and standing;
b. he has not been found guilty of moral turpitude;
c. he has not convicted of any economic offence or violation of any securities loss and has furnished particulars as required in the prescribed form;
d. an asset management company or any of its officers or employees shall not be eligible to act as a trustee;
e. no person already appointed as a trustee of a mutual fund can be appointed again as a trustee of any other mutual fund unless he is an independent trustee and prior approval of the mutual fund of which he is already a trustee has been obtained for the new appointment;
f. 2/3 of the trustees shall be independent persons not associated with the sponsors in any manner;
g. where the companies appointed as trustee, then its directors can act as trustees of any other trust provided that the object of the trust is not in conflict with the object of the mutual fund; and
h. prior approval of SEBI shall be necessary for the appointment of any trustee.

Rights and Obligations of Trustees

Regulation 18 lays down the following rights and obligations for the trustees:

1. The trustees and the AMC shall with the prior approval of SEBI enter into an investment management agreement.
2. Such agreement shall contain all the clauses as detailed in the Fourth Schedule to the Regulations or as well as other clauses necessary for the purpose of making investments; The fourth Schedule contains clauses which are to be included as contents of the investment management agreement; and the same is reproduced below:

Investment Management Agreement

The Investment Management Agreement shall contain the following provisions about the duties and responsibilities of the AMC namely:

i. the AMC appointed by the trustees with the prior approval of SEBI shall be responsible for floating schemes for the mutual fund after approval of the same by the trustees and managing the funds mobilised under various schemes; in accordance with the provisions of the Trust Deed and Regulations;

ii. the AMC shall not undertake any other business activity other than activities specified therein and management of mutual funds and such other activities as financial services consultancy, exchange of research and analysis on commercial basis as long as these are not in conflict with the fund management activity itself without the prior approval of the trustees and SEBI;

iii. the AMC shall invest the funds raised under various schemes in accordance with the provisions of the Trust Deed and the Regulations;

iv. the AMC shall not acquire any of the assets out of the scheme property which involves the assumption of any liability which is unlimited or which may result in encumbrance of the scheme property in any way;

v. the AMC shall not take up any activity in contravention of the Regulations;

vi. no loss or damage or expenses incurred by the AMC or officers of AMC or any person delegated by the AMC, shall be met out of the trust property;

vii. the AMC shall ensure that no offer document of a scheme, key information memorandum, abridged half yearly results and annual results is issued or published without the trustees' prior approval in writing, and contains any statement or matter extraneous to the Trust Deed or Offer Document scheme particulars approved by the trustees and Board;

viii. the asset management company shall provide an option of nomination to the unitholders in terms of regulation 29A, in the form prescribed hereunder.

ix. the AMC shall disclose the basis of calculating the repurchase price and NAV of the various schemes of the fund in the scheme particulars and disclose the same to the investors at such intervals as may be specified by the trustees and SEBI;

x. the trustees shall have the right to obtain from the AMC all information concerning the operations of the various schemes of the mutual fund managed by the AMC at such intervals and in such a manner as required by the trustees to ensure that the AMC is complying with the provisions of the Trust Deed, and Regulations;

xi. the AMC shall submit quarterly report on the functioning of the schemes of the mutual fund to the trustees or at such intervals as may be required by the trustees or SEBI;

xii. the trustee shall have the power to dismiss the AMC under the specific events only with the approval of SEBI in accordance with the

Regulations.

3. The trustees are entitled to obtain from the AMC all the information which the trustees consider necessary;
4. the trustees shall ensure before the launch of any scheme that the asset management company has—
   a. systems in place for its back office, dealing room and accounting;
   b. appointed all key personnel including fund manager(s) for the scheme(s) and submitted their bio-data which shall contain the educational qualification, past experience in the securities market with the trustees, within 15 days of their appointment;
   c. appointed auditors to audit its accounts;
   d. appointed a compliance officer who shall responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines, instructions etc. issued by the board or the Central Government and for redressal of investors grievances.
   e. appointed registrars and laid down parameters for their supervision;
   f. prepared a compliance manual and designed internal control mechanisms including internal audit systems;
   g. specified norms for empanelment of brokers and marketing agents;

   In addition to the aforementioned certification, the trustees are required to certify that "the trustees have ensured that the (name of the scheme/Fund) approved by them is a new product offered by (name of the MF) and is not a minor modification of the existing scheme/fund/product. This certification shall also be disclosed in the offer document along with the date of approval of the scheme by the trustees. However, the said certification is not applicable to Fixed Maturity Plans and close-end schemes but is applicable to close-end schemes with a feature of conversion into open-ended on maturity.
5. The compliance officer appointed under clause (d) of sub-regulation (4) shall in immediately and independently report to the Board any non-compliance observed by him.
6. The trustees shall ensure that the asset management company (AMC) has been diligent in empaneling the brokers, in monitoring the securities transactions with brokers and avoiding undue concentration of business with any broker;
7. The trustees shall ensure the AMC has not given any undue or unfair advantage to any associate or dealt with any of the associates of the AMC in a manner detrimental to the unit holders;
8. The trustees shall ensure that the transaction entered into by the AMC or in accordance with these regulations and the mutual fund scheme concerned;
9. The trustees shall ensure that the AMC has been managing the mutual fund schemes independently of other activities and have taken adequate steps to see that the interest of the investors of one scheme are not being compromised with those of any other scheme or of other activities of the AMC;
10. The trustees shall ensure that all the activities of the AMC are in

accordance with the provisions of these regulations;

11. Where the trustees have reason to believe that the conduct of business of the mutual fund is not in accordance with these regulations and the scheme, they shall forthwith take such remedial steps as are necessary, and shall immediately inform SEBI of the violation and the action taken by them;
12. Each trustee shall file the details of his transactions of dealing in securities with a mutual fund on a quarterly basis;
13. The trustees shall be accountable for and be the custodian of the funds and the property of the respective schemes and shall hold the same in trusts for the benefit of the unitholders in accordance with these regulations and the trust deed;
14. The trustees shall take steps to ensure that the transactions of the mutual fund are in accordance with the provisions of the trust deed;
15. The trustees shall be responsible for the calculation of any income to be paid to the mutual fund and also of any income received in the mutual fund for the holders of the unit of any scheme in accordance with these regulations and the trust deed;
16. The trustees shall obtain the consent of the unit holders –
    a. whenever required to do so by SEBI in the interest of the unit holders; or
    b. whenever required to do so on the requisition of 3/4 of the unit holders of any scheme; or
    c. when the majority of the trustees decide to wind up or pre-maturely redeem the units;
17. The trustees shall ensure that no change in the fundamental attributes of any scheme or the trust or fees and expenses payable or any other change which would modify the scheme and affects the interest of unit holders, shall be carried out unless, -
    i. a written communication about the proposed change is sent to each unit holder and an advertisement is given in one English daily newspaper having nationwide circulation as well as in a newspaper published in the language of the region where the Head Office of the mutual fund is situated; and
    ii. the unit holders are given an option to exit at the prevailing Net Asset Value without any exit load;
18. The trustees shall on a quarterly basis review all transactions carried out between the mutual funds, AMC and its associates and also the networth of the AMC. In case of any short fall the trustees shall ensure that the AMC make up for the short fall;
19. The trustees shall periodically review all service contracts such as custody arrangements, transfer agency of the securities and satisfy itself that they are executed in the interest of the unit holders. Similarly, the trustees shall periodically review the investor complaints received and ensure redressal by AMC;
20. The trustees shall abide by the code of conduct as specified in the Fifth Schedule, namely—

Code of Conduct for Mutual Funds

a. Mutual fund schemes should not be organised, operated, managed or the portfolio of securities selected, in the interest of sponsors, directors of AMCs, members of Board of trustees or directors of trustee company, associated persons in the interest of special class of unit holders rather than in the interest of all classes of unit holders of the scheme.
b. Trustees and AMCs must ensure the dissemination to all unit holders of adequate, accurate, explicit and timely information fairly presented in a simple language about the investment policies, investment objectives, financial position and general affairs of the scheme.
c. Trustees and AMCs should avoid excessive concentration of business with broking firms, affiliates and also excessive holding of units in a scheme among a few investors.
d. Trustees and AMCs must avoid conflicts of interest in managing the affairs of the schemes and keep the interest of all unit holders paramount in all matters.
e. Trustees and AMCs must ensure schemewise segregation of bank accounts and securities accounts.
f. Trustees and AMCs shall carry out the business and invest in accordance with the investment objectives stated in the offer documents and take investment decision solely in the interest of unit holders.
g. Trustees and the AMC shall maintain high standards of integrity and fairness in all their dealings and in the conduct of their business.
h. Trustees and AMC must not use any unethical means to sell; market or induce any investor to buy their schemes.
i. Trustees and the AMC shall render at all times high standard of service, exercise due diligence, ensure proper care and exercise independent professional judgment.
j. The AMC shall not make any exaggerated statement, whether oral or written, either about their qualifications or capability to render investment management services or their achievements.
k. (a) The sponsor of the mutual fund, the trustees or the asset management company and any of their employees shall not render, directly or indirectly any investment advice about and security in the publicity accessable media, whether real time or non-real-time, unless a disclosure of his interest including long or short petition in the said security has been made, while rendering such advice.
    b. In case, an employee of the sponsor, the trustees or the asset management company is rendering such advice, he shall also disclose the interest of his dependent family members and the employer including their long or short position in the said security, while rendering such advice.

21. The trustees shall furnish to SEBI on a half yearly basis—
    a. a report on the activities of the mutual fund;
    b. a certificate that the trustees have not found any instances of self dealing or front running by any of the trustees, directors or key personnel of the AMC and a certificate to the effect that the AMC has

been managing the schemes independently of any other activities and protecting the interest of the unit holders. The independent trustees shall give their comments on the report of the AMC as regards investments by the mutual fund in the securities of group companies of the sponsor.

General Due Diligence and Specific Due Diligence by Trustees

The trustees shall exercise due diligence as under:

A. *General Due Diligence:*
   i. the trustees shall be discerning in the appointment of the directors on SEBI of the asset management company.
   ii. trustees shall review the desirability of continuance of the asset management company if substantial irregularities are observed in any of the schemes and shall not allow the asset management company to float new schemes.
   iii. the trustee shall ensure that the trust property is properly protected, held and administered by proper persons and by a proper number of such persons.
   iv. the trustee shall ensure that all service providers are holding appropriate registrations from SEBI or concerned regulatory authority.
   v. the trustees shall arrange for test checks of service contracts.
   vi. trustees shall immediately report to SEBI of any special developments in the mutual fund.

B. *Specific Due Diligence:* The trustees shall:
   i. obtain internal audit reports at regular intervals from independent auditors appointed by the trustees;
   ii. obtain compliance certificate at regular intervals from the asset management company;
   iii. hold meeting of trustee more frequently;
   iv. consider the reports of the independent auditor and compliance reports of asset management company at the meetings of trustees for appropriate action;
   v. maintain records of the decisions of the trustees at their meetings and of the minutes of the meetings;
   vi. prescribe and adhere to a code of ethics by the trustees, asset management company and its personnel;
   vii. communicate in writing to the asset management company of the deficiencies and checking on the rectification of deficiencies.

Independent Directors' Responsibilities

The independent directors of the trustees or the AMC shall pay specific attention to the following:

1. the investment management agreement and the compensation paid under the said agreement;
2. service contract with affiliates to identify payments in excess of market rates with outside contractors;
3. selection of AMCs independent directors;
4. securities transactions involving affiliates where permissible;
5. selecting and nominating individuals to fill vacancies of independent

directors;

6. code of ethics to prevent fraudulent, deceptive or manipulative practices by insiders in connection with personal securities transactions;
7. reasonableness of fees paid to sponsors, AMCs and others for services rendered;
8. principal underwriting contracts and service contracts with associates of AMC.

Advertisement Code for Mutual Funds

All advertisements shall be in accordance with the advertisement code given in the Sixth Schedule and shall be submitted to SEBI within 7 days from the date of their issue. The advertisement code contains clauses which have to be complied with carefully by the AMC. The advertisement shall avoid misleading statements as well as incorrect or false opinions and shall disclose investment objective of each scheme.

The Advertisement code clauses are -

1. An advertisement shall be truthful, fair and clear and shall not contain a statement, promise or forecast which is untrue or misleading.
2. An advertisement shall be considered to be misleading if it contains -
   a. Misleading Statements: Representations made about the performance or activities of the mutual fund in the absence of necessary explanatory or qualifying statements, and which may give an exaggerated picture of the performance or activities, than what it really is.
   b. An inaccurate portrayal of a past performance or its portrayal in a manner which implies that past gains or income will be repeated in the future.
   c. Statements promising the benefits of owning units or investing in the schemes of the mutual funds without simultaneous mention of material risks associated with such investments.
3. The advertisement shall not be so designed in content and format or in print as to be likely to be misunderstood, or likely to disguise the significance of any statement. Advertisements shall not contain statements which directly or by implication or by omission may mislead the investor.
4. The sales literature may contain only information, the substance of which is included in the funds current advertisements in accordance with the Code.
5. Advertisements shall not be so framed as to exploit the lack of experience or knowledge of the investors. As the investors may not be sophisticated in legal or financial matters, care should be taken that the advertisement is set forth in a clear, concise, and understandable manner. Extensive use of technical or legal terminology or complex language and the inclusion of excessive details which may detract the investors should be avoided.
6. The advertisement shall not contain information, the accuracy of which is to any extent dependent on assumptions. Any advertisement that makes claims about the performance of the fund shall be supported by relevant figures.
7. The advertisement shall not compare one fund with another, implicitly or explicitly, unless the comparison is fair and all information relevant to the

comparison is included in the advertisement.

8. The funds which advertises yield must use standardised computations such as annual dividend on face value, annual yield on the purchase price, and annual compounded rate of return.
9. Mutual funds shall indicate in all advertisements, the names of the Settlor, Trustee, Manager and/or Financial Advisor to the Fund, bringing out clearly their legal status and liability of these entities. All advertisements containing information regarding performance, advertising yield, return or any scheme detail or inviting subscription to the scheme shall contain disclosures of all the risk factors.
10. All advertisements shall also make a clear statement to the effect that all mutual funds and securities investments are subject to market risks, and there can be no assurance that the fund’s objectives will be achieved.
11. If however, in any advertisement a mutual fund guarantees or assures any minimum rate of return or yield to prospective investors, resources to back such a guarantee shall also be indicated.
12. If any existing mutual fund indicates the past performance of the fund in advertisements, the basis for computing the rates of return/yield and adjustments made, if any, must be expressly indicated with a statement that, such information is not necessarily indicative of future results and may not necessarily provide a basis for comparison with other investments. Any advertisement containing information regarding performance, NAV, yield or returns shall give such data for the past three years, wherever applicable.
13. All advertisements issued by a mutual fund or its sponsor or AMC, shall state all investments in mutual funds and securities are subject to market risks and the NAV of the schemes may go up or down depending upon the factors and forces affecting the securities market.
14. All advertisement launched in connection with the scheme should also disclose prominently the risks factors as stated in the offer document along with the following warning statements:
    a. is only the name of the scheme and does not in any manner indicate either the quality of the scheme, its future prospects or returns; and
    b. please read the offer document before investing;

    Any advertisement reproducing or purporting to reproduce any information contained in a offer document shall reproduce such information in full and disclose all relevant facts and not be restricted to select extracts relating to that item which could be misleading. No celebrities shall form part of the advertisement.
15. No name can be given to a scheme with a view to subtly indicate any assurance of return, except in the cases of guaranteed return scheme in accordance with regulation 38.
16. No advertisement shall be issued stating that the scheme has been subscribed or oversubscribed during the period the scheme is open for subscription.
17. If a corporate advertisement is issued by the sponsor or any of the companies in the group, or an associate company of the sponsor during

the subscription period, no reference shall be made to the scheme of the mutual fund or mutual fund itself; otherwise it will be treated as an issue advertisement.

18. If a corporate advertisement of a sponsor issued prior to the launch of a scheme makes a reference to the mutual fund sponsored by it or any of its schemes launched/to be launched, it shall contain a statement to the effect that the performance of the sponsor has no bearing on the expected performance of the mutual fund or any of its schemes.
19. Advertisement on the performance of a mutual fund or its AMC shall compare the past performances only on the basis of per unit of statistics as per these Regulations. Advertisements for NAVs must indicate the past as well as these latest NAV of a scheme. The yield calculations will be made as provided in these regulations.

Regulation 32 lays down that every close ended scheme shall be listed in a recognised stock exchange within 6 months from the date of closure of the subscription. It also indicates cases in which such listing may not be mandatory.

Regulation 33 authorises the AMC at its option to repurchase or reissue repurchased units of a close ended scheme at stated intervals as disclosed in the offer document. It also permits conversion of close ended scheme into open ended scheme subject to specified conditions, otherwise a close ended scheme shall be fully redeemed at the end of the maturity period unless rolled over with due information to SEBI. Such roll over is permitted only where unit holders express their consent in writing therefor and the others who have not so expressed, their holdings shall be redeemed in full at NAV based price. The asset management company is not permitted to repurchase units of a capital protection oriented scheme before end of the maturity period.

Regulation 34 lays down that no scheme of mutual fund other than an initial offering of equity linked savings scheme shall be open for subscription for more than 45 days.

Regulations 35 and 36 deal with allotment of units, refunds and issue of unit certificates and statement of accounts.

Regulation 37 states that unit certificates are freely transferable except where it is specifically restricted or prohibited under the scheme. Such transfers which confirm to proper procedure shall be effected within 30 days from the date of application.

Guaranteed Returns

Regulation 38 lays down that no guaranteed return shall be provided in a scheme unless fully guaranteed by the sponsor or AMC. The name of the person guaranteeing the return shall be mentioned in the offer document and the manner in which the guarantee is to be met be also indicated therein.

Capital protection oriented schemes

Regulation 38A of the Regulations provides that a capital protection oriented scheme may be launched, subject to the following:

a. the units of the scheme are rated by a registered credit rating agency from the viewpoint of the ability of its portfolio structure to attain protection of the capital invested therein;

b. the scheme is close ended; and
c. there is compliance with such other requirements as may be specified by the Board in this behalf.

Regulation 39 to 42 deal with winding up of a close ended scheme on the expiry of its duration, the effect of winding up, the procedure and manner thereof. It is enjoined that trustees shall forward to SEBI and to the unitholders a report on the winding up. On SEBI being satisfied about the completion of all the necessary measures, a scheme shall cease to exist.

Investment objectives and valuation policies

Regulation 43 lays down that the monies collected under any scheme of a mutual fund shall be invested only in securities, money market instruments; privately placed debentures; securitised debt instruments which are either asset backed or mortgage backed securities or gold or gold related instruments. Investment shall be made in accordance with the investment objective of the relevant mutual fund scheme. However monies collected under any money market scheme of a mutual fund shall be invested only in money market instruments. Moneys collected under any gold exchange trade fund scheme shall be invested only in gold or gold related instruments.

Regulation 44 talks about investment, borrowing and connected restrictions. Any investments shall be made subject to the investment restriction specified in the Seventh Schedule to the Regulations which contains 11 clauses, as reproduced below. However, seventh schedule does not apply to a gold exchange traded fund scheme.

Restrictions on Investments by Mutual Funds

1. A mutual fund scheme shall not invest more than 15% of its NAV in debt instruments issued by a single issuer which are rated now below investment grade by a credit rating agency authorised to carry out such activity under the Act. Such investment limit may be extended to 20% of the NAV of the scheme with the prior approval of the Board of Trustees and the Board of AMC;
   However such limit shall not be applicable for investments in government securities and money market instruments and investment within such limit can be made in mortgaged backed securitised debt which are rated not below investment grade by a credit rating agency registered with SEBI.
   A mutual fund scheme shall not invest more than 10% of its NAV in unrated debt instruments issued by a single issuer and the total investment in such instruments shall not exceed 25% of the NAV of the scheme. All such investments shall be made with the prior approval of the Board of Trustees and the Board of AMC;
   It has been clarified by SEBI that investments made in securitised debt (mortgage backed securities/asset backed securities) restrictions at the originator level would not be applicable.
2. No mutual fund under all its schemes should own more than 10% of any company's paid up capital carrying voting rights;
3. Transfers of investments from one scheme to another scheme in the same mutual fund shall be allowed only if—
   a. such transfers are done at the prevailing market price for quoted

instruments on spot basis.
'Spot basis' shall have same meaning as specified by stock exchange for spot transactions.

b. the securities so transferred shall be in conformity with the investment objective of the scheme to which such transfer has been made.

4. A scheme may invest in another scheme under the same AMC or any other mutual fund without charging any fees, provided that aggregate investment made by all schemes under the same management or in schemes under the management of any other AMC shall not exceed 5% of the net asset value of the mutual fund. It has been provided in the regulations that this clause will not apply to any fund of fund scheme.
5. The initial issue expenses in respect of any scheme may not exceed 6% of the funds raised under that scheme.
6. Every mutual fund shall buy and sell securities on the basis of deliveries and shall in all cases of purchases, take delivery of relative securities and in all cases of sale, deliver the securities and shall in no case put itself in a position whereby it has to make short sale or carry forward transaction or engage in badla finance.
   However the mutual funds may enter into derivatives transactions in a recognised stock exchange subject to such guidelines as may be specified by the Board.
7. Every mutual fund shall, get the securities purchased or transferred in the name of the mutual fund on account of the concerned scheme, wherever investments are intended to be of long term nature.
8. Pending deployment of funds of a scheme in securities in terms of investment objectives of the scheme a mutual fund can invest the funds of the scheme in short term deposits of scheduled commercial banks.
9. No mutual fund shall make any investment in
   a. any unlisted security of an associate or group company of the sponsor; or
   b. any security issued by way of private placement by an associate or group company of the sponsor; or
   c. the listed securities of group companies of the sponsor which is in excess of 25% of the net assets.
10. No mutual fund scheme shall invest more than 10% of its NAV in the equity shares or equity related instruments of any company;
    However the limit of 10% shall not be applicable for investments in index fund or sector or industry specific scheme.
11. A mutual fund scheme shall not invest more than 5% of its NAV in the unlisted equity shares or equity related instruments in case of open ended scheme and 10% of its NAV in case of close ended scheme.
12. A fund of funds scheme shall be subject to the following investment restrictions:
    a. A fund of funds scheme shall be subject to the following investment restriction.
    b. A fund of funds scheme shall not invest its asset other than in schemes of mutual funds, except to the extent of funds required for meeting the

liquidity requirement for the purpose of repurchase or redemptions, as disclosed in the offer documents of funds of funds scheme.

A mutual fund having an aggregate of securities which are worth Rs. 10 crore or more as on the latest balance sheet date, shall settle their transactions only through dematerialised securities, as per instructions of SEBI. The mutual funds shall not borrow except to meet temporary liquidity needs for the purpose of repurchase, redemption of units or payment of interest or dividend to the unit holders. Such borrowals should not exceed 20% of the net asset value of the scheme and the duration of the borrowing shall not exceed six months. The mutual fund shall not advance any loans for any purpose but may lend securities in accordance with the stock lending scheme of SEBI.

Overseas Investment by Mutual Funds

The aggregate ceiling for overseas investments is US $ 5 billion.b) Within the overall limit of US $ 5 billion, mutual funds can make overseas investments subject to a maximum of US $ 300 million per mutual fund. The overall ceiling for investment in overseas ETFs that invest in securities is US $ 1 billion subject to a maximum of US $ 50 million per mutual fund.

In this regard, Mutual Funds can invest in

i. ADRs/ GDRs issued by Indian or foreign companies
ii. Equity of overseas companies listed on recognized stock exchanges overseas
iii. Initial and follow on public offerings for listing at recognized stock exchanges overseas
iv. Foreign debt securities in the countries with fully convertible currencies, short term as well as long term debt instruments with rating not below investment grade by accredited/registered credit rating agencies
v. Money market instruments rated not below investment grade
vi. Repos in the form of investment, where the counterparty is rated not below investment grade; repos should not however, involve any borrowing of funds by mutual funds
vii. Government securities where the countries are rated not below investment grade
viii. Derivatives traded on recognized stock exchanges overseas only for hedging and portfolio balancing with underlying as securities
ix. Short term deposits with banks overseas where the issuer is rated not below investment grade
x. Units/securities issued by overseas mutual funds or unit trusts registered with overseas regulators and investing in (a) aforesaid securities, (b) Real Estate Investment Trusts (REITs) listed in recognized stock exchanges overseas or (c) unlisted overseas securities (not exceeding 10% of their net assets.

Transaction in excess of permissible limits- A case study

SEBI v. Shriram Mutual Fund & Others - Appeal No. 9523-24 of 2003

a. A penalty of Rs.2 lakh was imposed by Adjudicating Officer (AO) on Shriram Mutual Fund (SMF) as it had repeatedly exceeded the permissible limits of transactions through its associate broker, in terms of Regulation

25(7) (a) of SEBI (Mutual Funds) Regulations.

b. On an appeal by SMF, SAT vide its final judgment and order dated August 21, 2003, set aside AO's order inter-alia on the ground that the limit was not exceeded intentionally.
c. SEBI filed an appeal under Section 15Z of the SEBI Act in the Hon'ble Supreme Court.
d. The Hon'ble Supreme Court pronounced its final judgment and order on May 23, 2006. Hon'ble Supreme Court set aside the judgment of SAT and settled the issues, as under:

   — Mens rea is not an essential ingredient for contravention of the provisions of a Civil Act.

   — Penalty is attracted as soon as contravention of the statutory obligation as contemplated by the Act is established, and therefore the intention of the parties committing such violation becomes immaterial.

   — Unless the language of the statute indicated the need to establish the element of mens rea, it is generally sufficient to prove that a default in complying with the statute has occurred.

   — Once the contravention is established, the penalty has to follow and only the quantum of penalty is discretionary

   — The SAT has erroneously relied on the judgment in the case of Hindustan Steel Limited vs. State of Orissa (AIR 1970 SC 253) as the said case has no application in the present case which relates to imposition of civil liabilities under SEBI Act and Regulations; and is not a criminal / quasi-criminal proceeding.

   — Imputing mens rea into the provisions of Chapter VIA is against the plain language of the statute and frustrates entire purpose and object of introducing Chapter VIA which was to give teeth to the SEBI to secure strict compliance of the Act and the Regulations.

Gold Exchange Traded Funds

SEBI (Mutual Funds) (Amendment) Regulations dated January 24, 2006 permitted introduction of Gold Exchange Traded Fund schemes by Mutual Fund. Gold Exchange Traded Fund (GETF) schemes are permitted to invest primarily in

a. Gold
b. Gold related instruments i.e. such instruments having gold as underlying, as are specified by SEBI from time to time.

A gold exchange traded fund scheme is subject to the following investment restrictions:

a. the initial issue expenses in respect of any such scheme should not exceed six percent of the funds raised under that scheme;
b. the funds of any such scheme should be invested only in gold or gold related instruments in accordance with its investment objective, except to the extent necessary to meet the liquidity requirements for honouring repurchases or redemptions, as disclosed in the offer document; and
c. pending deployment of funds in accordance with clause (b), the mutual fund may invest such funds in short term deposits of scheduled commercial banks.

1. **Valuation**
   Since physical gold and other permitted instruments linked to gold are denominated in gold tonnage, it will be valued based on the market price of gold in the domestic market and will be marked to market on a daily basis. The market price of gold in the domestic market on any business day would be arrived at as under:
   Domestic price of gold = (London Bullion Market Association AM fixing in US$/ounce X conversion factor for converting ounce into kg for 0.995 fineness X rate for US$ into INR) + custom duty for import of gold + sales tax/octroi and other levies applicable.
   The Trustees reserve the right to change the source (centre) for determining the exchange rate. The AMC should record in writing the reason for change in the source for determining the exchange rate.
2. **Determination of Net Asset Value**
   NAV of units under the Scheme would be calculated as shown below:

	Market or Fair Value of Scheme's investments + Current
NAV (Rs.) =	Assets – Current Liabilities and Provision
	No. of Units outstanding under Scheme on the Valuation Date

   The NAV shall be calculated up to four decimals.
3. **Recurring Expenses**
   For a GETF, the limits applicable to equity schemes as specified in SEBI Regulations shall be applicable.
4. **Benchmark for GETF**
   As there are no indices catering to the gold sector/securities linked to Gold, currently GETF shall be benchmarked against the price of Gold.
   Regulation 45 prohibits option trading or short selling or carry forward transactions with funds of a mutual fund scheme. But the mutual funds are permitted to enter into derivatives transactions in a recognised stock exchange subject to such guidelines as may be specified by SEBI.
   Regulation 46 permits mutual funds to enter into underwriting agreement after obtaining a certificate of registration in terms of SEBI Underwriters Rules and SEBI Underwriters Regulations. The Underwriting obligations will be deemed to be investments made in such securities. The capital adequacy norms for the purpose of underwriting shall be the net asset of the scheme. However the Underwriting obligation of a mutual fund shall not at any time exceed the total NAV of the scheme.
   Regulation 47 deals with the method of valuation of investments. Every mutual fund shall compute and carry out valuation of its investments in its portfolio and publish the same in accordance with the valuation norms specified in the Eighth Schedule to the Regulations namely—
   Investment Valuation Norms
   Mutual fund shall value its investments according to the following valuation norms:
   NAV of a scheme as determined by dividing the net assets of the scheme by the number of outstanding units on the valuation date.

1. Traded Securities:
    i. The securities shall be valued at the last quoted closing price on the stock exchange.
    ii. When the securities are traded on more than one recognised stock exchange, the securities shall be valued at the last quoted closing price on the stock exchange where the security is principally traded. It would be left to the AMC to select the appropriate stock exchange, but the reasons for the selection should be recorded in writing. There should however be no objection for all scrips being valued at the prices quoted on the stock exchange where a majority in value of the investments are principally traded.
    iii. Once a stock exchange has been selected for valuation of a particular security, reasons for change of the exchange shall be recorded in writing by the AMC.
    iv. When a security is not traded on any stock exchange on a particular valuation day, the value at which it was traded on the selected stock exchange or any other stock exchange, as the case may be, on the earliest previous day may be used provided such date is not more than thirty days prior to the valuation date.
2. Non-traded Securities:
    i. When a security is not traded on any stock exchange for a period of thirty days prior to the valuation date, the scrip must be treated as a 'non-traded' scrip.
    ii. Non-traded securities shall be valued 'in good faith' by the AMC on the basis of appropriate valuation methods based on the principles approved by the Board of AMC. Such decision of the Board must be documented in the Board minutes and the supporting data in respect of each security so valued must be preserved. The methods used to arrive at values 'in good faith' shall be periodically reviewed by the trustees and reported upon by the auditors as 'fair and reasonable' in their report on the annual accounts of the fund. For the purpose of valuation of non-traded securities, the following principles should be adopted -
        a. equity instruments shall generally be valued on the basis of capitalisation of earnings solely or in combination with the net asset value, using for the purposes of capitalisation, the price or earning ratios of comparable traded securities and with an appropriate discount for lower liquidity;
        b. debt instruments shall generally be valued on a yield to maturity basis, the capitalisation factor being determined for comparable traded securities and with an appropriate discount for lower liquidity;
        c. while investments in call money, bills purchased under rediscounting scheme and short term deposits with banks shall be valued at cost plus accrual; other money market instruments shall be valued at the yield at which they are currently traded. For this purpose, non traded instruments, that is, instruments not

traded for a period of seven days will be valued at cost plus interest accrued till the beginning of the day plus the difference between the redemption value and the cost spread uniformly over the remaining maturity period of the instruments; government securities will be valued at yield to maturity based on the prevailing market rate;

d. in respect of convertible debentures and bonds, the non convertible and convertible components shall be valued separately. The non convertible component be valued on the same basis as would be applicable to a debt instrument. The convertible component should be valued on the same basis as would be applicable to an equity instrument. If after conversion the resultant equity instrument would be traded pari-passu with an existing instrument which is traded, the value of the latter instrument can be adopted after an appropriate discount for the non-tradability of the instrument during the period preceding the conversion. While valuing such instruments, the fact whether the conversion is optional should also be factored in;

e. in respect of warrants to subscribe for shares attached to instruments, the warrants can be valued at the value of the share which would be obtained on exercise of the warrant as reduced by the amount which would be payable on exercise of the warrant. A discount similar to the discount to be determined in respect of convertible debentures must be deducted to account for the period which must elapse before the warrant can be exercised.

f. where instruments have been bought on ‘repo’ basis, the instrument must be valued at the resale price after deduction of applicable interest upto date of resale. Where an instrument has been sold on a ‘repo’ basis, adjustment must be made for the difference between the repurchase price (after deduction of applicable interest upto date of repurchase) and the value of the instrument. If the repurchase price exceeds the value, the depreciation must be provided for and if the repurchase price is lower than the value, credit must be taken for the appreciation.

3. Until they are traded, the value of the ‘rights’ shares should be calculated as:

$$V_r = \frac{n}{m} \times (P_{ex} - P_{of})$$

Where

V_r = Value of rights

n = no. of rights offered

m = no. of original shares held

P_{ex} = Ex-rights price

P_{of} = Rights Offer Price

Where the rights are not treated pari-passu with the existing shares, suitable adjustment should be made to the value of rights. Where it is decided not to subscribe for the rights but to renounce them and renunciations are being traded, the rights can be valued at the renunciation value.

4. All expenses and incomes accrued upto the valuation date shall be considered for computation of net asset value. For this purpose, while major expenses like management fees and other periodic expenses should be accrued on a day to day basis, other minor expenses and income need not be so accrued, provided the non-accrual does not affect the NAV calculations by more than 1%.
5. Any changes in securities and in the number of units be recorded in the books not later than the first valuation date following the date of transaction. If this is not possible given the frequency of the Net Asset Value disclosure, the recording may be delayed upto a period of seven days following the date of the transaction, provided that as a result of the non-recording, the Net Asset Value calculations shall not be affected by more than 1%.
6. In case the Net Asset Value of a scheme differs by more than 1%, due to non-recording of the transactions, the investors or scheme/s as the case may be, shall be paid the difference in amount as follows:
   i. If the investors are allotted units at a price higher than Net Asset Value or are given a price lower than Net Asset Value at the time of sale of their units, they shall be paid the difference in amount by the scheme.
   ii. If the investors are charged lower Net Asset Value at the time of purchase of their units or are given higher Net Asset Value at the time of sale of their units, asset management company shall pay the difference in amount to the scheme.
7. Thinly traded securities as defined in the guidelines should be valued in the manner as specified in the guidelines issued by the Board.
8. The aggregate value of illiquid securities as defined in the guidelines should not exceed 15% of the total assets of the scheme and any illiquid securities held above 15% of the total assets shall be valued in the manner as specified in the guidelines issued by Board.

Regulation 48 lays down that every mutual fund shall compute the NAV of each scheme by dividing the net assets of the scheme with a number of units of that scheme outstanding on the valuation date. It shall be calculated and published at least in two daily newspapers at intervals not exceeding one week. However the NAV of any scheme for special target scheme or any monthly income scheme which are not mandatorily required to be listed in any stock exchange may publish the NAV at monthly or quarterly intervals as permitted by SEBI.

Regulation 49 deals with pricing of units. The price at which units may be subscribed or sold and the price at which such units may at any time be purchased by the mutual fund shall be made available to the investors. In the case of open ended scheme the mutual fund shall at least once in a week publish in a daily newspaper of All India circulation, the sale and repurchase price of the units. The funds shall ensure that such repurchase price is not lower than 93% of the NAV and the sale price is not more than 107% of the NAV. However, the repurchase price of units of a close ended scheme shall not be lower than 95% of the NAV and the difference between the repurchase price and sale price of the unit shall not exceed 7% calculated on the sale price.

No entry load is charged by any close-ended scheme. Where a mutual fund repurchases units in a close ended scheme which fulfills the conditions mentioned below shall deduct an amount representing proportionate initial issue expenses or part thereof remaining unamortized, from the repurchase proceeds.

For the purpose, the term ‘proportionate initial issue expenses or part thereof remaining unamortised’ refers to such proportion of the expenses of the scheme as are attributable to the units being repurchased.

The conditions referred are as follows:

a. the scheme is launched after commencement of the Securities and Exchange Board of India (Mutual Funds) (Second Amendment) Regulations, 2006; and
b. initial issue expenses in respect of the scheme have been charged or are proposed to be charged to the mutual fund, as per clause (a) of sub-regulation (4) of regulation 52.

The amount recovered above are credited to the unamortized initial issue expenses of the scheme.

The price of units shall be determined with reference to the last determined NAV, unless the scheme announces the NAV on a daily basis and the sale price is determined with or without a fixed premium added to the future NAV which is declared in advance.

General Obligations of the Mutual Funds

Regulation 50 lays down that every AMC for each scheme shall keep and maintain proper books of accounts, records and documents, for each scheme so as to explain its transactions and to disclose at any point of time the financial position of each scheme and in particular, give a true and fair view of the state of affairs of the fund and intimate to SEBI the place where such books of accounts, records and documents are maintained. All these documents shall be preserved by the AMC for a period of 8 years.

The AMC shall follow the accounting policies and standards as specified in the Ninth Schedule to the Regulations to provide appropriate details of the scheme-wise disposition of the assets of the fund at the relevant accounting date and the performance during that period together with information regarding distribution or accumulation of income accruing to the unit holder in a fair and true manner. The said ninth schedule is reproduced below:

Accounting Policies and Standards

a. For the purposes of the financial statements, mutual fund shall mark all investments to market and carry investments in the balance sheet at market value. However, since the unrealised gain arising out of appreciation on investments cannot be distributed, provision has to be made for exclusion of this item when arriving at distributable income.

b. Dividend income earned by a scheme should be recognised, not on the date of dividend is declared, but on the date the share is quoted on an ex-dividend basis. For investments which are not quoted on the stock exchange, dividend income must be recognised on the date of declaration.
c. In respect of all interest bearing investments, income must be accrued on a day to day basis as it is earned. Therefore when such investments are purchased, interest paid for the period from the last interest due date upto the date of purchase must not be treated as a cost of purchase but must be debited to Interest Recoverable Account. Similarly, interest received at the time of sale for the period from the last interest due date upto the date of sale must not be treated as an addition to sale value but must be credited to Interest Recoverable Account.
d. In determining the holding cost of investments and the gains or loss on sale of investments, the 'average cost' method must be followed.
e. Transactions for purchase or sale of investments should be recognised as of the trade date and not as of the settlement date, so that the effect of all investments traded during a financial year are recorded and reflected in the financial statements for that year. Where investment transactions take place outside the stock market, for example, requisitions through private placement or purchases or sales through private treaty, the transaction should be recorded, in the event of a purchase, as of the date on which the scheme obtains an enforceable obligation to pay the price or, in the event of a sale, when the scheme obtains an enforceable right to collect the proceeds of sale or an enforceable obligation to deliver the instruments sold.
f. Bonus shares to which the scheme becomes entitled should be recognised only when the original shares on which the bonus entitlement accrues are traded on the stock exchange on an ex bonus basis. Similarly, rights entitlements should be recognised only when the original shares on which the right entitlement accrues are traded on the stock exchange on an ex rights basis.
g. Where income receivable on investments has been accrued and has not been received for, the period specified in the guidelines issued by SEBI, provision should be made by debit to the revenue account for the income so accrued and no further accrual of income should be made in respect of such investment.
h. When in the case of an open ended scheme units are sold, the difference between the sale price and the face value of the unit, if positive, should be credited to reserves and if negative is debited to reserve, the face value being credited to Capital Account. Similarly, when in respect of such a scheme, units are repurchased, the difference between the purchase price and face value of the unit, if positive should be debited to reserves and, if negative, should be credited to reserves, the face value being debited to the capital account.
i. In the case of an open ended scheme, when units are sold an appropriate part of the sale proceeds should be credited to an Equalisation Account

and when units are repurchased an appropriate amount should be debited to Equalisation Account. The net balance on this account should be credited or debited to the Revenue Account. The balance on the Equalisation Account debited or credited to the Revenue Account should not decrease or increase the net income of the fund but is only an adjustment to the distributable surplus. It should therefore be reflected in the Revenue Account only after the net income of the fund is determined.

j. In a close ended scheme which provide to the unit holders the option for an early redemption or repurchase their own units, the par value of the unit has to be debited to Capital Account and the difference between the purchase price and the par value, if positive, should be credited to reserves and, if negative, should be debited to reserves. A proportionate part of the unamortized initial issue expenses should also be transferred to the reserves so that the balance carried forward on that account is proportional to the number of units remaining outstanding.
k. The cost of investments acquired or purchased should include brokerage, stamp charges and any charge customarily included in the broker's bought note. In respect of privately placed debt instruments any front end discount offered should be reduced from the cost of the investment.
l. Underwriting commission should be recognised as revenue only when there is no devolvement on the scheme. Where there is devolvement on the scheme, the full underwriting commission received and not merely the portion applicable to the devolvement should be reduced from the cost of the investment.

Regulation 51 provides that the financial year for the all the schemes shall end as on March, 31 every year.

Regulation 52 lays down that all expenses should be clearly identified and apportioned to the individual schemes. The AMC may charge the mutual fund with investment and advisory fees as provided in the Regulation and disclose it fully in the offer document. In the case of no load schemes, AMC is allowed to collect additional management fee not exceeding 1% of the weekly average net assets outstanding in each financial year. In addition the AMC is allowed to charge the mutual fund various other expenses as detailed in this Regulation. Expenses other than the above shall be borne by AMC or trustee or sponsors. The initial expenses of launching a close ended scheme shall not exceed 6% of the initial resources raised under that scheme and shall be accounted in the accounts books of the scheme in accordance with the Tenth Schedule which contains 6 clauses listed below:

Initial Issue Expenses

Accounting treatment with regard to initial issue expenses:

a. AMCs, (trustee company or sponsor) may launch schemes either on a 'load' or 'no-load basis' or on a mixed basis with two classes of units in the same scheme - one with load and the other without load, provided that the implications of such load on the NAV for the investors shall be clearly explained through a worked-out example in the offer document. AMC may also launch 'partial load' schemes in which a part of the load would be borne by the AMCs and the balance by the scheme. However such schemes will not qualify to be ‘no load’ schemes and would be treated in the same manner as ‘load’ schemes. In case of a no load scheme, the initial issue expenditure shall be borne by the AMC.

b. For a close ended scheme floated on a ‘load’ basis, the initial issue expenses shall be amortised on a weekly basis over the period of the scheme.
   However, in case the schemes provides for partial redemption during the life of the scheme, the amortisation shall take into account the number of outstanding units and the aggregate amount during the relevant periods.
c. In case of close ended floated on a load basis, the unamortised portion of the expenses shall be included in the calculation of the NAV. However such portion shall not be included in the NAV for the purposes of determining the AMCs investment management and advisory fees or for determining the limitation of expenses under Regulation 51 of these regulations;
d. For schemes floated on a no-load basis, the AMC may levy an additional management fee not exceeding 1% of the NAV. The AMC may be entitled to levy a contingent deferred sales charge for redemption during the first four years after purchase, not exceeding 4% of the redemption proceeds in the first year, 3% in the second year, 2% in the third year and 1% in the fourth year.
e. All subsequent distribution charges must in the case of load schemes shall be borne by the scheme and in the case of no-load schemes borne by the AMC.

Regulation 52A provides that a mutual fund may declare dividends in accordance with the offer document and subject to such guidelines as may be specified by the Board.

Regulation 53 lays down that every mutual fund and AMC shall despatch to the unit-holders the dividend warrants within 42 days of the declaration of the dividend (now reduced to 30 days) and despatch the redemption or repurchase proceeds within 10 working days from the date of such redemption or repurchase. If AMC fails in this regard, it shall be liable to pay interest to the unit holders at such rate as may be specified by SEBI for the period of delay. Besides this, the AMC may also be liable for penalty in respect of the delay.

Regulations 54 to 57 deal with the annual report, auditors report, publication thereof and forwarding to SEBI. Every mutual fund or AMC shall prepare in respect of each financial year an annual report and an annual statement of accounts of the schemes and the fund as specified in the Eleventh Schedule which runs to 10 pages. Every mutual fund shall have the annual statement of accounts audited by a practising Chartered Accountant who is not in any way associated with the auditor of the AMC. The auditor shall be appointed by the trustees to whom the auditor shall forward his report. It shall be included as part of the annual report of the mutual fund.

Regulation 56 requires that the scheme-wise annual report of a mutual fund or an abridged summary thereof shall be published through an advertisement and that an abridged scheme-wise annual report shall be mailed to all unit

holders within 6 months from the date closure of the relevant accounting year.
Regulation 57 requires that the mutual funds annual report shall be forwarded to SEBI within 6 months from the date of closure of each financial year.
Regulations 58 and 59 indicate the periodical and continual disclosures as well as half yearly disclosures to be made by the mutual fund, AMC and others closely connected to them.
Regulation 60 enjoins that the trustee shall be bound to make all essential disclosures to unit holders to keep them informed about any information which may have an adverse bearing on their investments.

Inspection and Audit

SEBI is empowered to appoint inspecting officer to inspect and investigate the affairs of a mutual fund, the trustees, the AMC etc. SEBI may give a notice to the fund before such inspection or may dispense with it, if it feels the need.
Regulation 63 indicates the obligations of the mutual fund, trustees or AMC when they are taken up for inspection by SEBI.
The inspecting officer shall submit his reports to SEBI and SEBI after considering the same communicate the findings of the inspecting officer to the mutual fund, trustees or AMC and give him an opportunity to be heard.

Procedure for Action in Case of Default

Chapter IX containing Regulation 68 to 76 deals with the above subject. The action may include suspension of the certificate of registration or cancellation of the certificate.
Regulation 71 provides the manner of holding inquiry before suspension or cancellation.
Regulation 72 states that on receipt of the report from the inquiry office, SEBI shall consider the same and issue to the mutual fund, trustees or AMC a show-cause notice who shall within 14 days of the receipt of the show-cause notice send a reply to SEBI.
Regulation 73 stipulates that on suspension or cancellation, the different parties including mutual fund, trustees or AMC shall cease to carry on their activities. The order of suspension or cancellation shall be published in two newspapers and thereafter SEBI may initiate action against the defaulting parties. In respect of certain offences, SEBI is authorised to arrange for adjudication.
Regulation 77 authorises SEBI to issue clarifications and guidelines to the different parties.

LESSON ROUND-UP

- Mutual Funds, pool their marginal resources, invest in securities and distribute the returns therefrom among them on cooperative principles.
- As in mature markets, mutual funds in emerging markets have been among the fastest growing institutional investors.
- Mutual funds are regulated by SEBI (Mutual Fund) Regulations, 1996
- Various schemes of Mutual Funds are Open ended mutual funds; Close ended mutual funds; Income Oriented Schemes; Growth Oriented Schemes; Hybrid Schemes; High Growth Schemes; Money Market Mutual Funds; Tax Saving Schemes etc.
- Various risks involved in mutual funds are Excessive diversification of

portfolio; losing focus on the securities of the key segments; Too much concentration on blue-chip securities; Poor planning of investment with minimum returns; Unresearched forecast on income, profits and Government policies etc.

FOOTNOTES

**Source:* SEBI Annual Report 2006-2007.

*a Net assets of Rs. 2,214.67 crore pertaining to Fund of Funds schemes are not included in the above data.