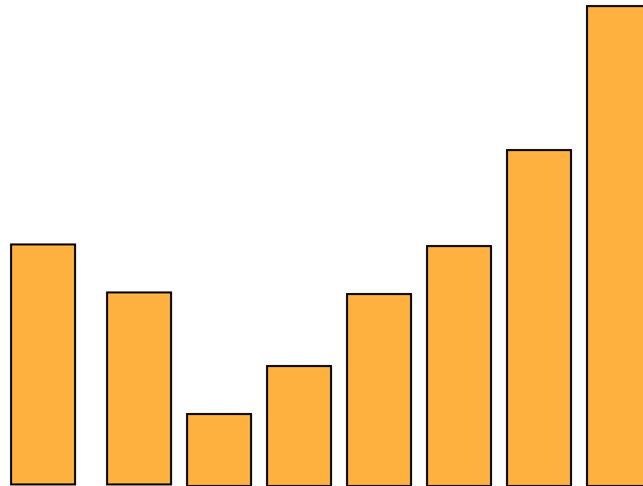
THE FALL AND RISE OF MUTUAL FUNDS IN INDIA



Kaushal Shah & Associates
Advocates, Solicitors and Legal Consultants

Corporate Office:

406, Peninsula Plaza,
Fun Republic Lane,
Off Andheri Link Rd,
Andheri (W).
Mumbai 400 056
Tel: # 91 22 267 333 94
Tele Fax: # 91 22 401 098 21

Research Center:

Chamber 10 A, 4th Floor
Central Bank of
India Bldg
Fountain
Mumbai 400 023
Tel:# 91 22 226 549 25

E-mail: kaushal@ksaattorneys.com

Web: http://www.ksaattorneys.com

Kaushal Shah & Associates is a boutique law firm located in Mumbai the commercial capital of India, which provides a unique service by focusing on effective discussion, careful listening, skilled and systematic planning process to approach our work. Based on our knowledge of key industry sectors and legal practice, the Law Firm provides holistic, innovative flexible commercial solutions to result in good transaction management.

The Law Firm is distinguished by its unsurpassed expertise in Corporate, Media Entertainment and Sport, Private Equity and Venture Capital Investment Funds, Intellectual Property, Human Resource, Life sciences, Technology and Real Estate. Each of our associates has expertise in specific area of law and is a leader in one's own field. Each of our specialist teams has a wealth of knowledge and practical experience.

At Kaushal Shah & Associates, we offer more than just law. We make it our business to understand your business and complex legal problems. We aim to be an integral part of your organisation and place our emphasis on working closely with you to achieve your business goals through our sound, distinctive culture that puts people first. We believe that cultivating relationships is the key to our success.

This article is a copyright of Kaushal Shah & Associates. No reader should act on the basis of any statement contained herein without seeking professional advice. The authors and the firm expressly disclaim all and any liability to any person who has read this article, or otherwise in respect of anything, and of consequences of anything done, or omitted to be done by any such person in reliance upon this article

© *Kaushal Shah & Associates 2007*

Introduction

We have attempted by virtue of this article to take the reader through the entire journey of Mutual Fund industry in India, Its origin, its fall and rise through out all these years and tried to predict what the future may hold for the Mutual Fund Investors in the long run. What really is a mutual fund? A mutual fund, also called an investment company, is an investment vehicle which pools the money of many investors. The fund's manager uses the money collected to purchase securities such as stocks and bonds. The securities purchased are referred to as the fund's portfolio.

History and Origin of Mutual Fund

More than 40 years of existence of Mutual Fund Industry in India has witnessed some dramatic pitfalls and surely a bumpy ride. After the debacle performance of 1994-95, it was a slow and painstaking recovery for the private sector funds. In the five years that followed, many more private sector funds threw their hat into the ring, some of them big global names.

The origin of India mutual fund industry is with the introduction of the concept of mutual fund by UTI in the year 1963. Though the growth was slow, but it accelerated from the year 1987 when Non-UTI players entered the industry.

In the past decade, Indian mutual fund industry had seen a dramatic imporvements, both quality wise as well as quantity wise. Before, the monopoly of the market had seen an ending phase, the Assets Under Management (AUM) grew to about Rs. 67bn. The private sector entry to the fund family rose the AUM to Rs. 470 bn in March 1993 and till April 2004, it reached the height of 1,540 bn.

Putting the AUM of the Indian Mutual Funds Industry into comparison, the total of it is less than the deposits of SBI alone, constitute less than 11% of the total deposits held by the Indian banking industry. The main reason of its poor growth is that the mutual fund industry in India is relatively new in the country. Large sections of Indian investors are yet to be educated on this concept.

In the year between 1963 to 1987, when Unit Trust of India (UTI) was established on 1963 by an Act of Parliament and was acting as the sole player in the industry. It was set up by the Reserve Bank of India and functioned under the Regulatory and administrative control of the Reserve Bank of India. In 1978 UTI was de-linked from the RBI and the Industrial Development Bank of India (IDBI) took over the regulatory and administrative control in place of RBI. The first scheme launched by UTI was Unit Scheme 1964. At the end of 1988 UTI had Rs.6,700 crores of assets under management.

The year 1987 marked the entry of Non-UTI, public sector mutual funds set up by public

© Kaushal Shah & Associates 2007

sector banks and Life Insurance Corporation of India (LIC) and General Insurance Corporation of India (GIC). SBI Mutual Fund was the first Non- UTI Mutual Fund established in June 1987 followed by Canbank Mutual Fund (Dec 87), Punjab National Bank Mutual Fund (Aug 89), Indian Bank Mutual Fund (Nov 89), Bank of India (Jun 90), Bank of Baroda Mutual Fund (Oct 92). LIC established its mutual fund in June 1989 while GIC had set up its mutual fund in December 1990.

With the entry of private sector funds in 1993, a new era started in the Indian mutual fund industry, giving the Indian investors a wider choice of fund families. Also, 1993 was the year in which the first Mutual Fund Regulations came into being, under which all mutual funds, except UTI were to be registered and governed. The erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private sector mutual fund registered in July 1993.

The number of mutual fund houses went on increasing, with many foreign mutual funds setting up funds in India and also the industry has witnessed several mergers and acquisitions. As at the end of January 2003, there were 33 mutual funds with total assets of Rs. 1,21,805 crores. The Unit Trust of India with Rs.44,541 crores of assets under management was way ahead of other mutual funds.

In February 2003, following the repeal of the Unit Trust of India Act 1963 UTI was bifurcated into two separate entities. One is the Specified Undertaking of the Unit Trust of India with assets under management of Rs.29,835 crores as at the end of January 2003, representing broadly, the assets of US 64 scheme, assured return and certain other schemes. The Specified Undertaking of Unit Trust of India, functioning under an administrator and under the rules framed by Government of India and does not come under the purview of the Mutual Fund Regulations.

Structure Of Mutual Fund

SEBI (Mutual Fund) Regulations, 1996 regulates the Structure of Mutual Funds in India. Mutual Funds in India are constituted in the form of Public Trust created under the Indian Trusts Act, 1882. This trust will be created by sponsor of the mutual fund. The sponsor will make initial contribution in this trust and will appoint trustees to hold the assets of the trust for the benefit of the unit holders, who are the beneficiary of the trust. The trustees will appoint AMC to act as investment manager of the assets of the trust. The AMC then launches schemes on behalf of trustees inviting investors to contribute to the common pool by buying units of the schemes. AMC takes care of all the operations of managing the money of the investors.

As per these regulations mutual funds should have the following structure:

1. Sponsor
2. Trust/trustee
3. Asset Management Company
4. Custodian.

© Kaushal Shah & Associates 2007

Sponsor

SEBI regulations define Sponsor as any person who either itself or in association with another body corporate establishes a mutual fund. In simple words, a Sponsor is an entity that sets up the mutual fund. Sponsor does the following important activities:

1. Sponsor creates a Public Trust under the Indian Trust Act, 1882

2. Sponsor appoints trustees to manage the trust with the approval of SEBI

3. Sponsor creates an Asset Management Company under the Companies Act, 1956.

4. Sponsor appoints and registers the trust as a Mutual Fund with SEBI.

Trustee

Trustees manage a Trust. Trustees are responsible to the Investors in the Mutual Funds. They take care of the interests of Investors in the Mutual Funds. Trustees can be formed in either of the following two ways:

1. Board of Trustees (Governed by the provisions of Indian Trust Act, 1882), and

2. Trustee Company (Governed by the provisions of Indian Trust Act, 1882 and Companies Act, 1956)

Functions of trustees:

- Trustees ensure that the activities of the mutual fund are in accordance with SEBI (Mutual Fund) regulations, 1996.

- Trustees ensure that the AMC has proper systems and procedures in place.
- Trustees ensure that all the other fund constituents are formed and that proper due diligence is exercised by the AMC in the appointment of constituents and business associates.

- All schemes floated by the AMC have to be approved by the trustees.

- Trustees review and ensure that the net worth of the AMC is as per the SEBI stipulated norms.

- Trustees furnish to SEBI, on a half yearly basis, a report on the activities of AMC.

Regulations regarding appointment of trustees

The following are few of the important essential for the appointment of trustees:

- Sponsor with prior approval of SEBI appoints trustees.

- There should be at least four members in the board of trustees.

© *Kaushal Shah & Associates 2007*

- At least 2/3rd of the trustees should be independent.

- Trustee of one mutual fund cannot be trustee of another mutual fund, unless he is an independent trustee in both cases and has the approval of both the boards.

- The trustees are appointed by executing and registering a trust deed.

Asset Management Company (AMC)

An asset management company is a company registered under the Companies Act, 1956. Sponsor creates the asset management company and this is the entity, which manages the funds of the mutual fund (trust). The mutual fund pays a small fee to the AMC for management of its fund. The AMC acts under the supervision of Trustees and is subject to the regulations of SEBI too. At present there are some 30 AMC in India.

AMC are mainly divided into 3 parts. These are:

1. Bank sponsored
2. Institutions, and
3. Private Sector

Restrictions on the business activities of an AMC

When an AMC acts as an Investment Manager to a mutual fund, then it becomes very important to see that such an AMC focuses just on its core business. It also becomes very important for the regulator to ensure that the activities of AMC's are not in conflict of each other. With these objectives, SEBI has imposed some restrictions on the business activities of an AMC. These are:

- An AMC shall not undertake any business activity except in the nature of portfolio management services, management and advisory services to offshore funds etc, provided these activities are not in conflict with the activities of the mutual fund.

- An AMC can not invest in any of its own schemes unless full disclosure of its intention to invest has been made in the offer document.

- An MNC shall not act as a trustee of any mutual fund.

Custodian

The most important asset of any mutual fund is portfolio. Hence it becomes very important to keep safe the securities. This responsibility of keeping safe the securities, which are in the material form, are kept in safe custody with Custodian.

Custodian performs a very important back office operation. They ensure that delivery has been taken of the securities, which are bought, and that they are transferred in the name of mutual fund. They keep the investment account of the mutual fund. They collect and account for the dividends and interest receivables on mutual fund

© Kaushal Shah & Associates 2007

investments. They also keep track of various corporate actions like bonus issue, right issue, and stock split, buy back offers, open offers etc.

Regulations Of Mutual Funds

Mutual Funds in India are regulated by SEBI (Securities and Exchange Board of India). All the mutual funds in India are regulated by SEBI.

SEBI has framed the SEBI (Mutual Funds) Regulations, 1996, (hereinafter referred to as SEBI Regulations) which provides the scope of the regulations of mutual fund in India. It is mandatory for all the mutual funds to get registered with SEBI.

SEBI Regulations provide for the following points:

1. The structure and formation of mutual funds
2. Appointment of key functionaries
3. Operations of mutual fund
4. Rights and obligations of functionaries and investors
5. The restriction imposed on investment
6. The compliance to be fulfilled and the penalties imposed on non fulfillment of the same.

Importance Of Mutual Fund

Small investors face a lot of problems in the share market, limited resources, lack of professional advice, lack of information etc. Mutual funds have come as a much needed help to these investors. It is a special type of institutional device or an investment vehicle through which the investors pool their savings which are to be invested under the guidance of a team of experts in wide variety of portfolios of corporate securities in such a way, so as to minimise risk, while ensuring safety and steady return on investment. It forms an important part of the capital market, providing the benefits of a diversified portfolio and expert fund management to a large number, particularly small investors.

The alternative to mutual fund is direct investment by the investor in equities and bonds or corporate deposits. All investments whether in shares, debentures or deposits involve risk: share value may go down depending upon the performance of the company, the industry, state of capital markets and the economy; generally, however, longer the term, lesser the risk; companies may default in payment of interest/ principal on their debentures/bonds/deposits; the rate of interest on an investment may fall short of the rate of inflation reducing the purchasing power. While risk cannot be eliminated, skillful management can minimise risk. Mutual Funds help to reduce risk through diversification and professional management. The experience and expertise of Mutual Fund managers in selecting

© Kaushal Shah & Associates 2007

fundamentally sound securities and timing their purchases and sales help them to build a diversified portfolio that minimises risk and maximises returns.

As mutual fund is a collective process, it will have all the benefits of a collective investment process. It is also an indirect form of investment so it has benefits of indirect form of investment too. The following are the benefits:

1. Mutual fund investment increases the purchasing power of investors.

2. It enables the investor to have a well diversified portfolio even with very small amount of money.

3. It reduces the risk of the investor.

4. The money managed by the professional is managed at a low cost.

5. The transaction cost also reduces as the economies of operation are at a large scale.

6. It is also convenient for the investor to invest the money and also track the performance of the money invested.

7. It also provides flexibility for the investor to change the investment objectives.

Types Of Mutual Fund

Wide varieties of Mutual Fund Schemes exist to cater to the needs such as financial position, risk tolerance and return expectations etc. The details provided herein below gives an overview into the existing types of schemes in the Industry.

Open-ended Funds

An open-end fund is one that is available for subscription all through the year. These do not have a fixed maturity. Investors can conveniently buy and sell units at Net Asset Value ("NAV") related prices. The key feature of open-end schemes is liquidity.

Closed-ended Funds

A closed-end fund has a stipulated maturity period which generally ranging from 3 to 15 years. The fund is open for subscription only during a specified period. Investors can invest in the scheme at the time of the initial public issue and thereafter they can buy or sell the units of the scheme on the stock exchanges where they are listed. In order to provide an exit route to the investors, some close-ended funds give an option of selling back the units to the Mutual Fund through periodic repurchase at NAV related prices. SEBI Regulations stipulate that at least one of the two exit routes is provided to the investor.

Interval Funds

© *Kaushal Shah & Associates 2007*

Interval funds combine the features of open-ended and close-ended schemes. They are open for sale or redemption during pre-determined intervals at NAV related prices.

Equity Fund

These funds invest a major part of their corpus in equities. The composition of the fund may vary from scheme to scheme and the fund manager's outlook on various scrip. The Equity Funds are sub-classified depending upon their investment objective, as follows:

- Diversified Equity Funds
- Mid-Cap Funds
- Sector Specific Funds
- Tax Savings Funds (ELSS)

Equity investments are meant for a longer time horizon. Equity funds rank high on the risk-return matrix.

Debt Fund

These Funds invest a major portion of their corpus in debt papers. Government authorities, private companies, banks and financial institutions are some of the major issuers of debt papers. By investing in debt instruments, these funds ensure low risk and provide stable income to the investors. Debt funds are further classified as:

Gilt Funds: Invest their corpus in securities issued by Government, popularly known as GoI (Government of India) debt papers. These Funds carry zero Default risk but are associated with Interest Rate risk. These schemes are safer as they invest in papers backed by Government.

Income Funds: Invest a major portion into various debt instruments such as bonds, corporate debentures and Government securities.

MIPs: Invests around 80% of their total corpus in debt instruments while the rest of the portion is invested in equities. It gets benefit of both equity and debt market. These scheme ranks slightly high on the risk-return matrix when compared with other debt schemes.

Short Term Plans (STPs): Meant for investors with an investment horizon of 3-6 months. These funds primarily invest in short term papers like Certificate of Deposits (CDs) and Commercial Papers (CPs). Some portion of the corpus is also invested in corporate debentures.

Liquid Funds: Also known as Money Market Schemes, These funds are meant to provide easy liquidity and preservation of capital. These schemes invest in short-term instruments like Treasury Bills, inter-bank call money market, CPs and CDs. These funds are meant for short-term cash management of corporate houses and are meant for an investment horizon of 1day to 3 months. These schemes rank low on risk-return matrix and are considered to be the safest amongst all categories of mutual funds.

© Kaushal Shah & Associates 2007

Conclusion

With the structural liberalization policies no doubt Indian economy is likely to return to a high grow path in few years. Hence mutual fund organisations are needed to upgrade their skills and technology. Success of mutual fund however would bright depending upon the implementation of suggestions.

With regard to the Mutual Fund investor we are of the view that the investor needs to adopt two crucial skills for successful investing i.e. a sense of timing and investment discipline both need to be adopted at the same time.

© *Kaushal Shah & Associates 2007*