Collective Investment Vehicles

Three distinct categories of collective investment vehicles namely, MFs, collective investment schemes and venture capital funds, mobilise resources from market for investment purposes. The fiscal ending March 2002 witnessed several developments in this segment of market.

Mutual Funds

"Put your money in trust, not trust in money" entices the small investors, who generally lack expertise to invest on their own in the securities market and prefer some kind of collective investment vehicles (CIV), which can pool their marginal resources, invest in securities and distribute the returns therefrom among them on co-operative principles. The investors benefit in terms of reduced risk, and higher returns arising from professional expertise of fund managers employed by such investment vehicle. This was the original appeal of mutual funds (MFs) which offer a path to stock market far simpler and safer than the traditional call-a-broker-and-buy-securities route. This caught the fancy of small investors leading to proliferation of MFs. In developed financial markets, MFs have overtaken bank deposits and total assets of insurance funds. In the USA, the number of MFs far exceeds the number of listed securities.

Experimentation with MFs in India began in 1964 with the establishment of the Unit Trust of India (UTI), a statutory corporation with the objective of encouraging saving and investment. This was followed by entry of MFs promoted by public sector banks and insurance companies in 1987. The industry was opened up to private sector in 1993 providing Indian investors a broader choice. Starting with an asset base of Rs. 25 crore in 1964, the industry has grown exponentially to Rs. 100,594 crore at the end of March 2002. The number of households owning units of MFs exceeds the number of households owning equity and debentures. At the end of March 1999, according to the SEBI-NCAER survey of Indian Investors (2000), 23 million unit holders had invested in units of MFs, while 19 million individual investors invested in equity and or debentures.

The 1990s witnessed emergence of a variety of funds. There are funds which invest in growth stocks, funds which specialise in stocks of a particular sector, funds which assure returns to the investors, funds which invest in debt instruments and fund which invest aggressively and fund which do not do all these. Thus, we have income funds, balanced funds, liquid funds, gilt funds, index funds, exchange traded funds, sectoral funds and there are open-ended funds, closed-ended funds and assured return funds - there is a fund for every requirement. The number of funds and schemes offered by them increased to 37 and 417 respectively at the end of March 2002 though recent past has witnessed consolidation of funds. The number of units available today compares favourably with the number of securities/companies listed on stock exchanges and far exceeds the number of active securities. Such proliferation of number of MFs and their schemes has made investors as bewildered as they are with securities. The investor likes choice, but he is lost with too many choices.

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Policy Developments

The policy and regulatory initiatives during April 2001-June 2002 include:

SAT Order

The Securities Appellate Tribunal (SAT) upheld an order of the Adjudicating Officer which had concluded that the Appellant had failed to comply with the requirements of section 15B of the SEBI Act, 1992 read with rule 4(1)(b) of the SEBI (Registrar to an Issue and Share Transfer Agents) Rules, 1993 and imposed a penalty of Rs. 5 lakh on the Appellant. It was contended by the Appellant that he was not covered by the Rules as he was not dealing in securities, but in units of MFs which are not securities and hence the Respondent had therefore no powers, authority or jurisdiction to conduct any enquiry or impose any penalty on the Appellant. While disagreeing with this, the SAT interpreted the definition of "securities" under section 2 (h) of the Securities Contracts (Regulations) Act, 1956 having regard to the object and purpose underlying the SEBI Act, and the relevant Rules and the Regulations. It observed: "The reach of the definition of the word 'security' under the Act being an inclusive definition is very wide. All securities which are marketable and which have an ease or facility of selling and/or which have a high degree of liquidity and or/are capable of being sold in a market, i.e., stock exchange, are considered to be included. Units of MFs certainly come under this. To hold that the units are not securities would be in effect curtailing and restricting the ambit of the definition, against the legislative intent. In my view units issued by MFs are securities."

Union Budget, 2001-02

i. The Budget proposed that the tax payable on the distribution of dividends of domestic companies and income in respect of units of MFs and UTI would be reduced from 20% to 10% to provide a stimulus to the growth of capital market.

ii. The Budget added a new Section 54ED that exempted tax on capital gain arising from sale of securities and units of MFs if the same was invested in IPO of eligible issue with a lock in period of one year.

Union Budget, 2002-03

i. Further legislative changes in the UTI Act to put in place needed reform measures would be proposed during the year.

ii. Indian MFs can invest in rated securities in countries with fully convertible currencies, within the existing limits. Earlier such investment was permitted only in ADR's/GDRs issued by Indian companies in overseas markets.

iii. The distribution tax of 10% on companies and MFs on the dividends or income distributed by them would be abolished. Such income would henceforth be taxed in the hands of the recipients at the rates applicable to them, and would be subject to tax deduction at source at the rate of 10%. In order to avoid a cascading effect, companies receiving such income would be entitled to claim a deduction for the amount in turn distributed by them as dividends. To continue the support given to equity oriented funds of the UTI and other MFs, the income received during the financial year 2002-03 by unit holders of such funds would be taxed only at prevailing 10%.

Amendments in MF Regulations

SEBI amended the Mutual Fund (MF) Regulations, 1996 to incorporate the following:

i. The AMC must appoint a compliance officer who shall be responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines, instructions etc. issued by SEBI or Central Government and for redressal of investors' grievances. The compliance officer shall immediately and independently report to SEBI any non-compliance observed by him.

ii. The sponsor of the MF, the trustees or the AMC or any of their employees shall not render, directly or indirectly any investment advice about any security in the publicly accessible media, whether real-time or non real-time, unless a disclosure of his interest including long or short position in the said security has been made, while rendering such advice.

iii. Each director of the AMC would file the details of his transactions of dealing in securities with the trustees on a quarterly basis.

iv. Every MF and AMC would despatch the dividend warrants to unit holders within 30 days of the declaration of the dividend.

v. Every MF and AMC will publish its unaudited financial results before the expiry of one month from the close of each half-year, i.e. 31st March and 30th September.

vi. A MF scheme can invest up to 10% of its NAV in the equity shares or equity related instruments of any company, up to 5% of its NAV in the unlisted equity shares or equity related instruments in case of open ended scheme and up to 10% of its NAV in case of closed ended scheme. Within these limits, the MF schemes can invest in the listed or unlisted securities or units of Venture Capital Funds (VCFs) as the case may be.

vii. All brokers would collect volatility margins on equity shares from their clients, including institutional clients such as MFs.

viii. The scheme-wise annual report or an abridged annual report shall be mailed to all unit holders.

Guidelines under MF Regulations

Large Holdings: SEBI directed MFs in April 2001 to disclose large unit holdings (holding over 25% of the net assets of a scheme by an investor) in their schemes. The information on the number of such investors and total holdings by them in percentage terms shall be disclosed in the allotment letters after the initial public offerings and also in the annual and the half-yearly results.

Brokerage Payments: SEBI advised MFs in April 2001 not to make payment of brokerage / commission on the subscription of units by their sponsors.

Investment/Trading in Securities by Employees: SEBI laid down procedure and code of conduct in May 2001 for investments / trading in securities by employees of AMCs and trust companies. The objectives of this prescription are: (i) to ensure that all personal securities transactions are conducted in such a manner so as to avoid any actual or potential conflict of interest or any abuse of an individual's position of trust and responsibility, (ii) to prevent employees from taking undue advantage of any price sensitive information that they may have about any company, and (iii) to guide employees in maintaining a high standard of probity. Specified categories of employees are now required to obtain prior approval before making personal transactions.

Clients Codes for MFs: SEBI directed MFs in July 2001 to furnish codes to the brokers while executing securities transactions. They were advised to use the SEBI registration number as their client code to be followed by any number given by them to denote the scheme/plan.

Certification Programme: With a view to improving professional standards, SEBI made it mandatory in September 2001 for all MFs to appoint agents/distributors who have obtained AMFI certification w.e.f November 1, 2001. The existing agents/distributors are expected to pass the certification programme by March 31, 2003. In case of firms/ companies, the requirement of certification may be made applicable to the persons engaged in sales and marketing. The existing and new employees of MFs, particularly those who are involved in sales and marketing, shall be encouraged to pass the certification process by December 2002. Compliance of the above requirements and progress made in their implementation shall be reported to SEBI in the quarterly compliance reports of AMCs and half yearly reports of the Trustees.

Disclosure on Web Sites: SEBI decided in September 2001 that the MFs shall post half yearly financial results on their web sites. Also, for the purpose of easy reference by the investors, all MFs shall display these results on AMFI web site (www.amfiindia.com) before the expiry of one month from the close of each half-year. The MFs shall also disclose the portfolios on their web sites before the expiry of one month from the close of each half-year.

Benchmarking Performances: In order to give the investors objective analysis of the performance of the MFs in comparison with the rise or fall in the markets, SEBI in consultation with AMFI decided in March 2002 that all MFs have to disclose the performance of the benchmark indices in case of equity oriented schemes while disclosing the yields of the schemes in the format of half-yearly results. The MFs may select any of the indices available, e.g. BSE (Sensitive) index, S&P CNX Nifty, BSE 100, BSE 200 or S&P CNX 500, depending on the investment objective and portfolio of the scheme. In case of sector or industry specific schemes, they may select any sectoral indices published by stock exchanges and other reputed agencies. These benchmark indices may be decided by the AMCs and trustees and any change at a later date shall be recorded and reasonably justified. As the purpose of introducing benchmarks is to indicate the performance of the markets to the investors, the MFs may give performance of more than one index if they so desire. Also, they have the option to give their management perception on the performance of their schemes.

In consultation with AMFI, SEBI decided in April 2002 that all MFs shall also disclose the performance of benchmarks in case of various types of debt-oriented schemes and balanced fund schemes while publishing half yearly results. These benchmarks shall be developed by research and rating agencies recommended by AMFI on a regular basis. Other guidelines as specified in aforesaid paragraph like change in benchmark indices at a later date, giving management perception, review of performance by the AMCs and trustees, reporting of its compliance to SEBI in its quarterly reports of AMCs and half yearly reports of trustees, shall remain the same.

ICICI Securities and Finance Company Limited (Isec) has been maintaining ICICI Securities Sovereign Bond Index (i-BEX) since 1994 representing gilts market. In order to meet specific needs of market participants, it has also been maintaining short-maturity index (Si-BEX) comprising securities maturing in one to three years, medium maturity index (Mi-BEX) comprising securities maturing in three to seven years, and long-maturity

index (Li-BEX) comprising securities maturing later than seven years since March 1996. These three new indices along with a composite index, which is an average of Si-BEX, Mi-BEX and Li-BEX were chosen by AMFI as benchmark gilt indices for mutual fund schemes. In addition, in consultation with AMFI, Crisil.com developed 4 indices to benchmark performance of other schemes - Liquid Fund Index (LiquiFEX) for liquid schemes, Composite Bond Fund Index (CompBEX) for income schemes, Balanced Fund Index (BalanCEX) for balance schemes and MIP Blended Index (MIPEX) for monthly income plan schemes of MFs. All the 4 Isec indices and 4 CRISIL indices are based on publicly available information. These were launched on June 19, 2002 by Chairman, SEBI for benchmarking the performance of individual MFs against an Index that is representative of the universe of that fund.

Investment in Foreign Securities: Pursuant to budget proposal to permit MFs to make investments in rated securities in countries with fully convertible currencies, SEBI issued guidelines for such investments in March 2002. The MFs can now make investments in foreign debt securities in the countries with fully convertible currencies, short term as well as long term debt instruments with highest rating by accredited/registered credit rating agencies. They may also invest in government securities where the countries are AAA rated. They may also invest in units/securities issued by overseas MFs/unit trusts which invest in aforesaid securities. Each MF can invest up to 4% of its net assets as on February 28, 2002 subject to the maximum of US$ 50 mn.

Apart from the SEBI (MF) Regulations, 1996, the MFs shall adhere to the following specific guidelines for making investments in foreign securities:

i. The Boards of AMCs and Trustees shall exercise due diligence in making investment decisions. They shall make a detailed analysis of risks and returns of investments in foreign securities, comparing them with likely yields of the securities available in domestic markets and how these investments would be in the interest of investors. Investments must be made in liquid actively traded securities.

ii. The intention to invest in foreign securities shall be disclosed in the offer documents of the schemes. The attendant risk factors and returns ensuing from such investments shall be explained clearly in the offer documents. The MFs shall disclose exposure limits i.e. the percentage of assets of the scheme they would invest in foreign securities.

iii. The existing schemes of MFs may invest in foreign securities, consistent with the investment objectives of the schemes and where the offer documents provide for such investments and disclose attendant risk factors. Any additional disclosures as specified above shall be informed to unit holders by way of addendum.

iv. The AMCs shall send periodical reports to the trustees which would include the performance of investments made in foreign securities in various countries, amount invested in various schemes and any breach of the exposure limit laid down in the scheme offer document. After reviewing the performance, the Board of AMCs and trustees would compare the yield with that of investment opportunities available in domestic markets.

Valuation of Unlisted Equity Shares: With a view to bring uniformity in calculation of NAVs of MFs schemes, SEBI issued guidelines in May 2002 for valuation of unlisted equity shares in consultation with AMFI. Unlisted equity shares of a company shall be valued "in good faith" on the basis of the following valuation principles:

(a) Based on the latest available audited balance sheet, net worth shall be calculated as lower of (i) and (ii) below:

(i) Net worth per share = [share capital plus free reserves (excluding revaluation reserves) minus Miscellaneous expenditure not written off or deferred revenue expenditure, intangible assets and accumulated losses] divided by Number of Paid up Shares.

(ii) Net worth per share = [share capital plus consideration on exercise of Option/ Warrants received/receivable by the Company plus free reserves(excluding revaluation reserves) minus Miscellaneous expenditure not written off or deferred revenue expenditure, intangible assets and accumulated losses] divided by {Number of paid up shares plus number of shares that would be obtained on conversion/exercise of Outstanding Warrants and Options}

(b) Average capitalisation rate (P/E ratio) for the industry, either based on NSE or BSE data, would be taken and discounted by 75% i.e. only 25% of the industry average P/E would be taken as capitalisation rate. Earnings per share of the latest audited annual accounts would be considered for this purpose.

(c) The value as per the net worth value per share and the capital earning value calculated as above shall be averaged and further discounted by 15% for illiquidity so as to arrive at the fair value per share.

In case where the latest balance sheet of the company is not available within nine months from the close of the year, the shares of such companies would be valued at zero. If the net worth of the company is zero, the share would be marked down to zero. In case the EPS is negative, the EPS value for that year would be taken as zero for arriving at capitalized earning. In case an individual security accounts for more than 5% of the total assets of the scheme, an independent valuer would be appointed for the valuation of the said security. At the discretion of the AMC and with the approval of the trustees, an unlisted equity share may be valued at a price lower than the value derived using the aforesaid methodology.

The MFs would not make investment in unlisted equity shares at a price higher than the price obtained by using the aforesaid methodology.

Code of Conduct for Intermediaries: SEBI advised in June 2002 that all distributors and agents of MF units shall follow the code of conduct prescribed by AMFI for MF intermediaries. If any intermediary does not comply with the code of conduct, the MF shall report it to AMFI and SEBI. No MF shall deal with those intermediaries who do not follow code of conduct. Under the code of conduct, the intermediaries are required to:

i. Take necessary steps to ensure that the interests of the clients are protected.

ii. Adhere to the SEBI (MFs) Regulations and guidelines related to selling, distribution and advertising practices.

iii. Provide full and latest information of schemes to investors in the form of offer documents, performance reports, fact sheets, portfolio disclosures and brochures and recommend schemes appropriate for the clients situation and needs.

iv. Highlight risk factors of each scheme, avoid misinterpretation and exaggeration and urge investors to go through offer documents/key information memorandum before deciding to make investments and also disclose all material information related to schemes/plans.

v. Abstain from indicating or assuring returns in any type of scheme, unless the offer document is explicit in this regard.

vi. Maintain necessary infrastructure to support the AMCs in maintaining high service standards to investors and ensure that critical operations such as forwarding forms and cheques to AMCs/registrars and despatch of statement of account and redemption cheques to investors are done within the time frame prescribed in the offer document and SEBI (MF) Regulations.

vii. Avoid colluding with clients in faulty business practices such as bouncing cheques, wrong claiming of dividend/redemption cheques, etc.

viii. Avoid any commission driven malpractices.

ix. Avoid making negative statements about any AMC or scheme and ensure that comparisons if any, are made with similar/comparable products.

x. Ensure investor related statutory communications are sent to investors reliably and on time.

xi. Maintain confidentiality of all investor deals and transactions.

xii. Not rebate commission back to investors and avoid attracting clients through temptation of rebate/gifts etc.

xiii. Obtain AMFI certification.

Demat Transactions: SEBI advised in June 2002 that all MFs should enter into transactions relating to government securities only in dematerialised form.

Market Design

MFs operates as CIV that pools resources by issuing units to investors and collectively invests those resources in a diversified portfolio comprising of stocks, bonds or money market instruments in accordance with objectives disclosed in the offer document issued for the purpose of pooling resources. The profits or losses are shared by investors in proportion to their investments. The process gathered momentum in view of regulatory protection, fiscal concession and change in preference of investors. The MF industry in India is governed by SEBI (MF) Regulations, 1996, which lay the norms for the MF and its AMC. All MFs in India are constituted as trusts. A MF is allowed to issue open-ended and closed-ended schemes under a common legal structure. There were a total of 37 MFs as on March 31, 2002. This includes UTI, which is set up under the UTI Act and is not required to be registered with SEBI. There is however, an arrangement of voluntary compliance by UTI for the schemes launched after July 1994. UTI has made a voluntary compliance with MF regulation in respect of many schemes. Only 5 schemes including the largest scheme US-64 do not come under the purview of SEBI.

Structure of MFs

A typical MF in India has the following constituents:

Fund Sponsor: A 'sponsor' is any person who, acting alone or in combination with another body corporate, establishes a MF. It obtains the certificate of registration as a MF from SEBI. The sponsor of a fund is similar to the promoter of a company. In accordance with SEBI Regulations, the sponsor forms a trust and appoints a Board of Trustees, and also generally appoints an AMC as fund manager. In addition, the sponsor also appoints a custodian to hold the fund assets. The sponsor contributes at least 40% of the net

worth of the AMC. It must have a sound financial track record over five years prior to registration and general reputation of fairness and integrity in all its business transactions.

Mutual Fund: A MF is constituted in the form of a trust under the Indian Trusts Act, 1882. The instrument of trust is executed by the sponsor in favour of trustees and is registered under the Indian Registration Act, 1908. The fund invites investors to contribute their money in the common pool, by subscribing to 'units' issued by various schemes established by the trust. The assets of the trust are held by the trustee for the benefit of unit holders, who are the beneficiaries of the trust. Under the Indian Trusts Act, the trust or the fund has no independent legal capacity, it is the trustee(s) who have the legal capacity.

Trustees: The MF or trust can either be managed by the Board of Trustees, which is a body of individuals, or by a Trust Company, which is a corporate body. Most of the funds in India are managed by a Board of Trustees. The trustees are appointed with the approval of SEBI. Two thirds of trustees are independent persons and are not associated with sponsors. The trustees being the primary guardians of the unit holders' funds and assets, a trustee has to be a person of high repute and integrity. The Trustees, however, do not directly manage the portfolio of securities. The portfolio is managed by the AMC as per the defined objectives, in accordance with trust deed and SEBI (MF) Regulations.

Asset Management Company: The AMC, which is appointed by the sponsor or the Trustees and approved by SEBI, acts like the investment manager of the Trust. It functions under the supervision of its Board of Directors, and also under the direction of the Trustees and SEBI. AMC, in the name of the Trust, floats and manages the different investment 'schemes' as per the SEBI Regulations and as per the Investment Management Agreement signed with the Trustees.

Apart from these, the MF has some other fund constituents, such as custodians and depositories, banks, transfer agents and distributors. The custodian is appointed for a safe keeping of securities and participating in the clearing system through approved depository. The bankers handle the financial dealings of the fund. Transfer agents are responsible for issue and redemption of units of MF. AMCs appoint distributors or brokers who sell units on behalf of the Fund, and also serve as investment advisers. Besides brokers, independent individuals are also appointed as 'agents' for the purpose of selling fund schemes to investors. The regulations require arm's length relationship between the fund sponsors, trustees, custodians and AMC. The agents and distributors are required to pass AMFI certification programme.

Types of Funds

There are many types of MFs/schemes of funds available to investors. Broadly, they can be classified as open-ended fund or closed-ended funds. An open-ended fund gives the investors an option to redeem and buy units at any time from the fund. They can conveniently buy and sell units at NAV related prices which are declared on a daily basis. In closed-ended funds, the investors have to wait a given maturity before they can redeem their units to the fund. However, to provide liquidity, it is mandatory for closed-ended funds to get themselves listed on a stock exchange within six months from the closure of the subscription. Funds can also be classified as being tax-exempt or non-tax-exempt, depending on whether they invest in securities that give tax-exempt returns or not. Some schemes assure a specific return to the unit holders irrespective of performance of the scheme. These are called assured return schemes. A scheme cannot promise returns unless such returns are fully guaranteed by the sponsor or AMC.

Several types of MFs can also be distinguished on the basis of the nature of their portfolios, i.e. whether they invest in equities or fixed income securities or some combination of both. Broadly, there are money market funds, gilt funds, debt on income funds, equity funds, hybrid funds, commodity or gold funds, and real estate funds. Every type of fund has a unique risk profile that is determined by its portfolio. Such schemes may be open-ended or close-ended schemes.

Growth/Equity Oriented Schemes provide capital appreciation over the medium to long-term. These schemes normally invest a major part of their corpus in equities and are good for investors having a long-term outlook seeking appreciation over a period of time. Income/Debt Oriented Schemes provide regular and steady income to investors. Such schemes generally invest in fixed income securities such as bonds, corporate debentures, government securities and money market instruments. Such funds are less risky compared to equity schemes. Balanced Funds provide both growth and regular income as such schemes invest both in equities and fixed income securities in the proportion indicated in their offer documents. These are appropriate for investors looking for moderate growth. Money Market or Liquid Funds provide easy liquidity, preservation of capital and moderate income. These schemes invest exclusively in safer short-term instruments such as treasury bills, certificates of deposit, commercial paper and inter-bank call money, government securities, etc. These funds are appropriate for corporate and individual investors as a means to park their surplus funds for short periods. Gilt Funds invest exclusively in government securities which have no default risk. Index Funds replicate the portfolio of a particular index such as the S&P CNX Nifty and invest in the securities in the same weightage comprising of an index. There are also exchange traded index funds which are traded on the stock exchanges. There are the funds/schemes which invest in the securities of only those sectors or industries as specified in the offer documents. e.g. Pharmaceuticals, Software, Fast Moving Consumer Goods (FMCG), Petroleum stocks, etc. The examples are UTI Software Fund, Pioneer ITI Internet Opportunities Fund, etc. The returns in these funds are dependent on the performance of the respective sectors/industries.

Regulation of Funds

The prime authority for regulating MFs in India is SEBI. SEBI requires all MFs to be registered with it. The SEBI (MF) Regulations, 1996 lay down detailed procedure for launching of schemes, disclosures in the offer document, advertisement material, listing and repurchase of closed-ended schemes, offer period, transfer of units, investments, etc. SEBI Regulations also specify the qualifications for being the sponsor of a fund; the contents of Trust Deed; rights and obligations of Trustees; appointment, eligibility criteria, and restrictions on business activities and obligations of the AMC and its Directors. The AMCs, members of Board of trustees or directors of Trustee Company and other associated company have to follow certain code of conduct. They should ensure that the information disseminated to the unit holders is adequate, accurate and explicit. They should also avoid conflicts of interest in managing the affairs of the schemes and keep the interest of all unit holders paramount in all matters.

In addition to SEBI, RBI also supervises the operations of bank-owned MFs. While SEBI regulates all market related and investor related activities of the bank/FI-owned funds, any issues concerning the ownership of the AMCs by banks fall under the regulatory ambit of the RBI.

Further, MFs, AMCs and corporate trustees are companies registered under the Companies Act, 1956 and therefore answerable to regulatory authorities empowered by

the Companies Act. The Registrar of Companies ensures that the AMC, or the Trustee Company complies with the provisions of the Companies Act.

Many closed-ended schemes of the MFs are listed on one or more stock exchanges. Such schemes are subject to regulation by the concerned stock exchange(s) through a listing agreement between the fund and the stock exchange.

MFs, being Public Trusts are governed by the Indian Trust Act, 1882. The Board of Trustees or the Trustee Company is accountable to the office of the Public Trustee, which in turn reports to the Charity Commissioner. These regulators enforce provisions of the Indian Trusts Act.

Unit Trust of India – Special Status

UTI was set up by a special statute called the UTI Act, 1963. Till recently, all of UTI's schemes and its overall functioning were completely governed by the UTI Act. However, schemes launched after July 1994 fall under SEBI purview. Among the major schemes of UTI, only US-64 remains outside the purview of SEBI. The salient features of UTI Act are:

- The management of the Trust is under a Board of Trustees which has nominees of RBI, IDBI, LIC and SBI. The Chairman is appointed by the Central Government in consultation with IDBI.
- Unlike other MFs, UTI can, besides investing in various securities, grant loans against security, enter into bills discounting activities, launch savings cum insurance schemes, acquire immovable property, provide leasing/hire purchase finance and merchant banking services, provide portfolio management services to non-residents and deal in foreign exchange to the extent required for the discharge of its functions.
- In case of default by any entity in terms of its obligations towards the Trust, the Trust can initiate legal proceedings for sale of security, taking over the management of the defaulting entity or an injunction on movement of property owned by the entity.
- Unlike other funds, UTI may borrow, in India or abroad, from any person, on terms, which are agreed upon.
- For any scheme, its capital comprises unit capital, reserves created, borrowing, gifts and donations and any other capital allocated to the scheme by the Board of Trustees. The first unit scheme also has the initial capital contributed by its sponsors.
- In any year, surplus of income over expenses allocated to initial capital may be distributed among contributing institutions. At least 90% of surplus of income over expenses allocated to unit capital for the first unit scheme must be distributed, unless a dividend of at least 10% on unit capital is declared by the Trust. For other schemes, surplus allocated to the respective unit capital may be distributed at the Board's discretion or reinvested in accordance with the provisions of the scheme.

Investment Restrictions

Investment policies of each scheme are dictated by the investment objective of the scheme as stated in the offer document. However, the AMC and its fund managers have to comply

with the restrictions imposed by SEBI. Investments shall be made only in transferable securities in the money market or in the capital market or in privately placed debentures or securitised debts. Moneys collected under money market schemes shall be invested only in money market instruments. Investment by a MF shall be subject to following restrictions:

i. No MF under all its schemes should own more than 10% of any company's paid up capital carrying voting rights.

ii. Investments in the equity shares or equity-related instruments of a single company are restricted to 10% of the NAV of a scheme. This limit is not applicable in case of index funds and in case of sector/industry specific schemes subject to adequate disclosures in the offer document. Investments by index funds are in accordance with the weightage of the securities in the specific index as disclosed in the offer document. In case of sector/industry specific schemes, the upper ceiling on investments may be in accordance with the weightage of the securities in the representative sectoral index/sub-index as disclosed in the offer document or 10% of the NAV of the scheme whichever is higher. The basic objective of these is to ensure that a fund has an adequately diversified portfolio, unless the specific objective of the scheme is to limit the investments.

iii. Similarly, for debt schemes, SEBI restricts the investment in 'rated investment grade' debt instruments issued by a single issuer to 15% of NAV of the scheme. This limit may be extended to 20% of the NAV of the scheme with the prior approval of the Board of AMC and the Board of Trustees. Investments within this limit can be made in mortgage backed securitised debt which are not below investment grade. In case of unrated as well as rated but 'below investment grade' debt instruments, the investment in the instruments of a single issuer is not allowed to exceed 10% of the NAV of the scheme. In case of such debt instruments of all the issuers in a scheme shall not exceed 25% of NAV subject to approval of Boards of AMC and Trustee Company. In the interest of investor protection, SEBI has restricted the total level of investment in such more risky securities. These restrictions do not apply to money market and government securities, as they carry inherently less risk.

iv. SEBI restricts the investment in unlisted shares to a maximum of 10% of the NAV of a scheme for closed-ended schemes. In case of open-ended schemes the limit is more stringent at 5% of the NAV of the scheme as there is continuous repurchase by investors in such a scheme.

v. A MF is prohibited from investing in any unlisted security or a security issued through private placement by an associate or group company of the sponsor. In the case of listed securities of group companies of the sponsor, it is not allowed to invest an amount in excess of 25% of the net assets of any of its schemes of the fund.

vi. SEBI permits MFs to invest abroad in ADRs/GDRs, within an overall limit of US$500 million for all funds put together. There is a sub-ceiling for individual MFs, which should not exceed 4% of the net assets managed by them as on the date of the last audited balance sheet, subject to a maximum of US$50 million for each MF.

vii. The MFs can invest in foreign debt securities in the countries with fully convertible currencies, short term as well as long term debt instruments with highest rating by

accredited/registered credit rating agencies. They may also invest in government securities where the countries are AAA rated. They may also invest in units/ securities issued by overseas MFs/unit trusts which invest in aforesaid securities. Each MF can invest up to 4% of its net assets as on Feb 28, 2002 subject to the maximum of US$ 50 mn.

viii. MFs are required to buy and sell securities only "for delivery" 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. Trading in derivatives by MFs has been restricted to hedging and portfolio balancing purposes and not for speculative trading purposes.

The MF having an aggregate of securities which are worth Rs. 10 crore or more shall settle their transactions only through dematerialised securities. All MFs shall enter into transactions in government securities only in demat form. The MF shall not borrow except to meet temporary liquidity needs for repurchase/ redemption of units or payment of interest/dividend to unit holders. It shall not advance any loans for any purpose. It may lend securities in accordance with SEBI's stock lending scheme. The funds of a scheme shall not be used in option trading or in short selling or carry forward transactions.

Disclosure of Performance

A MF is required to compute net asset value (NAV) of each scheme by dividing net assets of the scheme by the number of units outstanding on the valuation date. The performance of a scheme is reflected in its NAV which is disclosed on daily basis in case of open-ended schemes and on weekly basis in case of close-ended schemes. The NAVs of MFs are required to be published in newspapers. The NAVs are also available on the web sites of MFs. All MFs are also required to put their NAVs everyday on the web site of AMFI, so that the investors can access NAVs of all MFs at one place.

The price at which units may be sold or repurchased by a MF is made available to investors. The repurchase price can not be lower than 93% of the NAV and sale price can not be higher than 107% of NAV. The repurchase price of a closed ended scheme shall, however, not be less than 95% of NAV. The difference between repurchase and sale price shall not exceed 7% of the sale price.

The MFs are required to publish their performance in the form of half-yearly results which also include their returns/yields over a period of time i.e. last six months, 1 year, 3 years, 5 years and since inception of schemes. The MFs are required to send annual report or abridged annual report to the unit holders at the end of the year.

All MFs are required to disclose the performance of the benchmark indices in case of equity oriented schemes, debt oriented scheme and balanced fund scheme while disclosing the yields of the schemes in the format of half-yearly results. The MFs may select any of the indices available, e.g. BSE (Sensitive) index, S&P CNX Nifty, BSE 100, BSE 200 or S&P CNX 500, depending on the investment objective and portfolio of the scheme for equity schemes. In case of debt/balanced schemes, the benchmarks have been developed by research and rating agencies recommended by AMFI.

Code of Conduct

The MF regulations regulate and conduct MFs and AMCs, their employees and intermediaries in the following manner:

i. Trustees and AMCs must maintain high standards of integrity and fairness in all their dealings and in the conduct of their business. They must keep the interest of all unit holders paramount in all matters.

ii. The sponsor of the MF, the trustees or the AMC or any of their employees shall not render, directly or indirectly any investment advice about any security in the publicly accessible media, whether real-time or non real-time, unless a disclosure of his interest including long or short position in the said security has been made, while rendering such advice.

iii. Each director of the AMC would file details of his transactions of dealing in securities with the trustees on a quarterly basis.

iv. The AMC shall file with the trustees the details of transactions in securities by its key personnel. Also, the trustees shall furnish to SEBI a certificate stating that they have satisfied themselves that there have been no instances of self dealing or front running by any of the trustees, directors and key personnel of the asset management company.

v. The employees of AMCs and trust companies shall follow the procedure and code of conduct laid down by SEBI for investments/trading in securities. Specified categories of employees are required to obtain prior approval before making personal transactions.

vi. The intermediaries are required to take necessary steps to protect the interests of the clients, provide full and latest information of schemes to investors, highlight risk factors of each scheme, avoid misinterpretation and exaggeration, avoid any commission driven malpractices, not rebate commission back to investors, and obtain AMFI certification.

Mutual Fund Service System

While a good number of closed-ended schemes are traded on the Exchanges, the facilities for transacting in open-ended schemes of the MFs are very limited. The transactions in units of open-ended scheme take place directly between the individual investor and the AMC. To fulfill the need for a common platform for sale and repurchase of units of schemes managed by different Funds, NSE/NSCCL provide a facility called Mutual Fund Service System (MFSS), which enables investors to transact in the dematerialized units of open-ended schemes of MFs. NSE with its extensive network covering around 400 cities and towns across the country offers a mechanism for electronic on-line collection of orders from the market and NSCCL acts as a central agency for the clearing and settlement of all the orders.

The salient features of the system are:

- Orders for purchase and sale (redemption) of units from investors are collected using the on-line order collection system of NSE.
- Orders are settled using the Clearing and Settlement system of NSCCL.
- Orders are settled on order-to-order basis.
- Settlement on rolling basis with orders entered on T day are settled on T+3 (working days).
- Settlement to the extent of securities/funds pay-in are made by the Participants.

- Securities are settled in dematerialised mode only.
- Transactions are not covered by settlement guarantee.

MF Distribution through Post Offices

On January 22, 2001, India Post in partnership with IDBI-Principal, launched a scheme for distribution of MF products through select post offices. A pilot project was initialised with distribution of MF products only in four cities of Mumbai, Delhi, Patna and Kolkata. From June 15, 2001, the scheme was extended to cover post offices in all major cities across the country. Prudential ICICI and SBI Mutual Funds also tied up with the post offices for distribution of their respective schemes. The MF supplies application forms for their schemes to the post office for sale over the counter and any customer who wishes to invest in MF can take a form from the counter, fill it in and hand it back to the officials in the post office which in turn are handed over to the MF office. This system of distribution is now operational with regards to four products *viz.* income, index, balanced and tax savings fund available at over 500 post offices from more than 50 cities all over India.

Mutual Fund Ranking

In order to judge the performance of MF schemes in an objective manner and offer investors an easy way to identify funds that have performed better in relation to their peers, a number of entities are evaluating and ranking their performance. The most popular of them are rankings/evaluations by CRISIL, Value Research India and Credence Analytics. The Composite Performance Rankings of CRISIL covers all open ended schemes which have disclosed their net asset value for at least two years and make a 100% disclosure of their portfolio composition. It ranks the schemes of MFs as compared with their respective peer group in each scheme category (currently five categories namely Equity Schemes, Debt Schemes, Gilt Schemes, Balanced Schemes and Liquid Schemes). Top 10% in the category is considered very good, next 20% good, next 40% average, next 20% below average and last 10% poorest. It is based on four criteria namely, risk adjusted return of the scheme's NAV, diversification of its portfolio, its liquidity and asset size. The weights given to these criteria vary from category to category. The Fund Rating of Value Research is a composite measure of risk and return and gives a quick summary of how a fund has performed historically relative to its peers. Each scheme is assigned a risk grade and a return grade and fund rating is determined by subtracting risk grade from its return grade. Top 10% in the category is considered five star, next 22.5% four star, next 35% three star, next 22.5% two star and last 10% one star performance. The details of the rankings given to various schemes are available on www.crisil.com and www.valueresearchindia.com.

Market Outcome

Resource Mobilisation

The MF vehicle is quite popular with investors who are wary of directly investing in the securities market. The popularity of the MFs as an investment avenue is clearly visible from the data presented in Table 3-1. In India, investment in MFs is considered to be as safe as bank deposits. This is due to assured return schemes offered by some MFs in the past and because of the fact that the MFs in India have been primarily sponsored by government, banks and FIs. Thus, the schemes of MFs of the commercial banks and the insurance companies, which entered the market in 1987, were well received. The boom

continued into the nineties with liberalisation evoking positive response from the investors.

The resource mobilisations by MFs remained steady during the period 1992-95 with annual gross mobilisation averaging Rs. 11,000 crore per annum during the period. The

Table 3-1: Resource Mobilisation by Mutual Funds

(Rs. crore)

Year	Public SectorMFs			Private	Grand
	Bank sponsored	FI sponsored	UTI	Sector MFs	Total
1990-91	2,352	604	4,553	-	7,509
1991-92	2,140	427	8,685	-	11,252
1992-93	1,204	760	11,057	-	13,021
1993-94	148	239	9,297	1,560	11,244
1994-95	765	576	8,611	1,322	11,274
1995-96	113	235	-6,314	133	-5,833
1996-97	6	137	-3,043	864	-2,036
1997-98	237	203	2,875	749	4,064
1998-99	231	691	170	2,519	3,611
1999-00	156	357	4,548	14,892	19,953
2000-01	—1,520—		322	9,292	11,135
2001-02	—1,330—		-7,284	13,977	8,024

Source: RBI.

MFs were, however, hit severely by the bearish sentiments in the secondary market since October 1994. The years 1995-96 and 1996-97 witnessed net outflows of funds from MFs. The MF industry managed to mobilise modest sums during the next two financial years. It was in 1999-00 that the MF industry witnessed a sharp turnaround with record resource mobilisation amounting to Rs.19,953 crore. Tax sops announced in the Union Budget 1999-00 and emergence of bullish trends in the secondary market fuelled the recovery. The year 2000-01 witnessed a slowdown once again with net resource mobilisation by all MFs taken together aggregating Rs. 11,135 crore, which could be attributed to a slump in secondary market and increase in tax on income distributed by debt-oriented MFs. During 2001-02, the US-64 debacle caused a net outflow of Rs. 7,284 crore from UTI and as a result the MFs together could raise a net amount of only Rs. 8,024 crore.

The data on resource mobilisation by MFs are compiled by a number of agencies including RBI, SEBI and AMFI. The following analysis is based on AMFI data.

During 2001-02, though the number of MFs declined from 39 to 37, 90 new schemes, 74 open-ended and 16 closed-ended were launched as against 41 new schemes launched during the preceding year. This took the total number of schemes as at end-March 2002 to 417 from 393 at end-March 2001. These schemes together mobilised Rs. 164,523 crore during 2001-02 as against Rs. 92,957 crore during the preceding year. After adjustment of repurchases and redemptions, there was an inflow of funds of Rs. 9,128 crore and Rs. 7,175 crore during 2000-01 and 2001-02, respectively (Table 3-2). While the gross mobilisation was up by 77% during 2001-02, the net mobilisation was down by 27% due to 88% rise in redemptions. The resources mobilised by MFs have shown a strong correlation with the movements in secondary market.

Public sector MFs (including UTI) made gross mobilisation of Rs.18,256 crore accounting for about 11% of total resource mobilisation by MFs during 2001-02. The share of public

Table 3-2: Accretion of Funds with Mutual Funds

(Rs. crore)

Category	2000-01			2001-02			Assets under Management at end	
	Sale	Purchase	Net	Sale	Purchase	Net	March 01	March 02
A. Public Sector (I+II+III)	**18,605**	**19,362**	**-757**	**18,256**	**23,806**	**-5,550**	**64,857**	**59,638**
i Unit Trust of India	12,413	12,090	323	4,643	11,927	-7,284	58,017	51,434
ii Bank Sponsored	2,181	4,125	-1,944	4,242	3,329	913	3,333	3,970
iii Institution Sponsored	4,011	3,147	864	9,371	8,550	821	3,507	4,234
B. Private Sector (I+II+III)	**74,352**	**64,467**	**9,885**	**146,267**	**133,542**	**12,725**	**25,730**	**40,956**
i Indian	19,901	17,576	2,325	33,634	31,181	2,453	3,370	5,177
ii Joint Ventures - Predominately Indian	20,796	18,353	2,443	48,396	43,239	5,157	8,620	15,502
iii Joint Ventures - Predominately Foreign	33,655	28,538	5,117	64,237	59,122	5,115	13,740	20,277
Grand Total (A+B)	**92,957**	**83,829**	**9,128**	**164,523**	**157,348**	**7,175**	**90,587**	**100,594**

Source: AMFI Updates.

sector MFs in total resource mobilisation was 20% in 2000-01 and 30% in 1999-00. UTI, the largest MF, raised less than 3% of total resources mobilised during 2001-02. The share of UTI in the amount raised has declined considerably in the recent past. In net terms, the public sector MFs suffered a net outflow of Rs. 757 crore during 2000-01 and Rs. 5,550 crore during 2001-02. The private sector MFs surged ahead in terms of resource mobilisation. They raised about 80% and 89% of gross resources mobilised by MF industry during 2000-01 and 2001-02 respectively. While private sector MFs, institution and bank sponsored MFs experienced positive inflows, UTI suffered net outflows of Rs. 7,284 crore during 2001-02.

The share of open-ended schemes in total funds raised by MFs increased from 97.7% in 2000-01 to 98.8% in 2001-02. During the same period, the share of assured return schemes in total funds raised rose from 0.6% to 0.84%. No new assured return scheme was launched during 2001-02. The share of closed-ended schemes, on the other hand, decreased from 1.5% during 2000-01 to 0.4% during 2001-02. The open-ended schemes and assured return schemes registered net inflow of Rs. 8,775 crore and Rs. 1,016 crore, respectively, during 2001-02, while the closed-ended schemes registered outflows to the tune of Rs. 2,616 crore during the same period. Details of funds mobilised and repurchase/ redemption by MFs under different schemes are presented in Table 3-3A.

The liquid/money market schemes emerged as the first preference of investors. These schemes accounted two-third of total resources mobilized during 2001-02. The sale as well as repurchase was very high in case of these schemes, resulting in a net inflow of

Table 3-3A: Scheme-wise Resource Mobilisation by Mutual Funds

(Rs. crore)

Scheme	2000-01			2001-02		
	Sale	Purchase	Net	Sale	Purchase	Net
Open-ended	90,905	77,367	13,538	162,500	153,725	8,775
Close-ended	1438	4,800	-3,362	635	3,251	-2,616
Assured Return	614	1662	-1,048	1388	372	1,016
Total	**92,957**	**83,829**	**9,128**	**164,523**	**157,348**	**7,175**

Source : AMFI Updates.

Table 3-3B: Scheme-wise Resource Mobilisation by Mutual Funds

(Rs. crore)

Scheme	2000-01			2001-02		
	Sale	Purchase	Net	Sale	Purchase	Net
Income	26,674	21,835	4,839	51,021	42,812	8,209
Growth	17,996	18,299	-303	1,983	2,243	-260
Balanced	7,701	4,919	2,782	477	5,831	-5,354
Liquid/ Money Market	36,212	33,648	2,564	104,570	101,272	3,298
Gilt	4,160	4,472	-312	6,439	4,875	1,564
ELSS	214	656	-442	33	315	-282
Total	**92,957**	**83,829**	**9,128**	**164,523**	**157,348**	**7,175**

Source: AMFI.

Rs. 3,298 crore during the year. The balance schemes were the worst performer in terms of mobilization. These schemes had a net inflow of Rs. 2,782 crore in 2000-01, while they suffered a net outflow of Rs. 5,354 crore during 2001-02. Income schemes raised about 31% of resources mobilising Rs. 51,021 crore during 2001-02. The ELSS schemes raised a gross amount of only Rs. 33 and suffered a net outflow of Rs. 282 crore. Scheme-wise details of inflows/outflows are presented in Table 3-3 B.

Assets under Management

During 2001-02, the assets under management of all MFs taken together increased by 11%, from Rs. 90,587 crore as at end-March 2001 to Rs. 100,594 crore as at end-March 2002 (Table 3-2). The share of private sector MFs in total assets under management increased from 28.4% as at end-March 2001 to 41% as at end-March 2002 (Chart 3-1). UTI continues to be market leader with 51.1% share in assets under management as at end-March 2002. During 2001-02, the assets under management of public sector MFs declined by Rs. 5,219 crore, while that of private sector MFs increased by Rs. 15,226 crore.

The open-ended schemes accounted for 71.5% of total assets under management of MFs as at end-March 2002 (Table 3-4). The closed-ended and assured return schemes accounted for about 10.9% and 17.6%, respectively, of assets under management as at end-March 2002.

The income schemes accounted for 55.6% of total assets under management of MFs as at end-March 2002, followed by balanced schemes with 16.9%. The growth schemes accounted for 13.8% of assets under management of MFs as at end-March 2002.

Table 3-4: Assets under Management as at end March, 2002

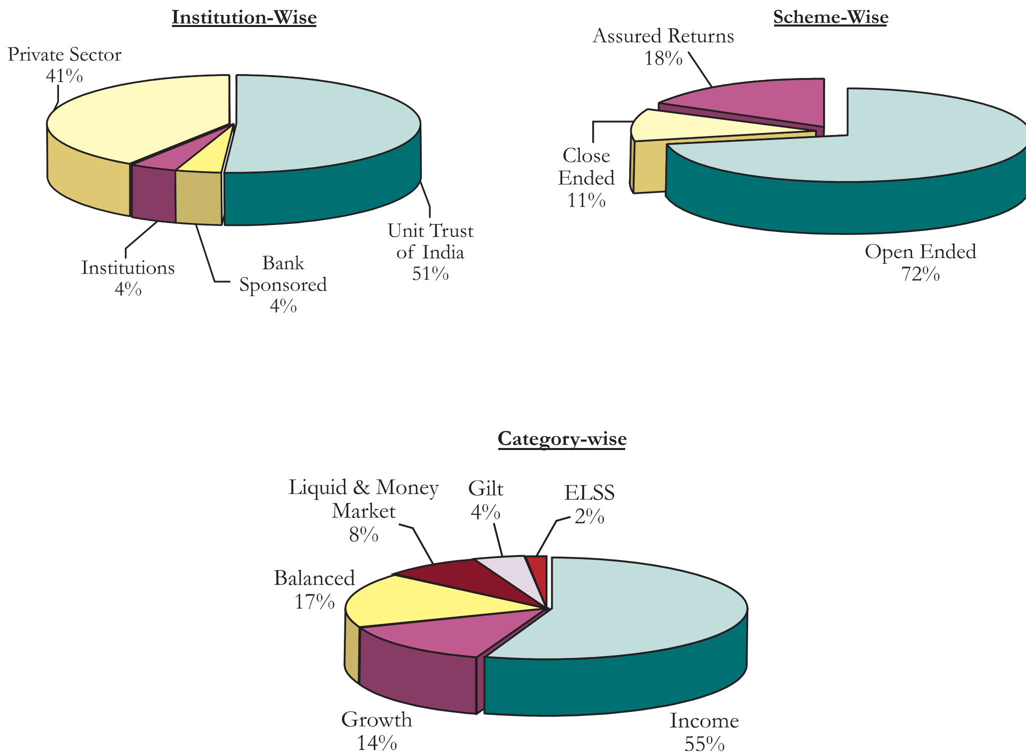
(Rs. crore)

Scheme	Open Ended	Close Ended	Assured Returns	Total
Income	33,587	4,522	17,679	55,788
Growth	8,981	4,871	—	13,852
Balanced	16,720	234	—	16,954
Liquid/Money Market	8,069	—	—	8,069
Gilt	4,163	—	—	4,163
ELSS	418	1,350	—	1,768
Total	**71,938**	**10,977**	**17,679**	**100,594**

Source: AMFI Updates.

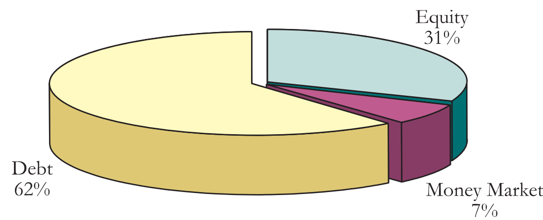
The shares of different types of institutions, and categories of schemes in assets under management are presented in Chart 3-1.

Chart 3-1: Assets under Management at the end of March 2002



The investment of assets of MFs showed a marked shift towards debt and government securities which constituted about 62% of the total assets. The share of equity reduced from 41% in 2000-01 to 31% in 2001-02. Investment distribution of total assets under management of MFs is presented in Chart 3-2.

Chart 3-2: Investment of Assets as at end-March 2002



Assured Return Schemes

Some of the schemes, which had assured returns, faced difficulties in meeting the assurance. In order to protect the interest of investors in such cases, SEBI directed sponsors/AMCs of MFs to honour their commitment of assured returns. In pursuance to such directions, the sponsors/AMCs of seven MFs, excluding UTI, contributed a total amount of Rs. 2,430 crore to meet the shortfall in case of 26 schemes by the end of March 2002. These seven MFs are BOI MF, Canbank MF, GIC MF, PNB MF, Indian Bank MF, SBI MF and LIC MF. SEBI (MF) regulations now provide that no return can be assured in a scheme unless such returns are fully guaranteed by the sponsor of AMC and the same is disclosed in the offer document.

Index Funds

An Index Fund is a MF that tries to mirror a market index, like Nifty or Sensex, as closely as possible by investing in all the stocks that comprise that index in proportions equal to the weightage of those stocks in the index. Thus, index funds are designed to replicate the performance of a well-established stock market index or a particular segment of the stock market. Unlike a typical MF, these are passively managed funds wherein the fund manager invests the funds in the stocks comprising the index in similar ratios. They may at times hold their stocks for the full year even if there are changes in the composition of index. This helps in reducing transaction fees. While reducing the risk associated with the market, index funds offer many benefits to the investors. Firstly, the investor is indirectly able to invest in a portfolio of a blue chip stock that constitutes the index. Next, they offer diversification across a multiplicity of sectors as at least 20-25 sectors find their way into the index. Added to these is the relatively low cost of management. Index funds are considered appropriate for conservative long term investors looking at moderate risk, moderate return arising out of a well-diversified portfolio.

A few index funds were launched in the recent past to reduce the bias of fund managers in stock selection and to provide a return at par with the index. They are UTI Master Index Fund, UTI Index Equity Fund, Franklin India Index Fund and IDBI Principal Index Fund, etc. Templeton launched the 'Franklin India Index Tax Fund' in February 2001 which is the first tax saving index fund based on S&P CNX Nifty. There are a total of ten funds based on S&P Nifty namely, Franklin India Index Fund, Franklin India Tax Index Fund, IDBI Principal Index Fund, UTI Nifty Fund, India Access Fund, Pioneer ITI Index Fund Nifty Plan, Magnum Index Fund, IL & FS Index Fund Nifty Plan, Prudential ICICI Index Fund Nifty Plan and HDFC Index Fund Nifty Plan.

The performance of index funds is generally similar to that of their benchmark indices. For example Franklin India Index Fund generated a return of 22.52% over the last six months, which is marginally less than the returns generated by Nifty i.e. 23.60%. Similarly the other index funds based on S&P CNX Nifty also generated returns over the 3 month and 6 month periods comparable to that of S&P CNX Nifty. A comparative table indicating returns of the index funds and their benchmark indices is presented in Table 3-5.

Exchange Traded Funds

Exchange Traded Funds (ETFs) are innovative products, which first came into existence in the USA in 1993. These have gained prominence over the last few years with over $100 billion (as on December 2001) invested in about 200 ETFs in over 30 indices globally.

About 60% of trading volumes on the American Stock Exchange are from ETFs. Among the popular ones are SPDRs (Spiders) based on the S&P 500 Index, QQQs (Cubes) based on the Nasdaq-100 Index, iSHARES based on MSCI Indices and TRAHK (Tracks) based on the Hang Seng Index.

Table 3-5: Performance of Index Funds

Index Funds	Launch Date	Returns*			Base Index
		3 months	6 months	12 months	
IDBI Principal Index Fund	July 26, 1999	8.70	26.10	-5.84	S&P CNX Nifty
Franklin India Index Tax Fund	February 26, 2001	8.49	22.05	-5.75	S&P CNX Nifty
Franklin India Index Fund	August 4, 2001	8.51	22.52	-5.63	S&P CNX Nifty
UTI Nifty Fund	March 27, 2000	9.53	23.99	-5.51	S&P CNX Nifty
Pioneer ITI Index Fund	August 27, 2001	9.82	25.91	-	S&P CNX Nifty
UTI Master Index	June 29, 1998	8.53	23.29	-7.02	BSE Sensex
S&P CNX Nifty	November 3, 1995	6.66	23.60	-1.62	—
BSE Sensex	January 2, 1986	6.35	23.39	-3.75	—

* Returns are calculated as on March 28, 2002.

Source: IISL.

ETFs provide exposure to an index or a basket of securities that trade on the exchange like a single stock. They have a number of advantages over traditional open-ended index funds as they can be bought and sold on the exchange at prices that are usually close to the actual intra-day NAV of the scheme. They are an innovation to traditional MFs as they provide investors a fund that closely tracks the performance of an index with the ability to buy/sell on an intra-day basis. Unlike listed closed-ended funds, which trade at substantial premia or more frequently at discounts to NAV, ETFs are structured in a manner which allows to create new units and redeem outstanding units directly with the fund, thereby ensuring that ETFs trade close to their actual NAVs.

Like any other index fund, ETFs are usually passively managed funds wherein subscription/redemption of units works on the concept of exchange with underlying securities. Units can also be bought and sold directly on the exchange. The funds have all the benefits of indexing such as diversification, low cost and transparency. As the funds are listed on the exchange, costs of distribution are much lower and the reach is wider. These savings in cost are passed on to the investors in the form of lower costs. Further, exchange traded mechanism helps reduce to the minimal of the collection, disbursement and other processing charges. The structure of ETFs is such that it protects long-term investors from inflows and outflows of short-term investor. This is because the fund does not bear extra transaction cost when buying/selling due to frequent subscriptions and redemptions. Tracking error, which is divergence between the price behaviour of a position or portfolio and the price behaviour of a benchmark, of an ETF is likely to be low as compared to a normal index fund. ETFs are highly flexible and can be used as a tool for gaining instant exposure to the equity markets, equitising cash or for arbitraging between the cash and futures market.

The first ETF in India, "Nifty BeEs (Nifty Benchmark Exchange Traded Scheme) based on S&P CNX Nifty was launched in December 2001 by Benchmark Mutual Fund. It is bought and sold like any other stock on NSE and has all characteristics of an index fund. It would provide returns that closely correspond to the total return of stocks included in

Nifty. One can buy or sell Nifty BeES in exactly the same way as one buys/sells any share. Each Nifty BeES is approximately 1/10th of the S&P CNX Nifty. Nifty BeES are in dematerialised form and is settled like any other share in T+3 rolling settlement.

Consolidation of Mutual Funds

The MF industry is witnessing consolidations in the form of mergers, acquisitions and takeovers in schemes and AMCs. The schemes of Indian Bank Mutual Fund were transferred to Tata Mutual Fund in accordance with MF regulations. Anagram Wellington Mutual Fund, which had launched only one scheme, wound up its operations and redemption amount was paid to unit holders. Reportedly Sun F&C Mutual Fund is in the process of taking over two schemes of Jardine Fleming (JF India Bond Fund and JF Personal Tax Saver, 1996) after giving investors an exit option without paying any exit load. It is also reported that Templeton AMC is in the process acquiring Pioneer ITI AMC.

Unit Holding Pattern

There were a total number of 3.08 crore investor accounts holding units worth Rs. 100,594 crore as on March 31, 2002 (it is likely that there may be more than one folio of an investor which might have been counted more than once by the MFs). Individuals accounted for 98% of total number of investors and contributed about 55% of total assets. Corporates and institutions who formed only 1.46% of the total number of investors, contributed 43% of the net assets in the MF industry. The NRIs/OCBs and FIIs constituted a very small percentage (0.5%) of investors and contributed only1.7% of net assets (Table 3-6).

Out of a total of 3.08 crore investors in the MF industry, 2.44 crore or 79.15% of the investors held units in UTI. The percentages of total investors holding units in private sector MFs and public sector MFs were 13.5% and 7.35% respectively.

Although about 96-98% of investors are individuals, they contributed about 73% of assets in case of UTI, 40% in case of other public sector MFs and 36% in case of private sector MFs. In case of private and public sector MFs, the corporates and institutions were the largest contributors to the net assets to the tune of 61.80% and 57.59% respectively.

Table No. 3-6: Unit Holding Pattern of Mutual Funds Industry as on March 31, 2002

Category	UTI		Rest of Public Sector MFs		Private Sector MFs		Total			
	No. of Investors (Lakh)	NAV (Rs. crore)	No. of Investors (Lakh)	NAV (Rs. crore)	No. of Investors (Lakh)	NAV (Rs. crore)	No. of Investors (Lakh)	% to Total Investor	NAV (Rs. crore)	% to Total NAV
Individuals	240.17	37,345.74	22.21	3,116.24	40.00	15,024.71	302.38	98.04	55,486.69	55.16
NRIs/OCBs	1.14	729.88	0.08	143.73	0.32	523.47	1.55	0.50	1,397.08	1.39
FIIs	0.00	11.06	0.01	6.35	0.00	288.61	0.01	0.00	306.02	0.30
Corporates/ Institutions/ Others	2.84	13,346.93	0.37	4,435.27	1.29	25,622.19	4.50	1.46	43,404.39	43.15
Total	244.14	51,433.61	22.68	7,701.59	41.62	41,458.98	308.44	100.00	100,594.18	100.00

Source: SEBI Web site.

Unit Scheme 1964 (US-64)

US-64 is a flagship scheme of UTI with over 20 million investors. The scheme was originally launched as a debt fund and was considered very safe. It provided high returns to the investors, especially in the first half of 1990s. The scheme encountered difficulties in July 1998, with reports that the original corpus of the scheme had been eroded to the extent of Rs. 1,098.5 crore, as a consequence of which, its reserves showed a negative balance. This shook the confidence of investors in the scheme.

UTI constituted a Committee under the Chairmanship of Mr. Deepak Parekh in October 1998 to undertake a comprehensive review of the functioning of the scheme and recommend measures for sustaining investor confidence and to strengthen the scheme. The Committee submitted its report in February 1999.

Following the recommendations of the Committee, mid-course reorganisation and portfolio rebalancing of US-64 was effected by UTI, which by the end of the year led to positive reserves. A number of measures were also taken by the Government of India. These included tax relief granted in the Budget for 1999-2000. A swap arrangement was worked out whereby the Special Unit Scheme 99 (SUS 99) was created to which PSU stocks of US-64 were transferred on May 1, 1999. Government subscribed to SUS 99 through issue of dated GoI securities worth Rs. 3,300 crore. SUS 99 discharged the transfer considerations of PSU stocks by transferring the dated GoI securities to US-64. As a result, the scheme declared a dividend of 13.7% for the year 1999-2000.

While many recommendations of the Parekh Committee were implemented by UTI, some key recommendations remained. These are (i) increasing the debt component in investment of the scheme, (ii) bringing the scheme under purview of SEBI, and (iii) shifting to NAV-based pricing. From negative reserves of Rs.1,098 crore as at end-June 1998, US-64 recorded positive reserve of Rs. 130 crore as at end-June 1999, and showed substantial increase in reserves to Rs. 3,492 crore by end-June 2000. UTI continued to repurchase the units of US-64 at a price different from the NAV of the scheme. Till the month of March 2001, the scheme's sales were higher than repurchases, thus the difference between NAV and repurchase price did not impact the scheme. However, in the months of April and May 2001, the scheme faced substantial redemption with negligible sales, thus impacting the NAV of the scheme. The equity portfolio of the scheme also reported significant depreciation in the first half of 2001. UTI, therefore, announced on July 2, 2001 suspension of the sales and repurchases of US-64 for a period of upto six months to enable it to make strategic changes to the scheme and the portfolio.

The freeze on sales and repurchases of the units of US-64 raised issues of the safety, and above all, liquidity of the scheme. As an interim liquidity measure, UTI announced that small investor holding upto 3,000 (subsequently increased to 5000) units of the US-64 on June 30, 2001 can avail of the repurchase facility from August 1, 2001 to May 31, 2003. The repurchase price in August 2001 was fixed at the face value of Rs.10 per unit. Thereafter, the repurchase price unit was increased by 10 paise every month and would become Rs. 12 per unit in May 2003. The scheme was made NAV-based from January 1, 2002. This measure gave the small investors an option of selling their units either at the prevailing NAV-based price or the administered price. The gap between the NAV and the assured price up to May 2003 is being met by the Government. In a NAV based scheme ordinarily such a facility is not provided, but with a view to reduce the hardship of unitholders, the above facility was extended with the support from Government of India.

Policy Debates

Legal Status of Unit Trust of India

UTI was formed under a special Act of Parliament, *viz.* the Unit Trust of India Act, 1963. While all other MFs come under the purview of the SEBI (MF) Regulations, 1996, UTI continues to have an independent status. SEBI (MF) Regulations set uniform standards and practices for all MFs. There has been an intense debate going on regarding whether UTI should be brought under SEBI purview notwithstanding the provisions of the UTI Act, 1963. UTI has, however, been voluntarily adhering to SEBI guidelines for most of its schemes.

A committee under the chairmanship of Justice D. R. Dhanuka, which was set up by SEBI in 1998 to examine the deficiencies in the securities laws was of the view that SEBI should be conferred powers to regulate and supervise the management and sponsors of all CISs, including MFs. It was also suggested that SEBI should be the sole regulatory agency for the securities market and UTI should be treated at par with other MFs. A similar view is reportedly taken by the finance ministry, which proposed to convert UTI into a full-fledged MF subjecting it to the scrutiny of SEBI under the latter's regulations.

Units vs. Securities

The units of MFs not only compete with securities in terms of numbers, but also resemble securities to a large extent and hence compete with securities for attention of investors. Units represent the interest of the unit holder in the specific scheme just as securities represent the interest of the holder in the issuer. The unit holder has similar rights as a security holder has on the future performance of any underlying asset or group of assets. Special kinds of units (units of assured return schemes), which represent the rights of investors on a fixed income flow over the future years or a fixed maturity value at the end of a specified period, are similar to debentures issued by companies. UTI and other MFs issue units in a manner similar to issue of shares, debentures and other securities. These are listed and traded on various recognised stock exchanges like, shares, debentures and other securities. These are transferred from one holder to another or sold back to the issuer, at pre-specified or market determined values, just like, shares, debentures and other securities are. UTI and other MFs, as issuers of units, also have to adhere to all the requirements under the listing agreement with the respective exchanges as are applicable to the issuers of shares and debentures. The holders of units and securities have the same need for safety, liquidity and return. Despite such close similarities between units and securities, they are not treated legally at par. The units of non-UTI MFs are not considered securities explicitly under law. There is no regulatory framework that governs trading of units of MFs and this is one of the reasons why the secondary market for units has not developed to an appreciable extent. Markets develop in a secured environment and this security is provided by a reliable regulatory framework.

Some people believe that units of MFs are securities and hence the regulatory framework applicable to securities is applicable to trading of units also. They believe that since units are listed and traded on stock exchanges just like securities, that is, these are marketable, these are *de facto* securities. It is a wrong presumption that all those traded on a stock exchange are securities and all those not traded on a stock exchange are not securities. The exim scrips which were traded in early 1990s on stock exchanges are not securities, while unlisted shares/ bonds of government companies/government securities, even though not listed/traded, are securities. In fact, the tradability or marketability is a necessary but not a sufficient condition,

for an instrument to be a security. While all securities are marketable, all marketable instruments are not securities. Even all marketable securities are not securities under the SCRA, which provides regulatory framework for trading of securities. Only those marketable securities, which have been specifically identified by SCRA as securities, are securities irrespective of the fact that they are listed/traded or not. The requirement of listing or facility of trading for an investment instrument does not make it a security.

The easiest way to develop the market for units of MFs and protect the investors investing in them is to consider the units to be securities so that the regulatory framework applicable to trading of securities would also apply to trading of units and SEBI which has the responsibility to protect the interests of investors in securities, can protect the interest of holders of units of MFs also. Since the jurisdiction of SEBI is limited to securities market and the units of MFs (except for units of UTI) are not explicitly recognised as securities in law, the actions of SEBI in protecting the interests of investors in units of MFs and developing a market for them is being challenged before the courts of law. In such a case, the Securities Appellate Tribunal held that all securities which are marketable and which have an ease or facility of selling and/or which have a high degree of liquidity and or/are capable of being sold in a market, i.e., stock exchange, are considered to be included in the definition of 'security' under SCRA. Units of MFs certainly come under this. This judicial pronouncemnent needs to be codified in law.

Passive vs. Active Investing

A fund manager manages its portfolio in two styles, *viz.*, passive or active. Under passive management, the fund manager's objective is to construct a portfolio which seeks to equal the return on a given equity market index. No effort is made by the fund manager to find out which stocks are potential out performers and investment is done in broad indices or asset classes so as to achieve returns which approximate only the returns of the index or the asset class. On the other hand, under the actively managed funds the fund managers undertake research about companies, perform fundamental and technical analysis and seek various information before zeroing in on stocks which they identify as potential winners. Active investment management might be described as an attempt to apply human intelligence, intuition and superior judgement to identify the potential winners in the financial markets.

There are MFs that offer Stock Index Funds whose main objective is to equal the return on a selected market index. While the style of investment may be called passive, it is only in the sense that the fund manager does not have to go through the process of stock selection unlike the active fund managers who try to pick stocks based on research or information, try to correctly time their decision to enter and exit from the markets and take positions in the options, futures and other derivatives market to hedge or take leveraged bets on the future direction of the market indices. Passive managers, on the other hand, invest in broad sectors or asset classes of the market, which could be a stock or a bond index and accept the average returns the various asset classes or indices produce. The main objective of the passive managers is to make a profit but they do not attempt to place judgement on stocks by doing research or analysing information.

Active fund management is more popular and more funds are managed in the similar fashion but researches have proved that it is actually more expensive and in most cases it is difficult to predict future prices correctly and outperform the markets. Stock prices are based on fundamental analysis which involves research into the operations and finances of a company with the objective of estimating its future earnings, technical analysis which

involves study of historical data on the company's share price movements and trading volume. The objective of this kind of study is to recognise patterns in the market price behaviour and use that knowledge to try to predict the future course of the market price of a share, or even an industry. The fund manager also uses mathematical models for equity valuation, which helps in evaluating the market as a whole or particular sector/industries.

In India, several index funds have been launched of late, which are passively managed funds. As pointed out by many studies, actively managed funds have failed to outperform the markets. It is therefore expected that the popularity of passively managed funds will gain further popularity.

Basis for Index Funds

There is a huge quality difference between Sensex and Nifty from the viewpoint of the index funds based on them. An analysis of the indices for last five years by Dr. L. C. Gupta (Sensex Vs. Nifty as Basis for Index Funds, NSENEWS, July 2002) finds that the Nifty declined by 13.7% between June-end 1997 and May-end 2002 whereas the Sensex declined by almost double (26.6%) over the same period. The period from June 1997 to May 2002 as a whole was one of decline but in-between there were peaks and troughs. From the trough at November-end 1998 to the peak at February-end 2000, Nifty rose by 102.3% whereas Sensex rose somewhat less, i.e. 93.8% (Table 3-7). The table also shows that during the declining phase of the market from February-end 2000 upto September-end 2001, Nifty declined by 44.8% but Sensex declined by a higher percentage, i.e. 48.4%, over this period.

Thus, while the dates on which both indices touched a major peak or a major trough were always identical, the magnitude of change in the indices was not identical and showed a characteristic difference between peaks and troughs. Nifty always tends to be higher than

Table 3-7: Behaviour (Peaks and Troughs) of Nifty and Sensex during 1997-2002

Event	Date	Nifty		Sensex	
		Level	% change from the preceding date	Level	% change from the preceding date
Beginning	30.06.97	1192.4	—	4256.1	—
Trough	30.01.98	963.5	-19.2	3224.4	-24.2
Peak	30.04.98	1159.4	20.3	4006.8	24.3
Trough	30.11.98	817.8	-29.5	2810.7	-29.9
Peak	26.02.00	1654.8	102.3	5447	93.8
Trough	28.09.01	913.9	-44.8	2811.6	-48.4
Period-end	30.05.02	1028.8	12.6	3125.7	11.2
% change from 30-06-97 to 30-05-02		—	-13.7	—	-26.6

Note: The percentage change given against 30-01-98 is the change since 30-06-97; and the percentage given against 30-04-98 is the change since 30-01-98 and so on successively.

Source : L.C. Gupta,"Sensex Vs. Nifty as Basis for Index Funds", NSENEWS, July 2002, Pg.8

Sensex over the long-term and also both at peaks and at troughs. In other words, Nifty has an upward long-term bias relative to Sensex. This means that when it fell from peak to trough, it fell less than Sensex but when it rose from trough to peak, it rose more than Sensex. Hence, it ends higher than Sensex over a long period; i.e. it out-performs the Sensex.

When the stock market as a whole is in a declining phase, the stocks of dynamic and fast-growing companies tend to decline less than others and some may even rise against the current. Hence, during the market's declining phase, an index which is "over-weighted" with dynamic companies shows a smaller decline than an index which is "under-weighted" in this regard. The effect of greater weight given to dynamic companies is also seen during the up-side phase of the market. During the upside phase, while the speculative stocks bounce stridently during the rising phase of the market, the stocks of dynamic companies bounce even more. That is why the upward bias of Nifty: it falls less during a market decline but rises more during the market's recovery relatively to Sensex. Nifty is always higher than Sensex at the peaks as well as at the troughs. This is because the dynamic companies are inexorably growing faster than the rest for most of the time.

Thus, Nifty-based index funds are likely to give a superior medium and long-term investment performance compared to Sensex-based index funds because the Nifty group of companies is more dynamic and growth-oriented than the Sensex group.

Rural Penetration

Though the MF has been one of the fastest growing segments, total assets under management of MFs has been hovering around Rs. 1,00,000 crore for about last 5 years, while the assets migrate from one fund/scheme to another without significant expansion in investor base. The major investors in MFs are corporates or residents of major cities. In case of private and public sector MFs (excluding UTI), the corporates and institutions are the largest contributors to the net assets to the tune of 61.80% and 57.59% respectively. Thus the marketing reach of MFs is very limited. The challenge is, therefore, to attract retail investors from rural areas.

Collective Investment Schemes

SEBI continued with its efforts aimed at protecting investors in Collective Investment Schemes (CISs) by asking individual entities, which had failed to apply for grant of registration, to wind up their schemes and repay investors, and by issuing public notices cautioning investors about the risks associated with CIS.

As per the provisions of SEBI (Collective Investment Schemes) Regulations, 1999, which was notified on October 15, 1999, no existing CIS could launch any new scheme or raise money from the investors even under the existing schemes, unless a certificate of registration was granted to it by SEBI. As on March 31, 2002, 50 applications for grant of registration were received, out of which 6 CIS entities were granted provisional registration. Applications of 35 entities were rejected and the remaining 9 were under consideration.

In terms of regulation, an existing CIS which has failed to make an application for registration to the Board; or has not been granted provisional registration by SEBI; or have obtained provisional registration but failed to comply with the provisions of regulations 71; or is not desirous of obtaining provisional registration; is required to wind up its existing schemes, make repayment to the investors and thereafter submit its winding up and repayment report to SEBI. SEBI has received such report from 51 entities.

According to SEBI press release dated April 30 2002, SEBI has filed complaints before criminal courts against 12 companies and directors which raised amounts between Rs. 50 lakh and Rs. 1 crore and failed wind up their schemes in terms of directions issued by SEBI under section 11B of the SEBI Act, 1992. Besides this, SEBI has also launched criminal prosecution under section 24 against 97 entities who raised substantial amounts of money

from the investors under various schemes and failed either to register the said schemes with SEBI or to wind up the schemes and refund the amounts to the investors, despite several directions of SEBI to do so. The directors of the said companies have also been prosecuted.

As on March 2002, there were 6 CISs registered with SEBI. The existing CIS has been given two years time to comply with the requirements in respect of provisional registration such as getting schemes rated, audited, appraised minimum net worth of Rs. 1 crore, etc. The status of CIS as on July 25 2002 is presented in Table 3-8.

Though the rules providing for listing of units of CIS have been framed, no CIS has yet sought listing of its units in any exchange.

Table 3-8: Status of Collective Investment Scheme as on July 25, 2002

Category	No. of Entities
Entities granted provisional registration- Not authorised to mobilise funds from the public	6
Entities whose applications for registration were rejected recently by SEBI and winding up of schemes to repay investors was ordered	12
Entities whose applications for registration are under process	5
Entities which, as certified by their statutory auditors, have wound up their schemes and repaid to the investors	53
Entities which, as certified by their statutory auditors, have repaid to a section of investors and have submitted positive consent from the rest of the investors (more than 25%)to continue with the scheme	4
Entities which have obtained stay orders from Hon'ble Courts	6
Entities in whose case Liquidator/Administrator/Receiver appointed by Hon'ble Courts	13
Entities to which orders u/s 11B of the SEBI Act, 1992 were issued directing for repayment to investors within one month from the date of the order	585
Entities: a. Referred by SEBI to the DCA for initiating winding up, b. Referred by SEBI to the State Governments for initiating civil/criminal proceedings c. and their promoters/directors/managers/persons in charge of business of schemes of the entities debarred by SEBI from operating in the capital Market for a period of 5 years	517
Micellaneous cases (court matter, claimed to have not raised money etc.)	25
Entities against which prosecution already launched by SEBI	132

Source: SEBI Web Site

Venture Capital Funds

SEBI is the single-point nodal agency for registration and regulation of both domestic and overseas VCFs. No approval of VCFs by tax authorities is required. VCFs enjoy a complete pass-through status. There is no tax on distributed or undistributed income of such funds. The income distributed by the funds is only taxed in the hands of investors at the rates applicable to the nature of income. This liberalisation is expected to give a strong boost to NRIs in Silicon Valley and elsewhere to invest some of their capital, knowledge and enterprise in ventures in their motherland.

Regulations for VCFs

i. VCF is a fund established in the form of a trust/a company including a body corporate and registered with SEBI. It has a dedicated pool of capital, raised in the specified

manner and invested in VCUs in accordance with the regulations. VCU is a domestic company whose shares are not listed on a stock exchange and is engaged in specified business.

ii. The minimum investment in a VCF from any investor would not be less than Rs. 5 lakh and the minimum corpus of the fund before it could start activities should be at least Rs. 5 crore.

iii. A VCF can not invest in associated companies. The investment in a single VCU can not exceed 25% of the corpus of VCF. At least 75% of the investible funds shall be invested in unlisted equity shares or equity linked instruments. A VCF seeking to avail benefit under the relevant provisions of the Income Tax Act will be required to divest from the investment within a period of one year from the listing of the VCU.

iv. The VCF is eligible to participate in the IPO through book building route as Qualified Institutional Buyer.

v. Automatic exemption is granted from applicability of open offer requirements in case of transfer of shares from VCFs in Foreign Venture Capital Investors (FVCIs) to promoters of a venture capital undertaking.

vi. VCF has to disclose the investment strategy at the time of application for registration.

Venture Financing

During the year 2001-02, 1 new domestic VCFs and 1 FVCIs were registered. There were 34 VCFs and 2 FVCIs registered with SEBI as at end March 2002. All VCFs are now required to provide information pertaining to their venture capital activity for every quarter starting from the quarter ending December 2000.

According to a survey conducted by Thomson Financial and PRIME Database on behalf of the Indian venture capital association, India ranked as the third most active venture capital market in Asia Pacific (excluding Japan). It recorded 115 deals in 2001 with average investment per deal amounting to US $ 7.9 million. 57 VCFs invested Us $ 908 million in 101 Indian companies during the year 2001 as against 88 VCFs investing US $ 1.20 billion in 270 companies in 2000. The communication and media sector secured US $ 585 million or 64.5% of total investments. Indian VCFs received US $ 395 million in new commitments in 2001 against US $ 826 million in 2000.