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**Structure of Mutual Funds in India**

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Investors are always puzzled about how mutual funds are formed in India. This blog will help you understand the provisions of the SEBI (MF) Regulations, 1996, pertaining to the structure of Mutual Funds in India.

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1. **Introduction**

In a mutual fund many investors contribute to form a common pool of money which is invested by another separate entity in accordance with a pre-stated investment objective. The ownership of the funds is mutual and belongs to all the investors. In the process the investors assume market risk but no other risk. Different countries use different business structures to give effect to this concept in practice. This paper gives an overview of the way in which mutual funds are formed in India. It describes how the concept of trust is used to ensure that the common pool of money is subject to no other risk but market risk. Section 2 traces the history of regulations governing the structure of mutual funds in India. Section 3 details the present regulations. Section 4 talks about regulatory bodies. Section 5 concludes the document.

1. **History**

The first structure of Mutual fund was the one adopted by UTI in 1963. This was followed by SEBI MF guidelines in 1993. These guidelines were later replaced by comprehensive set of SEBI MF regulations 1996.

* 1. **Unit trust of India** – The first Mutual fund of India was a Unit Trust of India. It was formed as a body corporate under an act of Parliament. Different provisions of the UTI Act laid down the structure of management, scope of business, powers and functions of the Trust as well as accounting, disclosures and regulatory requirements for the Trust. However, it was different from the present day mutual funds in more than one ways. It was a trust, custodian, and investment manager all in one. It was capable of buying property and borrows/lending money for project finance.”The management structure of UTI is thus distinct from the remaining mutual funds in more than one way. First, unlike other mutual funds, it is a statutory body corporate and not a Trust under the Indian Trusts Act. Second, there is no separate asset management company with a separate Board of directors of AMC to manage the schemes. The functions of the Board of directors of AMC, and Trustees are combined in the Executive Committee and Board of UTI. The Sponsors exist in the form of Government and IDBI, though they do not hold any equity in the Trustee Company or AMC for none exists. ”
  2. **Organisation Structure of Mutual Funds of Public Sector Banks** – In 1987, the public sector banks were allowed to set up mutual fund. State Bank of India was the first one to set up mutual fund. It preferred to adopt the Trust route and set up the mutual fund as a Trust under the Indian Trust Act 1882. Later, other mutual funds followed the same and thus Trusts set up under the Indian Trusts Act became the adopted legal form of mutual funds in India. These mutual funds combined the role of Trustee, fund manager and custodian in the sponsoring bank. However there was little demarcation in the role and responsibilities and the structure was open to conflict of interests.
  3. **SEBI MF Regulations 1996**– Securities and Exchange Board of India (SEBI) was formed in 1992 and was given the regulatory responsibility of Capital markets and Mutual Funds. SEBI formed Mutual Funds regulations in 1993 which were later replaced by new regulations in 1996. “SEBI, while framing the Mutual Fund Regulations, gave a lot of consideration to two major factors, one, that mutual funds garner large moneys from the pubic for investment in a dynamic market place which require specialisation on the part of persons performing these functions. Secondly, there could arise potential conflicts of interest which were to be avoided by ensuring arm’s length relationship between various functionaries. Such stipulation of arm’s length relationship ensures that the person who performs a function is answerable to another and does not assess or judge his own performance.” This is the structure which is followed by all the existing mutual funds in India.

1. **Structure of Mutual Funds**

The Mutual Funds in India are regulated by SEBI MF Regulations, 1996. Under the regulations mutual fund is formed as a Public Trust under the Indian Trusts Act, 1882. These regulations stipulate a three tiered structure of entities – sponsor (creation), trustees, and Asset Management Company (fund management) – for carrying out different functions of a mutual fund, but place the primary responsibility on the trustees.

* 1. **The Fund Sponsor** – SEBI regulations define Sponsor as any person who either itself or in association with another body corporate establishes a mutual fund. Sponsor sets up a mutual fund to earn money by doing fund management through its subsidiary company which acts as Investment manager of the fund. Largely, a sponsor can be compared with a promoter of a company. Sponsors activities include setting up a Public Trust under Indian Trust Act, 1882 (the mutual fund), appointing trustees to manage the trust with the approval of SEBI, creating an Asset Management Company under Companies Act, 1956 (the Investment Manager) and getting the trust registered with SEBI.
     1. **Eligibility of Sponsor** – Mutual funds involve managing retail investor’s money and hence, it becomes important to ensure that it is run by entities with capabilities and professional merits. SEBI (Mutual fund) Regulations, 1996 specifies the following eligibility criteria in this regard: (i) Sponsor is required to have financial services business experience of at least 5 years and a positive Net worth in all the preceding five years. (ii) Sponsors’ Net worth in the immediately preceding year is required to be more than the capital contribution to AMC. (iii) Sponsor is required to be profit making in at least three out of the last five years including the last year. (iv)Sponsor must contribute at least 40% of the Net worth of the Asset Management Company. Any entity, which contributes at least 40% to the Net worth of an AMC, is deemed sponsor and therefore is required to fulfil all the requirements given in 1 to 4.
  2. **Trustees**– The trust is created through a document called the trust deed which is executed by the fund sponsor in favour of the trustees. Trustees manage the trust and are responsible to the investors in the mutual funds. They are the primary guardians of the unit-holders funds and assets. Trustees can be formed in either of the following two ways -Board of Trustees, or a Trustee Company. The provisions of Indian Trust Act, 1882, govern board of trustees or the Trustee Company. A trustee company is also subject to provisions of Companies Act, 1956.
     1. **Obligations of trustees** – Trustees ensure that the activities of the mutual fund are in accordance with SEBI (mutual fund) regulations, 1996. They check that the AMC has proper systems and procedures in place. Trustees also make sure that all the other fund constituents are appointed 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 regulatory norms. They furnish to SEBI, on a half-yearly basis, a report on the activities of AMC.
     2. **Regulation regarding appointment of trustees** – Sponsor with prior approval of SEBI appoints trustees. There should be at least four members in the board of trustees with at least 2/3rd independent. A 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 under the provisions of Indian registration Act. This trust deed is also registered with SEBI.
     3. **Responsibilities of trustees** – The Trustees are required to fulfill several duties and obligations in accordance with SEBI (Mutual Funds) Regulations, 1996 and the Trust Deed constituting the Mutual Fund. These include 1. The Trustee and the Asset Management Company enter into an Investment Management Agreement (IMA) with the approval from SEBI. 2. The Investment Management Agreement shall contain such clauses as are mentioned in the Fourth Schedule of the SEBI (MFs) Regulations, 1996 and other such clauses as are necessary for making investments. 3. The Trustees shall have a right to obtain from the Asset Management Company such information as is considered necessary by the Trustees. 4. The Trustee shall ensure before the launch of any scheme that the Asset Management Company possesses/has done the following: a. Systems in place for its back office, dealing room and accounting; b. Appointed all key personnel including fund manager(s) for the Scheme(s) and submitted their bio-data which shall contain the educational qualifications, past experience in the securities market to SEBI, within 15 days of their appointment; c. Appointed Auditors to audit its accounts; d. Appointed a Compliance Officer to comply with regulatory requirement and to redress investor grievances; e. Appointed Registrars and laid down parameters for their supervision; f. Prepared a compliance manual and designed internal control mechanisms including internal audit systems; and g. Specified norms for empanelment of brokers and marketing agents
  3. **Asset Management Company** – The Asset Management Company (AMC) is the investment Manager of the Trust. The sponsor, or the trustees is so authorized by the trust deed, appoints the AMC as the “Investment Manager” of the trust (Mutual Fund) via an agreement called as ‘Investment Management Agreement’. 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.
     1. **Role of AMC** – The AMC is an operational arm of the mutual fund .AMC is responsible for all carrying out all functions related to management of the assets of the trust. The AMC structures various schemes, launches the scheme and mobilizes initial amount, manages the funds and give services to the investors .In fact, AMC is the first major constituent appointed .Later on AMC solicits the services of other constituents like Registrar, Bankers, Brokers, Auditors, Lawyers etc and works in close co-ordination with them.
     2. **Restrictions on business activities of the Asset Management**Company – In India, regulator has ensured that an AMC focuses just on its core business and that the activities of AMC’s are not in conflict of each other. These are ensured through the following restrictions on the business activities of an AMC. a. 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. b. An AMC cannot invest in any of its own schemes unless full disclosure of its intention to invest has been made in the offer document c. An AMC shall not act as a trustee of any mutual fund
  4. **Custodian** – Though the securities are bought and held in the name of trustees, they are not kept with them. The responsibility of safe keeping the securities is on the custodian. Securities, which are in material form, are kept in safe custody of a custodian and securities, which are in “De-Materialized” form, are kept with a Depository participant, who acts on the advice of 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 the mutual fund. They also ensure that funds are paid out when securities are bought. Custodians keep the investment account of the mutual fund. They collect and account for the dividends and interest receivables on mutual fund investments. They also keep track of various corporate actions like bonus issue, rights issue, and stock split; buy back offers, open offer etc and act on these as per instructions of the Investment manager. 3.4.1. Responsibility of custodian Following are the responsibilities of a custodian: (i) Provide post-trading and custodial services to the Mutual Fund; (ii) Keep securities and other instruments belonging to the Scheme in safe custody; (iii) Ensure smooth inflow/outflow of securities and such other instruments as and when necessary, in the best interests of the unit holders; (iv) Ensure that the benefits due to the holdings of the Mutual Fund are recovered; and (v) Be responsible for loss of or damage to the securities due to negligence on its part or on the part of its approved agents. The Custodian normally charge portfolio fee, transaction fee and out-of -pocket expenses in accordance with the terms of the Custody Agreement and as per any modification made thereof from time to time.
  5. **Other constituents** – Regulation imposes responsibility on the trustees to ensure that the AMC has proper system and procedures in place and has appointed key personnel and other constituents like R&T agents, brokers etc.
     1. **Registrar and transfer agent** – A mutual fund manages money of many unit-holders across cities and towns of the country. Investor servicing not only becomes important but challenging as well. This would typically include processing investors’ application, recording the details of investors, sending them account statements and other reports on periodical basis, processing dividend payouts, making changes in investor details and keeping investor records updated by adding details of new investors and by removing details of investors who withdraw their funds from the mutual funds. It is very impractical and expensive for any mutual fund to have adequate workforce all over India for this purpose. Instead, they use entities called as Registrars and transfer agents, which generally provide services to many mutual funds. This ensures quality services across all location and keeps the costs lower for the unit-holders.
     2. **Auditor** – Investor money is held by the trustees in trust. Regulation has ensured proper accounting norms to ensure fair and responsible record keeping of investor’s money. Separate books of account are maintained for each scheme of the mutual fund and individual annual report is prepared. The books of accounts and the annual reports of the scheme are audited by auditors. The AMC is a company under companies act, 1956 and therefore is required to get its accounts audited as per the provisions of the companies act. In order to maintain high standards of integrity and transparency regulations stipulate that the auditor of the mutual fund schemes and the auditor of the AMC will have to be different.
     3. **Brokers** – Brokers are registered members of the stock exchange whose services are utilized by AMCs to buy and sells securities on the stock exchanges. Many brokers also provide the Investment Manager (AMC) with research reports on the performance of various companies, sector and market outlook, investment recommendations etc. Regulations have imposes restrictions on the involvement of brokers in the investment process of any mutual fund in the following ways- a. If a broker is related to the sponsor or its associate, then the AMC shall not purchase or sell securities through that broker in excess of 5% of the aggregate of purchase and sale of securities made by the mutual fund in all its schemes. b. For transactions through any other broker the AMC can exceed the limit of 5% provided it has recorded justification in writing and report of such exceeding has been sent to the trustee on a quarterly basis

1. **Regulation**

Securities and Exchange Board of India (SEBI) is the primary regulator of mutual funds in India. SEBI is also apex regulator of capital markets. Issuance and trading of capital market instruments and the regulation of capital market intermediaries is under the purview of SEBI. Apart from SEBI, mutual funds follow the regulations of other regulators in limited manner.

* 1. **RBI**– RBI acts as regulator of sponsors of bank-sponsored mutual funds, especially in case of funds offering guaranteed/assured returns. No mutual fund is allowed to bring out a guaranteed returns scheme without taking approval from RBI
  2. **Companies Act, 1956** – Asset Management Company and Trustee Company will be subject to the provisions of the Companies Act, 1956.
  3. **Stock Exchange** – Closed-end funds might list their units on a stock exchange. In such a case, the listings are subject to the listing regulation of stock exchanges. Mutual funds have to sign the listing agreement and abide by its provisions, which primarily deal with periodic notifications and disclosure of information that may impact the trading of listed units.
  4. **Indian Trusts Act, 1882** – Recall that mutual funds are formed and registered as a public trusts under the Indian trusts Act, 1882. Hence, they have to follow the provisions of the Indian Trusts Act, 1882.
  5. **Ministry of Finance (MoF)** – The finance ministry is the supervisor of both the RBI and SEBI. The MoF is also the appellate authority under SEBI regulations. Aggrieved parties can make appeals to the MoF on the SEBI rulings relating to mutual funds.

1. **Conclusion**

Keeping in mind the fiduciary nature of functions in a mutual fund, regulation has stipulated a three tiered structure which ensures that arm length relationships are built between various constituents. These Arm’s length relationships are achieved by requiring a certain proportion of Trustees to be independent of the sponsor, requiring independent directors on the board of the AMC and requiring an independent custodian to be appointed. This is in line with international practices where, irrespective of the route adopted, a three tiered structure exists and there is segregation between the responsibility of fund management and the trustee responsibility.