

PN-ACC-418

**Assistance to Mutual Funds -
Review of Comprehensive Strategic Plan &
Investor Awareness Campaign**

**Financial Institutions Reforms and
Expansion (FIRE) Project**

March, 1998

**Financial Institutions Reform and Expansion (FIRE) Project
US Agency for International Development (USAID/India)
Contract #386-0531-C-00-5010-00
Project #386-0531-3-30069**

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Price Waterhouse LLP



March 16, 1998

Mr A P Kurian
Chairman
Association of Mutual Funds in India ("AMFI")
c/o Apple Asset Management Company, Ltd
38/39, Rajgir Chambers 4th Floor
Shahid Bhagat Singh Road, Fort
Mumbai - 400 023

Dear Mr Kurian

At the AMFI's request Price Waterhouse LLP ("PW") arranged for continuing assistance to AMFI by Mr Lewis J Mendelson, a former senior official of the United States Securities and Exchange Commission and an expert in mutual funds Mr Mendelson made his seventh visit to India between November 29 and December 22, 1997 As you are aware, his assistance, which began in July 1996, is aimed at improving the credibility of the mutual fund industry and helping it to gain wider public acceptance

Initially, PW recommended a comprehensive strategy to strengthen AMFI and helped to design and execute an AMFI Investor Awareness Campaign, including providing drafts of brochures to be used in the campaign During November and December, among other things, Mr Mendelson concentrated on Compliance Training for Chief Executives of Asset Management Companies ("AMCs") and Compliance Officers of their Mutual Funds and, in response to the request of the Securities and Exchange Board of India ("SEBI"), on training members of SEBI's mutual fund and investigative staffs and representatives of the independent audit firms which perform SEBI inspections of Mutual Funds and their AMCs He also focused on AMFI Strategic Planning for 1998 and implementation of the principal recommendation of the AMFI Action Memorandum of February 1997

Mr Mendelson was assisted in India by Mr R N K Prasad, Ms Sandhya Bhate and Ms Maryann Kurtz, a PW Training Specialist from its headquarters in Arlington, VA This assistance is carried out under the US Agency for International Development Financial Institutions Reforms and Expansion ("FIRE") Project which is administered by PW

I PURPOSE OF ASSISTANCE

The purpose of Mr Mendelson's visit was twofold

A. Assistance to AMFI. Continuing to strengthen AMFI with particular emphasis in the areas of



- ◆ administration
- ◆ professional standards and
- ◆ investor awareness

by assisting in more complete implementation of its Action Plan to ensure the sustainability of its program. Specific goals included

1. Administration:

- ◆ better defining AMFI's long and near term goals
- ◆ adopting an AMFI
 - ◇ Work Plan
 - ◇ Financial Plan and
 - ◇ Budget and
- ◆ hiring a professional staff to execute AMFI's policies,

2. Implementation of Professional Standards:

- ◆ promoting the industry-wide adoption and implementation of comprehensive compliance standards based upon the Model AMFI Compliance Manual by helping to design and conduct an AMFI "*Seminar on Mutual Fund Compliance,*"
- ◆ planning the strategy for working with the Institute of Chartered Accountants to implement the FIRE Project's recommendations (See Report of Mr. Rajesh Dadoo) for improving accounting standards for mutual funds,

3. Investor Awareness:

- ◆ reviewing and commenting upon the seven point program and budget proposed by the AMFI Investor Awareness Committee including production of a video, additional booklets on various types of mutual funds, sales agent training programs, a press conference, creation of an AMFI database and web site and performance reporting, and
- ◆ reviewing and commenting upon the proposed agenda, theme and speakers proposed by the UTI Institute of Capital Markets for the pending AMFI-UTI 4th Annual Mutual Fund Conference, and



B. Assistance to SEBI. Assisting SEBI in the inspection and regulation of Mutual Funds and their Asset Management Companies ("AMCs") by

1 Inspection Training: helping to arrange, design and present a SEBI Inspection Workshop "*Quality Control and Consistency in Mutual Fund Inspections Insights from the US SEC Inspection Process,*" to members of SEBI's Mutual Fund and Investigative staffs and representatives of the independent auditors who perform SEBI mutual fund and AMC inspections, and

2. Report and Recommendations on Inspections: submitting a "Report and Recommendations on Strengthening SEBI Mutual Fund Inspections" designed to improve their efficiency, quality and consistency

II. CONTENTS OF REPORT

A. With respect to AMFI, the report reviews progress in implementing the AMFI Comprehensive Strategic Plan and the AMFI Investor Awareness Campaign, including

- ◆ implementing the recommendations of the AMFI Action Memorandum of February 6, 1997, with respect to
 - ◇ refining and focusing AMFI's immediate and longer term goals
 - ◇ preparation of an AMFI Work Plan
 - ◇ financing AMFI, and
 - ◇ building AMFI's professional staff,
- ◆ training Chief Executives of AMCs and Mutual Fund Compliance Officers in
 - ◇ systematically strengthening and implementing Mutual Fund compliance structures, techniques and internal controls, including
 - utilizing the AMFI Model Compliance Manual and AMFI Code of Ethics increasing the involvement and initiative of mutual fund trustees, and
 - demonstrating the CEO's commitment to and support for their funds' Compliance Officers and Compliance Programs,



B. With respect to SEBI, the report reviews progress in strengthening the inspection and surveillance of mutual funds by the regulatory authority or its agents by

- 1 conducting training on Quality Control and Consistency in Mutual Fund Inspections, and
- 2 submitting a "Report and Recommendations on Strengthening SEBI Inspections "

III. NEXT STEPS

A. AMFI

In view of the excellent progress made by AMFI, PW recommends that AMFI and the fund industry would benefit from continued expert consultation in connection with

- ◆ AMFI's ability to raise the resources necessary to sustain its activities, its Financial and Work Plans, budget and projected staffing,
- ◆ designing and implementing a program to identify and reduce obstacles to successful investing in the Indian Capital Market and thereby identify itself as a champion of investors' interests,
- ◆ improving accounting and valuation standards for mutual funds and their guarantors by working with the AMFI Accounting and Valuation Committee and the Institute of Chartered Accountants,
- ◆ improving mutual fund regulatory compliance by working with the AMFI Compliance Committee to
 - ◇ draft Phase Two of the AMFI Model Compliance Manual including updated SEBI Mutual Fund Regulations, the relevant portions of the SEBI Act of 1992 and the SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, October 1995, and the Companies Act,
 - ◇ prepare an AMFI Compliance/Audit Inspection Program to assist in Mutual Fund Compliance Reviews,
 - ◇ design and execute a Trustees Forum, an interactive program to increase Mutual Fund Trustees' awareness of their role and responsibilities



- ◆ promoting wider public acceptance of mutual funds by working with the AMFI Investor Awareness Committee to
 - ◇ assist in designing and carrying out Sales Agent Training Programs
 - ◇ review and comment upon an AMFI Brochure on Mutual Fund Performance,
 - ◇ circulate for comment a draft of the AMFI Model Advertising Guidelines,
 - ◇ review and comment upon the design of an AMFI Web Site

- ◆ improving the credibility of the mutual fund industry by assisting AMFI in immediately structuring a study of the status and funding of outstanding guarantees, including describing
 - ◇ the duration
 - ◇ due dates and
 - ◇ extent of possible shortfalls of existing guarantees, andrecommending measures to assure that such guarantees
 - ◇ are appropriately accounted for on the books of the guarantors, and
 - ◇ will be timely met without the necessity of protracted negotiations or litigation when they fall due

B. SEBI

In view of the requests for continued training and the recommendations of the "*Report and Recommendations for Strengthening SEBI Inspections*," PW recommends that SEBI and the fund industry would benefit from continued expert consultation in connection with its mutual fund inspection program and on understanding concepts of securities market and mutual fund regulation

IV. DISTRIBUTION OF THE REPORT

Under the terms of the PW/FIRE Project, the report will be distributed to USAID and SEBI. We request your permission to distribute the report to selected participants in the Indian Capital market and we will advise you of the same. We will not distribute the report in its entirety to the media directly, however we will note comments on its contents from time to time in response to media enquiries.

We want to express our sincere appreciation for the warm welcome and cooperation which AMFI, its Board Members and Committees have provided to Mr. Mendelson and our staff.

Mr. A. P. Kurian
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March 16, 1998



Upon reading this report and its recommendations, please feel free to contact me with any questions. I can be reached at Tel 496 3599, Fax 496 3555

Thank you,

Sincerely yours,

W. Dennis Grubb *h/??*

W DENNIS GRUBB,
PRINCIPAL CONSULTANT CAPITAL MARKETS

Enclosure

cc Mr Pratip Kar
 Executive Director
 Securities and Exchange Board of India
 Mumbai

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I. EXECUTIVE SUMMARY

This is a review of the continuing technical assistance provided to the Association of Mutual Funds in India ("AMFI") and the Securities and Exchange Board of India ("SEBI") by the FIRE Project during November and December 1997, as part its continuing effort to help the mutual fund industry strengthen its credibility and gain increased public acceptance

Earlier, FIRE had designed a comprehensive strategic plan to improve the industry's credibility and an Action Memorandum for implementing it. The plan called for more closely identifying AMFI with unit holders' interests and structuring AMFI around five departments or committees to provide its major services

- Professional Standards
- Government Relations (Regulation)
- Statistical Research and Analysis
- Information Services (Investor Awareness) and
- Operations (Membership Services)

FIRE, together with AMFI, had also designed an AMFI Investor Awareness Campaign, a long term promotional and training effort, and provided drafts or outlines of the basic documents required for the Campaign

During November and December, FIRE took significant steps to help AMFI to implement its Comprehensive Strategic Plan and Investor Awareness Campaign. FIRE's principal mutual fund consultant, Mr Lewis J Mendelson, a former senior official of the U S Securities and Exchange Commission ("SEC") and an expert in mutual funds visited India between November 29 and December 22, 1997. His broad objective which he has consistently pursued since July 1996, was to assist in developing and implementing AMFI's program to improve the credibility of the mutual fund industry and the public's acceptance of mutual funds. Specific goals of Mr Mendelson's visit included

A. Assistance to AMFI

Continuing to strengthen AMFI with particular emphasis in the areas of

- ◆ administration
- ◆ professional standards and
- ◆ investor awareness

by assisting in more complete implementation of its Action Plan to ensure the sustainability of its program. Over the course of his visit he

- 1 Worked with the AMFI Board of Directors to develop a Strategic Plan to strengthen the Administration of AMFI by:

- better defining AMFI's long and near term goals
 - adopting an AMFI
 - Work Plan
 - Financial Plan and
 - Budget and
 - hiring a professional staff to execute AMFI's policies,
- 2 Worked with AMFI's Compliance Committee to improve the implementation of professional standards promote the industry-wide adoption and implementation of comprehensive compliance standards based upon the Model AMFI Compliance Manual by helping to design and conduct an AMFI "*Seminar on Mutual Fund Compliance,*"
- 3 Worked with AMFI's Accounting and Valuation Committee to plan the strategy for working with the Institute of Chartered Accountants to implement the FIRE Project's recommendations (See Report of Mr Rajesh Dadoo) for improving accounting and valuation standards for mutual funds,
- 4 Worked with AMFI's Investor Awareness Committee by reviewing and commenting upon
- the seven point program and budget proposed by the AMFI Investor Awareness Committee, and
 - the proposed agenda, theme and speakers proposed by the UTI Institute of Capital Markets for the pending AMFI-UTI 4th Annual Mutual Fund Conference, and

B. Assistance to SEBI

- 1 Assisting SEBI in improving its inspection and regulation of Mutual Funds and their Asset Management Companies ("AMCs") by
- helping to arrange, design and present a SEBI Inspection Workshop "*Quality Control and Consistency in Mutual Fund Inspections Insights from the US SEC Inspection Process,*" to members of SEBI's Mutual Fund and Investigative staffs and representatives of the independent auditors who perform SEBI mutual fund and AMC inspections, and
 - submitting a "Report and Recommendations on Strengthening SEBI Mutual Fund Inspections" designed to improve their efficiency, quality and consistency

B. BACKGROUND

In July and August 1996, FIRE designed a comprehensive strategic plan for AMFI to improve the credibility of the industry and the public's acceptance of mutual funds. The plan called for AMFI to establish five departments or committees: professional standards, government relations, statistical research and analysis, information services and membership services. Working closely with AMFI, FIRE also designed and laid the foundation for an AMFI Investor Awareness Campaign, a long term educational and promotional effort built around seven basic documents, five of which were provided by FIRE as first drafts to AMFI and two for which FIRE provided specifications to AMFI.

In January 1997, FIRE invited Mr. David Silver, former President of the Investment Company Institute and a world renowned expert in mutual funds to visit India. Among other things, Mr. Silver's visit resulted in an Action Memorandum to AMFI which called for AMFI to "immediately start the rapid build-up of a high quality professional staff with the capacity to play an appropriate role in helping to create and facilitate the growth of the fund industry which lies ahead." The Action Memorandum recommended that AMFI

- hire a professional staff
- adopt a work plan, organizational chart and budget
- set goals, priorities and dates
- assign Committees and independent contractors to begin working on achieving the program recommended

In May 1997, FIRE conducted a Leadership Training Program in the United States for certain members of the AMFI Board, senior officials of mutual funds and representatives of SEBI and the Ministry of Finance. One result of that training was a greater understanding of the need to create a "climate of compliance" and put the needs of unit holders first. Another result was a request by AMFI for further in-depth training seminars in mutual fund accounting and valuation (See Report of Mr. A. P. Kurian, Chairman of AMFI, July 1997).

In September 1997, AMFI adopted a Code of Ethics which had been prepared with the assistance of FIRE consultants Lewis J. Mendelson and R. N. K. Prasad and a Model Compliance Manual, which had been prepared with the assistance of FIRE consultants, Sandhya Bhate and R. N. K. Prasad.

In October 1997, SEBI requested the FIRE Project's assistance in training mutual fund inspectors.

In November 1997, Mr. Raj Dadoo of PW's Mutual Fund Services Department in New York delivered a series of well-attended seminars in Mumbai sponsored by the FIRE Project on Mutual Fund Accounting and Valuation.

III. FIRE RECOMMENDATIONS

Mr Mendelson's recommendations relate to four broad areas and are intended to

- Strengthen AMFI's internal organization
- Promote a climate of compliance
- Improve the credibility of the fund industry, and
- Promote wider public acceptance of mutual funds

More specifically FIRE recommends that AMFI

1. Strengthen and Sustain AMFI's Administration

In order to continue and to sustain its activities, take immediate steps to

- set goals, priorities and dates
- adopt a work plan, budget/financial plan and organizational chart
- raise the resources necessary to carry out its objectives, and
- hire a professional staff

2. Promote Compliance

- a. **Accounting and Valuation Standards.** AMFI needs to launch a structured effort to persuade SEBI and the Institute of Chartered Accountants to improve accounting and valuation standards relating to mutual funds and their guarantors
- b. **Update the AMFI Model Compliance Manual.** The AMFI Model Compliance Manual Should be updated and expanded to include any new SEBI Mutual Fund Regulations, the relevant portions of the SEBI Act of 1992 and the SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, October 1995, and the Companies Act
- c. **AMFI Compliance/Audit Inspection Program.** AMFI's members would benefit greatly if AMFI were to prepare an AMFI Compliance/Audit Inspection Program to assist in Mutual Fund Compliance Reviews
- d. **Conduct a Trustees Forum.** To facilitate trustees discussion and awareness of their role, responsibilities and potential liability and the methods, techniques and tools which they may call upon to assist them, AMFI should design and conduct an interactive Trustees Forum

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1. Improve Credibility

a. **Champion Investors' Interests.** AMFI should move dramatically to identify itself with investors' interests and to at the same time to deflect criticism of mutual funds by designing and implementing a program to identify and reduce obstacles to successful investing in the Indian Capital Market over which it has little or no control and from which it and all investors suffer. Among those obstacles on which it may wish to focus are

- lack of transparency
- illiquidity of the market
- poor clearing mechanisms
- speculativeness
- lack of a cash market
- weak corporate governance mechanisms
- regulator's role perception
- uncertainties arising from changes in government

Such a program would suggest that all members to take steps to combat such obstacles and would publicize steps taken by AMFI and its members and urge investors to support AMFI's efforts

b. **Study Guarantees.** Improve the credibility of the mutual fund industry by immediately commissioning an AMFI study of the status and funding of outstanding guarantees, including describing

- the duration
- due dates and
- extent of possible shortfalls of existing guarantees, and
- by recommending measures to assure that such guarantees
 - are appropriately accounted for on the books of the guarantors, and
 - will be timely met without the necessity of protracted negotiations or litigation when they fall due

4. Wider Public Acceptance

AMFI needs to take four concrete steps to promoting wider public acceptance of mutual funds

- a. **Performance Brochure.** Publish an AMFI Brochure on Mutual Fund Performance
- b. **Advertising Guidelines.** Adopt AMFI Model Advertising Guidelines
- c. **AMFI Website** Design and open an AMFI Website, and
- d. **Sales Agent Training** Design and carry out Sales Agent Training Programs focused not only on sales techniques and promotion, but also on registration

and certification of Sales Agents with a regulatory or self regulatory organization

IV. NEXT STEPS

A. AMFI

FIRE recommends that AMFI

1. Administration

In order to continue and to sustain its activities, AMFI should take immediate steps to

- set goals, priorities and dates
- adopt a work plan, budget/financial plan and organizational chart
- raise the resources necessary to carry out its objectives, and
- hire a professional staff

2. Public Acceptance

a. Appoint an Investors Advocacy Committee: To identify and reduce obstacles to successful investing in the Indian Capital Market and thereby identify itself as a champion of investors' interests, appoint an AMFI Committee to design, coordinate and implement this program

b. Fund and staff the Investors Awareness Committee. Instruct it to

- draft and publish an AMFI Brochure on Mutual Fund Performance,
- review and prepare recommendations to enable AMFI to circulate for adoption AMFI Model Advertising Guidelines (together with the AMFI Compliance Committee),
- publish an RFP for outside specialists to design, open and maintain an AMFI Website, and
- design and carry out Sales Agent Training Programs which include means of registering and certifying sales agents and their principals with a regulatory or self - regulatory organization

a. Appoint a Committee to Study the status of Mutual-Fund Guarantees.

Instruct it within 30 days to

- study the status and funding of outstanding guarantees, including describing
- the duration
- due dates and
- extent of possible shortfalls of existing guarantees, and
- recommend measures to assure that such guarantees

- are appropriately accounted for on the books of the guarantors, and
- will be timely met without the necessity of protracted negotiations or litigation when they fall due

◆ **3. Compliance**

a. Mutual Fund Accounting and Valuation. Instruct the AMFI Accounting and Valuation Committee to work with the Institute of Chartered Accountants to improve accounting and valuation standards for mutual funds and their guarantors,

b. Manuals, Guides and Training. Authorize the AMFI Compliance Committee to

- draft Phase Two of the AMFI Model Compliance Manual including updated SEBI Mutual Fund Regulations, the relevant portions of the SEBI Act of 1992 and the SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, October 1995, and the Companies Act,
 - prepare an AMFI Compliance/Audit Inspection Program to assist in Mutual Fund Compliance Reviews,
- ◇ design and execute a Trustees Forum, an interactive program to increase Mutual Fund Trustees' awareness of their role and responsibilities

B. SEBI

Mutual Fund Inspections. SEBI, upon review of the "*Report and Recommendations for Strengthening SEBI Inspections*," will determine what course it will follow with respect to mutual fund inspections. The FIRE Project stands ready to assist SEBI in this matter as it may wish or to work with SEBI to facilitate its regulation of the securities markets mutual funds and AMCs

December 10, 1997

Mr A P Kurian
Chairman
Association of Mutual Funds in India
c/o Apple Asset Management Ltd
38/39 Rajgir Chambers, 4th Floor
Shahid Bhagat Singh Road
Fort, Mumbai 400 023

Dear Mr Kurian

Re AMFI-FIRE Project 1998 Strategic Planning

As the year draws to its close, it seems a propitious time to review some of our achievements in light of the plans and goals which we agreed to earlier in the year and to develop a joint AMFI-FIRE Strategy for 1998 and beyond. That Strategy should include a sustainable structure which will enable AMFI to maximize and perpetuate the benefits of the technical assistance that FIRE offers and focused realizable programs which will best serve AMFI's and fund unit holders' needs.

As a start, we might use the FIRE Project Action Memorandum of February 6, 1997, copy attached, which was presented to the AMFI Board on or about that time. It offers a template against which to assess our accomplishments and define our future goals. It would facilitate our discussions if all board members could familiarize themselves with the Action Memorandum prior to the meeting.

You will note that, although still more can be done, substantial progress has been made in four of the seven recommendations contained in Section II of the Action Memorandum.

- ◆ Influencing the Regulatory Environment
- ◆ Promoting High Professional Standards
- ◆ Providing Guidelines and Training, and
- ◆ Taking the Lead in Investor Education

Of immediate overriding concern is the need to implement Mr Silver's primary recommendation, the rapid build-up of a high quality professional staff and taking the steps necessary to implement it (adopting an AMFI Work Plan, Organizational Chart and Financial Plan and Budget, and setting goals, priorities and dates). This structure

Mr A P Kurian
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December 10, 1997

should form the backbone for strengthening and sustaining AMFI and helping to facilitate the growth of the fund industry through its expertise in regulation, media relations, economic and statistical research and operations. USAID considers this a necessary precondition to the successful conclusion of the FIRE Project's assistance to AMFI.

As we have indicated, the FIRE Project is slated to wind-up in August 1998. There are many more worthwhile and important goals that remain to be achieved.

- ◆ In the area of Compliance, for example, we contemplate expansion of the AMFI Compliance Manual, Trustee Training, Revision of the AMFI Code of Ethics and adoption of the pending draft AMFI Advertising Guidelines, among other things.
- ◆ In the area of Investor Awareness, we contemplate working with AMFI's Investor Awareness Committee to help to structure AMFI's Sales Agent Training Program and to provide editorial assistance in the production of a Concise Guide to Mutual Fund Performance.
- ◆ In the area of Investor Protection, AMFI can position itself as the champion of Investors interests by promoting Transparency, not only among Mutual Funds, but by taking the lead in demanding greater transparency from all participants in its capital market and more effective distribution of that information, including by creating an AMFI Web Site.

Mr Grubb, Mr Prasad and I look forward to considering these concepts with the AMFI Board of Directors at your 10:30 A.M. meeting on Tuesday, December 16, 1997 at State Bank of India.

With warm personal regards,

Sincerely yours,

Lewis J Mendelson
Mutual Fund Consultant

Attachment: Action Memorandum of February 6, 1997

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Price Waterhouse LLP



December 19, 1997

Mr A P Kurian
Chairman
Association of Mutual Funds in India
c/o Apple Asset Management Ltd
38/39, Rajgir Chambers, 4th Floor
Shahid Bhagat Singh Road
Fort, Mumbai 400 023

Dear Mr Kurian

Re: FIRE Project Assistance to AMFI - Strategic Planning

Thank you for inviting us to the Board Meeting of AMFI held on December 16, 1997. It was our pleasure to participate in the discussions of the Board relating to future strategies of AMFI and particularly the role that AMFI would like to assume in influencing critical reforms in the other segments of capital market. Dr Nayak's eloquent presentation and Board's deliberations should help AMFI to identify itself in the public's mind as a champion of investors' interests and to evolve into a positive force in reforming India's Capital Market.

Our immediate concern is adoption by AMFI of a meaningful business plan along with a financial budget for the next 3 years. We would expect the business plan to focus on AMFI's long and short term objectives and goals and its immediate (next 1 year) plans and priorities. We would like to assure that AMFI has an effective strategy for raising the funds necessary to meet its objectives. This will enable AMFI to hire professional staff and set up the administrative functions necessary to sustain the program. The structure will then form the backbone in formulating various programs AMFI will like to undertake over the next two years and institutionalize the process AMFI and FIRE have already set in motion. In this connection we draw your attention to the letter dated December 10, 1997, addressed to you by Mr Lewis Mendelson and its enclosure which serves as a template to assess the accomplishments and set future goals.

As we informed your Board, the FIRE Project looks forward to continuing its technical assistance to AMFI in the areas we mutually agree upon. However, this assistance is contingent upon AMFI adopting a business plan and hiring professional staff to implement its strategic plan. As indicated to you, the FIRE Project is slated to wind-up in August 1998. Therefore, it is necessary that we immediately draw an agenda for FIRE's assistance to AMFI in the next 8 months. As soon as you are ready with your business plan, we would be happy to meet with you to consider such an agenda.

With warm personal regards,

Sincerely yours,

W DENNIS GRUBB
CHIEF OF FIRE PARTY

December 18, 1997

Mr. A. P. Kurian
Chairman, Association of Mutual Funds in India ("AMFI")
Apple Asset Management Ltd.
38/39, Rajgir Chambers, 4th Floor
Shahid Bhagat Singh Road
Fort, Bombay - 400 023

**Subject: Results of the AMFI Mutual Fund Compliance Workshop
"Meeting our Professional Responsibilities" December 4-5, 1997**

Dear Mr. Kurian:

At the request of the Association of Mutual Funds in India ("AMFI"), Price Waterhouse LLP (PW) presented a workshop on *Mutual Fund Compliance - "Meeting Our Professional Responsibilities,"* on December 4-5, 1997. This workshop was designed and delivered under the USAID-sponsored Financial Institutions Reform and Expansion (FIRE) project to provide a broad compliance framework for issues related to mutual funds in India. To that end, CEOs, managing directors, COOs and compliance officers from asset management companies (AMCs) were invited to participate in the workshop. The workshop's further purpose was to facilitate the implementation of the AMFI Compliance Manual and to ensure industry compliance with the Securities Exchange Board of India's 1996 Mutual Fund Regulations.

In total, 53 representatives of 26 AMCs, including 14 CEOs / MDs, attended the workshop's opening ceremonies and keynote address, and participated in a moderated case discussion highlighting key compliance issues. The balance of the workshop was attended by 34 professionals, mostly serving as the compliance officers of their respective AMCs.

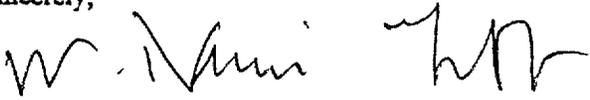
The workshop was delivered by a host of industry consultants and practitioners. Among the presenters and panelists from the local industry were:

- Mr. K. N. Vaidyanathan, Morgan Stanley Growth Fund
- Mr. S. V. Prasad, JM Mutual Fund
- Mr. L. Vedanarayanan, JM Mutual Fund
- Mr. P. C. Singh, Morgan Stanley Growth Fund
- Mr. P. Ghosh, PW India
- Mr. Ajai Kaul, Alliance Mutual Fund
- Mr. S. Haribhakti, Haribhakti & Co

Also serving as presenters were Ms. Anjali Karnat of Price Waterhouse - New York's Regulatory Compliance Practice and PW FIRE Project consultants Lewis Mendelson, R. N. K. Prasad, Sandhya Bhate, and Mariann Kurtz. The workshop also benefited by the participation of Mr. Pratap Kar of SEBI who represented the interests of the regulator.

Feedback from workshop participants (both formal and informal) was very positive. Nearly all participants were satisfied with the workshop and all found it relevant to their work. Results of written evaluations completed by the participants including recommendations for potential, future workshops are included in the enclosed report. If you have any questions, please do not hesitate to contact me at (022) 496-3599. Thank you.

Sincerely,

A handwritten signature in black ink, appearing to read "W. Dennis Grubb". The signature is written in a cursive style with a large, stylized "W" and "D".

W. Dennis Grubb
Principal Consultant Capital Markets

1. RESULTS FROM THE AMFI MUTUAL FUND COMPLIANCE WORKSHOP "Meeting our Professional Responsibilities"

The Price Waterhouse FIRE Project in conjunction with AMFI sponsored a two-day training workshop on Mutual Fund Compliance entitled "Meeting our Professional Responsibilities". The workshop was delivered on December 4th and 5th at the Taj Mahal Hotel in Mumbai.

The overarching objective of the workshop was to provide a broad compliance framework for issues related to mutual funds in India. Specific objectives of the workshop were to promote and facilitate the implementation of the AMFI Compliance Manual, ensuring industry compliance with SEBI's Mutual Fund Regulations of 1996.

1.1 Workshop Participants

The workshop was organized in two parts, the first provided an overview of compliance and its importance to industry growth, and the second focused in greater detail on the role of the compliance officer and specific compliance issues. Given the two-part structure of the workshop, chief executive officers, managing directors, chief operating officers, and compliance officers from asset management companies were invited to participate. In total, 53 representatives from 26 AMCs, including 14 CEOs / MDs, attended the workshop's opening ceremonies and keynote address, and participated in a moderated case discussion highlighting key compliance issues. The balance of the workshop was attended by 34 professionals, mostly serving as the compliance officers of their respective AMCs (please see Appendix A for a list of participants).

1.2 Workshop Content and Materials

The workshop was implemented through a variety of training methodologies including presentations by industry leaders and consultants, panel discussions by industry practitioners, and a moderated case study was used to highlight and facilitate debate around key compliance issues. The main topics of the workshop included:

- Compliance as the Foundation to Industry Growth
- Case Study on Critical Compliance Issues
- The Role of the Compliance Officer
- Investment Management and Compliance Issues
- Scheme Launch and Investor Services
- Preparing for an Inspection

Each participant received a binder of course materials which were also displayed on screen during formal presentations. These materials along with summary points of speeches or panelists' remarks are enclosed in Appendix B to this report. In addition, each participant received a copy of the AMFI Compliance Manual and the AMFI Code of Ethics.

1.3 Trainers

The workshop was delivered by a host of industry consultants and practitioners. Opening remarks were

given by Mr Dennis Grubb and Mr Lew Mendelson of the PW FIRE Project and Mr A P Kurian, Chairman of AMFI. Mr Pratap Karr of SEBI delivered the keynote address. Among the presenters and panelists from the local industry were

- Mr K. N. Vaidyanathan, Morgan Stanley Growth Fund
- Mr S.V. Prasad, JM Mutual Fund
- Mr. L. Vedanarayanan, JM Mutual Fund
- Mr. P. C. Singh, Morgan Stanley Growth Fund
- Mr P. Ghosh, PW India
- Mr Ajai Kaul, Alliance Mutual Fund
- Mr S. Haribhakti, Haribhakti & Co

Also serving as presenters were Ms Anjali Kamat of Price Waterhouse - New York's Regulatory Compliance Practice and PW FIRE Project consultants R.N.K. Prasad, Sandhya Bhate, and Mariann Kurtz.

1.4 Evaluations Results

Each participant who completed both days of the workshop was asked to complete an evaluation at the conclusion of the workshop. Thirty-three responses were received and the results have been tabulated and summarized in Appendix C. Overall, the participants were satisfied (96%) with the workshop and all (100%) found the objectives of the workshop to be relevant to their roles and responsibilities.

Several participants also commented on how the workshop helped them understand the importance of the compliance function and gain a deeper knowledge as to the role and responsibilities of the compliance officer. "Compliance as a serious business is a new trend and helps us to think more clearly and schedule accordingly," wrote one participant. Others stated, "It [the workshop] will help me to develop my role and responsibility in the organization and improve the system." "It definitely has helped us to make a better team of compliance and not just sign off all documents without proper evidence of documentation."

Topics which were noted as most helpful to participants include the Role of the Compliance Officer, Scheme Launch and Investor Services, and Compliance as the Foundation for Industry Growth. Topics deemed least effective in assisting participants in understanding the subject matter also include Scheme Launch and Investor Services and Investment Management. This result (the same session being noted as most helpful and least effective at the same time) illustrates that there is a wide range of experience and knowledge among the compliance officers. The respondents further echoed this finding by requesting additional training workshops with time allowed for detailed discussions of key compliance topics and more access to SEBI officers in order to discuss areas of regulation which remain ambiguous.

1.5 Recommendations for future training programs

As noted above, participants made a strong call for additional training programs. Their recommendations for additional programs may be summarized in four categories:

- Provide workshops to address areas of compliance/regulations that are vague or require further clarification
- Create working groups of compliance officers and SEBI officers
- Provide training to trustees

- Provide and package materials to facilitate onward training within AMCs

1.5.1 Provide workshops to address areas of compliance/regulations that are vague or require further clarification.

One of the participants said it best, "Compliance as a serious business is a new trend." Compliance officers as well as AMC managers are still internalizing the SEBI regulations and need both SEBI support and access to clarifications, rulings, etc. to best ensure compliance. To that end, participants are looking to SEBI and AMFI to structure and provide additional training programs. In order to be most responsive to this need, AMFI should poll AMC managers and compliance officers to determine which topics or areas of regulation in particular should be addressed. Further insights into common problem areas related to compliance may be found in the results from the FIRE Project sponsored Workshop on Mutual Fund Inspections delivered for SEBI inspection staff and external chartered accountants serving as inspectors.

1.5.2. Create working groups of compliance officers and SEBI officers

Noting the valuable contribution made by Mr. Pratip Kar during the past workshop, participants have asked for more participation and partnership with SEBI in future workshops. Participants have suggested the formation of working groups to dissect, discuss and analyze practical compliance problems. Further it is hoped that through such working groups better understanding of regulations may be accomplished which will result in standardized procedures and ultimately better compliance. Participants also liked the case discussion and requested additional case studies to be included in future workshops as fodder for the working groups.

1.5.3 Provide training to trustees

Participants of the workshop quickly noted the need for trustees to take a more active role in oversight and compliance issues. Unfortunately, participants noted that the relationship between compliance officers and trustees is often a weak or little used link. They also reported that the role of the compliance officer often is not fully understood and therefore afforded limited power and scope within the AMC. To address these concerns, participants have made two suggestions:

a) AMFI should draft a letter clarifying and standardizing the basic roles and responsibilities of the compliance officer. This letter should be shared with all officers of the AMC and the Trustees

B) A separate training workshop should be prepared for trustees and include a discussion of compliance. FIRE Project consultants currently are discussing such a workshop with officers of AMFI and SEBI. A useful way to facilitate discussion of compliance issues and procedures would be to invite a presentation by a representative panel of AMC officers and compliance officers during the workshop.

1.5.4 Provide and package materials to facilitate onward training within AMCs

Participants of the workshop were anxious to share training materials and hold discussions with their colleagues. To facilitate onward training within AMCs, AMFI should formalize its training outreach programs and provide materials in both hard and soft copies to workshop participants. To the extent available the FIRE Project will provide electronic versions of presentation materials to AMFI for further distribution. A further step in this process would be to identify a team of trainers within the industry who may be called upon to train others. Using a train-the-trainer approach, the FIRE Project could potentially make available a series of additional seminars which could then be replicated by local trainers.

December 18, 1997

Mr. Pratip Kar
Executive Director
Securities and Exchange Board of India ("SEBI")
Mittal Court B
Mumbai, India

• **Subject:** Results of the SEBI Mutual Fund Inspection Workshop, December 15, 1997
"Quality Control and Consistency in Mutual Fund Inspections:
Insights from the US SEC Inspection Process"

Dear Mr. Kar:

At the request of the Securities and Exchange Board of India, Price Waterhouse LLP (PW) presented a workshop on Mutual Fund Inspections entitled "Quality Control and Consistency in Mutual Fund Inspections: Insights from the US SEC Inspection Process". This workshop was delivered on December 15, 1997, for SEBI inspection officials and representatives of chartered accounting firms who conduct mutual fund inspections on SEBI's behalf. The workshop was sponsored by the USAID-Price Waterhouse Financial Institutions Reform and Expansion (FIRE) project.

The objective of the workshop was to aid in creating greater quality control and consistency to SEBI inspections of Indian mutual funds. To that end, the workshop highlighted the structure and best practice of the United States Securities and Exchange Commission in order to apply lessons learned and common tools to SEBI inspections. Ms. Anjali Kamat, a former US SEC inspector and current Price Waterhouse consultant serving in the New York-based Regulatory Compliance practice, served as the workshop's main presenter. In particular, Ms. Kamat presented an overview of the SEC highlighting the role of the inspection department and provided a comprehensive outline and discussion of the structure of the SEC inspection process.

Ms. Kamat was joined by FIRE Project consultants Mr. Lewis Mendelson, Mr. RNK Prasad, Ms. Sandhya Bahate and Ms. Mariann Kurtz to lead discussion on key inspection issues such as best price and execution, personal trading and front running, trade allocation, transaction with associates, portfolio review, accounting and valuation, and customer servicing.

Based on participant evaluations, the workshop was very well received. Nearly all participants (94%) were satisfied with the workshop and all (100%) reported that it was relevant to their roles and responsibilities. Of the 34 participants, 12 were SEBI officers. The balance represented 21 chartered accounting houses.

A complete summary of participant evaluations and their suggestions for potential future workshops are included in the enclosed report. If you have any questions, please do not hesitate to contact me at (022) 496-3599. Thank you.

Sincerely,

W. Dennis Grubb
Principal Consultant Capital Markets

Principal Consultant Capital Markets

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1. RESULTS FROM THE SEBI MUTUAL FUND INSPECTION WORKSHOP

Quality Control and Consistency in Mutual Fund Inspections. Insights from the US SEC Inspection Process

The Price Waterhouse FIRE Project in conjunction with SEBI sponsored a workshop on Mutual Fund Inspections entitled "Quality Control and Consistency in Mutual Fund Inspections Insights from the US SEC Inspection Process on December 15, 1997, at the Taj Mahal Hotel in Mumbai. The objective of the workshop was to foster greater quality control and consistency in SEBI inspections of Indian mutual funds. To that end, the workshop highlighted the structure and best practice of the United States Securities and Exchange Commission in order to apply lessons learned and common tools to SEBI inspections.

1.1 Workshop Participants

The workshop was designed for SEBI officers working with mutual funds or more broadly in the inspections and surveillance divisions. In addition, professionals from chartered accounting firms who conduct mutual inspections on SEBI's behalf were invited. In total, 34 professionals attended the workshop including 12 SEBI officers. The balance of the participants represented 21 chartered accounting houses (out of the 28 firms invited at SEBI's request). A full list of participants is provided in Appendix A.

1.2 Workshop Content and Materials

The workshop combined both presentations and working groups to cover a variety of topics and discussion points. The main topics included:

- Why inspect: Goals philosophy and responsibilities
- Overview of the US SEC
- Structure of the inspection process
- Review of documentation given to the board of trustees
- Overview of key inspection issues including: best price and execution, personal trading and front running, trade allocation, transaction with associates, portfolio review, accounting and valuation, and customer servicing.

Each topic was addressed through presentation / lecture with time allowed for question and answers. Course materials were prepared on each topic and were given in a binder to participants and displayed on screen during the presentations. A complete set of course materials is provided in Appendix B. Participants were also given a copy of the AMFI Compliance Manual.

Working groups were also formed among the participants to discuss in greater detail inspection issues related to best price and execution, transaction with associates, and front running and personal trading. Each group was asked to discuss and present tools currently used to inspect these areas, limitations to affecting thorough investigations in these areas and spheres of regulation which required further clarification by SEBI. The findings of the working groups are captured below in section 1.5 Recommendations.

1.3 Trainers

Ms Anjali Kamat, a former US SEC inspector and current Price Waterhouse consultant serving in the New York-based Regulatory Compliance practice, served as the workshop's main presenter. In particular, Ms. Kamat presented the overview of the SEC highlighting the role of the inspection department and provided a comprehensive outline and discussion of the structure of the SEC inspection process.

FIRE Project director Dennis Grubb gave opening remarks and Mr Lewis Mendelson, a 30 year veteran of the SEC and current FIRE Project consultant, set the tone for the workshop discussion the goals, philosophy and responsibilities of the inspection process and the inspector FIRE Project consultants Mr. RNK Prasad, and Ms Sandhya Bahate gave presentations on key inspection issues and Ms. Mariann Kurtz facilitated the working groups and their subsequent discussions

1.4 Evaluations Results

Each participant was asked to complete an evaluation at the conclusion of each workshop Tabulated and summarized results from each of the three sessions are attached in Appendix C All (100%) participants reported that the objectives of the workshop were relevant to their roles and responsibilities and nearly all (94%) were satisfied with the workshop

Participants particularly acknowledged the benefit of bringing together the disparate group which performs SEBI inspections. Among the comments to this point were

It was useful and thought-provoking It is the first interchange of ideas between auditors

An excellent opportunity to share our experience of inspection with others and gain more from the other inspectors

Good exposure, broadening the perspective, sharing the global experiences was very satisfying

The specific topics deemed most useful by the participants were Structure of the Inspection Process and the Overview of Key Inspection Issues which covered seven specific areas of inspection Still participants noted a desire for more detail and the application of such detailed discussions to the Indian context. Thus participants reported their desired to participate in additional training workshops

Topics most cited for inclusion in future workshops are transactions with associates, front running and personal trading, structure of the inspection process and the use of actual case studies encapsulating such issues Participants endorsed using a variety of workshop formats including a series of half day workshops each devoted to a single topic, one or two large workshops covering many topics and the establishment of working groups / committees devoted to improving procedures and testing methodologies

1.5 Recommendations

The participants almost unanimously (94%) endorsed the need for a standardized routine inspection structure They cited increased transparency and accountability as benefits of standardization Participants also noted areas which should be included in a standardized routine inspection (in addition to those covered in the workshop) Among these areas are investment decisions and NAV calculation coupled with the authority to inspect brokers' books

Related recommendations resulted from the working group discussions. As noted above, each group was asked to consider current limitation to effective testing and inspection in the group's given area and in which regulatory spheres related to the topic would they like further clarification/interpretation from SEBI. Results of each group are presented below

1.5.1 Transactions with Associates

Participants reported difficulty in defining and gaining information on group companies like Tata. They believe the definition of associate is not clearly defined by SEBI regulations which hampers their ability to test for compliance in relation to transactions completed with such companies. Additionally, it is difficult to gain information from private limited companies and even more difficult to uncover the often multi-layered structure of such firms. Finally, inspectors reported that the company secretary seems to be the only point of information distribution which again limits their understanding of the company's structure and dealings and therefore their ability to test for compliance.

Participants in this group would like SEBI to further clarify its definition of associates and review that definition for possible consistency with the company's act.

1.5.2 Front Running and Personal Trading

Common limitations cited by participants in this group include the inability to trade Be naam transactions, lack of cooperation and disclosure from key persons and the inability to affect third-party checks on trades of key persons. The group noted suggestions from Ms. Kamat's presentations suggesting that the use of investment committees and access to notes and procedures of such committees would help overcome these limitations. Also the outside inspectors noted that they do not have within their purview the right to inspect brokers' books. This limits their ability as well to fully track and test sample trades. Similar to the first group, these participants also called for SEBI to clarify the definition of associates. Further they cite the need to extend the definition to related parties and to cover associates of associates.

1.5.3 Best Price and Execution

Testing for best price and execution is most hindered by the inability of inspectors to access information on intra-day positions taken by brokers. Further they report difficulty to access data on spot trades, off-market trades and hand delivery. They also do not have access to data regarding delivery contracts on exchanges other than the NSE and BSE and will look to SEBI to help in obtaining it. This group would like further clarifications from SEBI on off market and spot deals.

Price Waterhouse LLP



March 17, 1998

Mr Pratip Kar
Executive Director
Securities and Exchange Board of India ("SEBI")
Mittal Court B
Mumbai, India

Subject: Report and Recommendations on Strengthening SEBI Mutual Fund Inspections

Dear Mr Kar

At the request of the Securities and Exchange Board of India (SEBI), Price Waterhouse FIRE project designed and on December 15, 1997 presented a Workshop for SEBI Inspectors on Mutual Fund Inspections entitled "*Quality Control and Consistency in Mutual Fund Inspections Insights from the US SEC Inspection Process*"

The objective of the workshop was to aid in creating greater quality control and consistency to SEBI inspections of Indian mutual funds. To that end, the workshop highlighted the structure and best practice of the United States Securities and Exchange Commission (SEC) in order to apply lessons learned and common tools to SEBI inspections. Ms Anjali Kamat, a former US SEC inspector and current Price Waterhouse consultant serving in the New York-based Regulatory Compliance practice, served as the workshop's main presenter. In particular, Ms Kamat presented an overview of the SEC highlighting the role of the inspection department and provided a comprehensive outline and discussion of the structure of the SEC inspection process.

Ms Kamat was joined by FIRE Project consultants Mr Lewis Mendelson, Mr RNK Prasad, Ms Sandhya Bahate and Ms Mariann Kurtz to lead discussion on key inspection issues such as best price and execution, personal trading and front running, trade allocation, transaction with associates, portfolio review, accounting and valuation, and customer servicing.

The attached report contains a discussion of the Strengths of the US SEC Inspection Process, Participants' Perception of the SEBI Inspection Process and Recommendations for SEBI to strengthen its Mutual Fund Inspection Program. Principal Recommendations include



- **Develop a cadre of professional inspectors within SEBI for the conduct of mutual fund and AMC inspections**
- **Develop key tools, including an Inspection Manual, for quality control and consistency in the inspection process**
- **Provide a standardized inspection process**
- **Provide initial and ongoing training for inspectors**
- **Register the AMC**
- **Impose individual supervisory responsibility**

These recommendations are intended to continue the process that SEBI has begun to strengthen market surveillance practices in India. PW/FIRE is willing to support SEBI's efforts in this area by providing assistance in any way SEBI finds desirable.

If you have any questions, please do not hesitate to contact me at (022) 496-3599.
Thank you

Sincerely,

A handwritten signature in black ink that reads "W. Dennis Grubb". The signature is written in a cursive, slightly slanted style.

W. Dennis Grubb
Principal Consultant Capital Markets

1. BACKGROUND

At the request of the Securities and Exchange Board of India (SEBI), Price Waterhouse FIRE project designed and on December 15, 1997 presented a Workshop for SEBI Inspectors on Mutual Fund Inspections entitled "*Quality Control and Consistency in Mutual Fund Inspections Insights from the U S SEC Inspection Process*"

At the onset of the design stage of the Workshop PW/FIRE met with Mr Pratip Kar, Executive Director of SEBI, who suggested the following topics to be addressed during the SEBI Workshop

- key areas of review and test checks to be conducted during a mutual fund inspection
- structure of an inspection
- structure of the inspection report and deficiency letter
- inspection follow up procedures
- interview techniques
- types of inspections (routine/cause inspections)
- SEC interpretation of certain statutes such as 5% and 10% diversification requirements

PW/FIRE also met with internal SEBI Inspectors, visited a mutual fund and obtained feed back from Compliance Officers during the AMFI seminar on "*Mutual Fund Compliance*" of December 4 and 5, 1997, all of which assisted in the preparation of the SEBI Workshop.

The Workshop was attended by 12 SEBI inspection officials and representatives of 21 chartered accounting firms

Certain observations on SEBI's current processes based on dialogue with SEBI internal and external inspectors during the Workshop are discussed in this report. In addition, appended to this report are exhibits that are designed to assist SEBI in creating tools that would strengthen the structure and processes of its inspection program

2. RESULTS FROM THE SEBI MUTUAL FUND INSPECTIONS WORKSHOP

Quality Control and Consistency in Mutual Fund Inspections: Insights from the US SEC Inspection Process

The Price Waterhouse FIRE Project in conjunction with SEBI sponsored a workshop on Mutual Fund Inspections entitled "Quality Control and Consistency in Mutual Fund Inspections Insights from the US SEC Inspection Process" on December 15, 1997, at the Taj Mahal Hotel in Mumbai. The objective of the workshop was to foster greater quality control and consistency in SEBI inspections of Indian mutual funds. To that end, the workshop highlighted the structure and best practice of the United States Securities and Exchange Commission in order to apply lessons learned and common tools to SEBI inspections.

2.1 Workshop Participants

The workshop was designed for SEBI officers working with mutual funds or more broadly in the inspections and surveillance divisions. In addition, professionals from chartered accounting firms who conduct mutual inspections on SEBI's behalf were invited. In total, 34 professionals attended the workshop including 12 SEBI officers. The balance of the participants represented 21 chartered accounting houses (out of the 28 firms invited at SEBI's request). A full list of participants is provided in Appendix A.

2.2 Workshop Content and Materials

The workshop combined both presentations and working groups to cover a variety of topics and discussion points. The main topics included:

- Why inspect: Goals philosophy and responsibilities
- Overview of the US SEC
- Structure of the inspection process
- Review of documentation given to the board of trustees
- Overview of key inspection issues including: best price and execution, personal trading and front running, trade allocation, transaction with associates, portfolio review, accounting and valuation, and customer servicing.

Each topic was addressed through presentation / lecture with time allowed for question and answers. Course materials were prepared on each topic and were given in a binder to participants and displayed on screen during the presentations. A complete set of course materials is provided in Appendix B. Participants were also given a copy of the AMFI Compliance Manual.

Working groups were also formed among the participants to discuss in greater detail inspection issues related to best price and execution, transaction with associates, and front running and personal trading. Each group was asked to discuss and present tools

currently used to inspect these areas, limitations to affecting thorough investigations in these areas and spheres of regulation which required further clarification by SEBI. The findings of the working groups are captured below in section 2.5 Recommendations.

2.3 Trainers'

1. Ms. Anjali Kamat, a former US SEC inspector and current Price Waterhouse consultant serving in the New York-based Regulatory Compliance practice, served as the workshop's main presenter. In particular, Ms. Kamat presented the overview of the SEC highlighting the role of the inspection department and provided a comprehensive outline and discussion of the structure of the SEC inspection process.

FIRE Project director Dennis Grubb gave opening remarks and Mr. Lewis Mendelson, a 30 year veteran of the SEC and current FIRE Project consultant, set the tone for the workshop discussion the goals, philosophy and responsibilities of the inspection process and the inspector. FIRE Project consultants Mr. RNK Prasad, and Ms. Sandhya Bhate gave presentations on key inspection issues and Ms. Mariann Kurtz facilitated the working groups and their subsequent discussions.

2.4 Evaluations Results

Each participant was asked to complete an evaluation at the conclusion of each workshop. Tabulated and summarized results from each of the three sessions are attached in Appendix C. All (100%) participants reported that the objectives of the workshop were relevant to their roles and responsibilities and nearly all (94%) were satisfied with the workshop.

Participants particularly acknowledged the benefit of bringing together the disparate group which performs SEBI inspections. Among the comments to this point were:

It was useful and thought-provoking. It is the first interchange of ideas between auditors.

An excellent opportunity to share our experience of inspection with others and gain more from the other inspectors.

Good exposure, broadening the perspective, sharing the global experiences was very satisfying.

The specific topics deemed most useful by the participants were Structure of the Inspection Process and the Overview of Key Inspection Issues which covered seven specific areas of inspection. Still participants noted a desire for more detail and the application of such detailed discussions to the Indian context. Thus participants reported their desired to participate in additional training workshops.

Topics most cited for inclusion in future workshops are transactions with associates, front

running and personal trading, structure of the inspection process and the use of actual case studies encapsulating such issues. Participants endorsed using a variety of workshop formats including a series of half day workshops each devoted to a single topic, one or two large workshops covering many topics and the establishment of working groups / committees devoted to improving procedures and testing methodologies.

2.5 Recommendations

The participants almost unanimously (94%) endorsed the need for a standardized routine inspection structure. They cited increased transparency and accountability as benefits of standardization. Participants also noted areas which should be included in a standardized routine inspection (in addition to those covered in the workshop). Among these areas are investment decisions and NAV calculation coupled with the authority to inspect brokers' books.

Related recommendations resulted from the working group discussions. As noted above, each group was asked to consider current limitations to effective testing and related areas needing further clarification/interpretation from SEBI. Results of each group are presented below.

2.5.1 Transactions with Associates

Participants reported difficulty in defining and gaining information on group companies. They believed the term "associate" is not clearly defined by SEBI regulations. Additionally, they cited the need to extend the definition to related parties and to cover associates of associates. Furthermore, participants would like SEBI to review the definition of associate for consistency with other regulations. Participants commented on the difficulty to gain accurate information on a firm's affiliates since they rely on the firm to provide such a list.

2.5.2 Front Running and Personal Trading

Common limitations cited by participants in this group include the inability to identify all key personnel. Participants suggested that firms should be required to maintain a register listing key personnel similar to the requirement in the Companies Act. Additionally, participants discussed their inability to obtain all transactions for key personnel and their relatives due to the lack of cooperation and disclosure from key persons and the inability to affect third-party checks on trades of key persons. Also, the outside inspectors noted that they do not have within their purview the right to inspect brokers' books for any transactions of key personnel. This limits their ability to fully track trades and test for front running.

2.5 3 Best Price and Execution

Testing for best price and execution is most hindered by the inability of inspectors to access information on intra-day positions taken by brokers. They do not have convenient access to trading data on exchanges other than the NSE and BSE and will look to SEBI to help in obtaining it. Additionally, since off market deals are not properly documented by mutual funds, it is difficult to check for best price and execution with respect to such deals.

3. STRENGTHS OF THE US SEC INSPECTION PROCESS

The United States Securities and Exchange Commission (SEC), established in 1934, has developed into a powerful regulatory body which effectively monitors its securities markets. Crucial to the success of its surveillance process is the role played by the SEC's inspection staff which monitors the activities of investment companies, investment advisers, transfer agents, broker-dealers and self-regulatory organizations. The Inspection staff, consisting of the Office of Compliance Inspections and Examinations (OCIE) in Washington and the Regional and District inspection teams, plays a vital role not only in ensuring that the interests of investors are protected, but also in providing the SEC with insights into the activities of the industry which are valuable in the SEC's rule-making process.

The SEC has developed its own cadre of professional inspectors and does not rely on outside inspectors to conduct inspections of mutual funds and AMCs. An internal inspection staff and the structure of the SEC's inspection process provides numerous benefits such as:

- **Expertise:** A dedicated inspection staff with a specialized function of conducting inspections of mutual funds and AMCs. Since the only function of the SEC mutual fund inspector is to conduct inspections of mutual funds, the level of expertise in inspection techniques and subject matter increases significantly and enables the inspector to keep abreast of all issues regarding the mutual fund industry and its practices.
- **Structure:** A well thought out and structured inspection process that is followed by all inspectors. The pre-inspection, the inspection and the post-inspection process are standardized, well documented and uniformly followed.
- **Consistency:**
 - in areas reviewed and techniques utilized during an inspection. The Inspection Manual is an important tool in ensuring uniformity in the areas reviewed during the inspection.
 - in interpreting regulations. This is made possible by resources available to the inspection staff which include:
 - Internal non-public interpretive positions circulated on an ongoing basis to all members of the inspection staff which assist in understanding and uniformly interpreting regulation that may be unclear.
 - Team leaders within the branch who are devoted to the training and development of the inspection staff.

- A liaison at OCIE in Washington for the inspection staff of each regional and district office, who clarifies regulations and policy and provides guidance with reference to specific issues noted during an inspection
- **Quality Control:** Assurance of the quality of an inspection and accuracy of deficiencies cited result from the multi-layer internal review process within the SEC
- **Institutional Learning:** Realization of the benefits of institutional learning including the.
 - **Training:** Ability to provide effective initial and ongoing training in order to maintain the level of quality in the inspection process
 - **Rule-making:** Ability to easily transfer industry observations made during the inspection process into the rule-making process
 - **Focus:** Ability to change the focus of inspections in response to shifting industry trends or concerns.
 - **Sensitivity:** Sensitivity to change and the ability to react quickly to observations made in the industry
 - **Resources:** Library of resources and reference materials created that provides guidance to the inspectors during the inspection process For example, internal interpretive positions, case studies and training materials utilized during formal training sessions, information that provide an understanding of on industry practices and operations
 - **Pre-Inspection Materials:** Significant background materials available on the firm being inspected which enables the inspector to gain knowledge about the firm and any conflicts of interests before the inspection commences The background materials reviewed include:
 - all filings with the SEC
 - list of affiliated persons/firms
 - dates of prior inspections
 - deficiencies noted during prior inspections
 - disciplinary action against firm/firm personnel, employment history of firm personnel
 - **Other Records:** Access to broker-dealer, transfer agent, investment adviser filings and any corporate records filed as a result of exchange requirements

4. PARTICIPANTS' PERCEPTION OF THE SEBI INSPECTION PROCESS

During our Workshop conducted for SEBI internal and external inspectors, we described in detail the structure of an SEC inspection and key areas of review in a mutual fund inspection. A common reaction to our presentation was that SEBI inspections are not so different from SEC inspections, except that SEC has an internal inspection staff and SEBI uses external inspectors. However, based upon discussions with the Workshop participants and limited discussions with industry representatives, it is apparent that there are material differences between the processes and structure of the SEC versus those of SEBI.

The observations discussed in the following section regarding the structure of SEBI and its inspection processes are based on discussions with SEBI inspectors and their perception of the inspection process. We have not had an opportunity to review the SEBI inspection process first-hand and would like to visit these issues with SEBI to understand the current processes in place and the tools and resources available to inspectors conducting mutual fund inspections.

We recognize that SEBI, due to resource constraints, uses external inspectors to conduct mutual fund and AMC inspections, however, various observations discussed point to the need for SEBI to develop an internal inspection department. Some of the disadvantages of having an external inspection staff were brought out as a result of discussions conducted during our Workshop. These include

- **Structure:** There is need for a structured inspection process with defined pre-inspection, inspection and post-inspection processes. A structured inspection brings tremendous benefits to the effectiveness of a monitoring process and leaves a trail of useful information for the regulator.
- **Uniformity:** External inspectors from different chartered accounting firms conduct mutual fund and AMC inspections differently. Thus, due to structural constraints it is difficult for SEBI to maintain uniformity in the inspection process. From one chartered accounting firm to another, there are
 - Differences in documents requested when reviewing a particular issue
 - Differences in the areas reviewed during an inspection
 - Differences in the depth of review of each issue
 - Differences in testing methodologies utilized
- **Pre-Inspection Process:** There is a need for background materials on the mutual fund and AMC to be reviewed prior to the commencement of an inspection. If SEBI inspectors review offer documents, lists of affiliates and any other filings that are made with SEBI, the inspection process will more effective and focused on areas of risk in the mutual fund and AMC.

- **Training:** There is a need for initial and ongoing training for external inspectors to ensure the uniformity and quality of mutual fund and AMC inspections. Although the chartered accounting firms have on the job training and a certain amount of formal training, the level and type of training differs from firm to firm. Training is an essential component of ensuring that effective and thorough inspections are conducted by inspectors
- **Regulatory Approach:** There is a need for a compliance oriented approach during a mutual fund inspection. Based on certain questions posed during the Workshop it appeared that external inspectors do not define their role as that of a compliance inspector who is supposed to conduct a general compliance review and comment on regulatory, prospectus and internal controls compliance. For example, an external inspector questioned if the poor performance of a growth fund should be mentioned in the inspection report when the fund is performing worse than the market even though there is no breach in investment objectives and/or the types of securities investments made by the fund manager based on disclosures in the offer document. It appeared that the external inspector viewed his role, in this case, as a judge of the portfolio manager's decision making capabilities rather than simply ensuring that investment decisions had been made in accordance with stated investment objectives and disclosures in the offer document.
- **Professional Conflict:** As expressed during the Workshop, there is a sense of hesitancy felt by an external SEBI Inspector if he has to comment on the work of a fellow chartered accountant that has signed off on a document due to the "professional courtesy" typically extended between peers
- **Comprehensive Review:** Recognizing the issue of confidentiality, SEBI has restricted the request and review of documents by external inspectors to documents of the mutual fund and AMC. However, in certain instances, this restriction results in the inability of the inspector to get a complete picture relating to transactions occurring between a mutual fund, its sponsor and any affiliated entities
- **Predictable Cycle of Inspections:** Currently, SEBI mutual fund inspections appear to be conducted on a predictable cycle each year (typically during the months of January through March). The disadvantages of a predictable inspection cycle are:
 - firms have the opportunity to clean up their books in anticipation of the SEBI inspection.
 - the regulator cannot benefit from continuous and staggered information on the industries activities.

5. RECOMMENDATIONS

5.1 **Internalize the Inspection Process:** Our principal recommendation is that SEBI internalize its inspection staff and develop a cadre of professional inspectors within SEBI that conduct mutual fund and AMC inspections

5.2 **Provide Key Inspection Tools:** SEBI can provide key tools for quality control and consistency in the inspection process. These would include:

A. **An Inspection Manual** which provides the inspector a "road map" of how to conduct an inspection. An Inspection manual will bring uniformity and quality control to the inspection process. Additionally, it will serve as a training tool for new inspectors (See recommended "Mutual Fund Inspection Manual Outline" attached as Exhibit B).

B. **Databases or files** containing information available in various SEBI departments. The databases will form an effective pre-inspection tool to gather information on affiliates, prior deficiencies, disciplinary actions, etc. Examples of databases that can be developed are:

- all information a firm/person has filed with SEBI. This will provide an effective pre-inspection tool since all information filed with SEBI by a particular firm and its affiliates would be accessible in one database or file.
- database or a file that tracks deficiencies cited and disciplinary action taken relating to a firm or a person.

C. **A Standardized pre-inspection process** which requires the inspector to review certain documentation on the firm prior to the commencement of the inspection (See Item III in Mutual Fund Inspection Manual Outline attached as Exhibit B)

D. **A Standard Request List** with containing basic items that must be reviewed during a mutual fund inspection. (See copy of SEC Standard Request List attached as Exhibit A).

E. **Standard inspection closing procedures** provide the industry and SEBI with appropriate closure to an inspection within a reasonable amount of time after the conduct of the inspection. Additionally, the industry will know what to expect after a SEBI inspection (See Item VI in Mutual Fund Inspection Manual Outline attached as Exhibit B).

5.3 **Standing of a SEBI Inspector as that of a Government Officer:** The standing of an SEC inspector is that of a federal officer. SEC regulations clearly make a firm aware that lying to a federal officer would be considered an offense and firms have been

penalized for doing so. It appears that the standing of a SEBI inspector does not hold a similar status. For example, external SEBI inspectors discussed how firm personnel have lied to them during an inspection and there is nothing that can be done about it because the information provided by the firm personnel was not in the form of a statement under oath.

- 5.4 **Provide Initial and Ongoing Inspection Training:** SEBI's process would benefit if inspectors were trained on the conduct of compliance inspections and testing methods. In addition, SEBI would benefit from issuance of internal non-public interpretive positions for its inspectors to help them better understand regulations that may be unclear and to ensure uniformity in the interpretation of such regulation.
- 5.5 **Random Inspection Cycle:** If SEBI were to conduct inspections on a random basis rather than on a predictable cycle firms would not be able to revise their books in anticipation of a SEBI inspection. In addition, SEBI would benefit from industry information on a continuous and staggered basis throughout the year.
- 5.6 **Partnership with the Industry:** Effective compliance involves a partnership between the regulator and the industry to create fair and honest securities markets. This can be achieved in several ways.
 - Publishing proposed regulation for industry comment.
 - Granting exemptive orders that permit the applicant to engage in an activity which may not comply with the letter of the law but abides by the spirit of the regulation. Exemptive orders are typically granted to address firm specific extenuating circumstances which are evaluated on a case by case basis.
 - Issuing no-action letters to the industry which clarify regulation or become alternatives to following the regulation. A no-action letter is a request from the investment management firm that the SEC staff react to a particular set of circumstances or facts. Other firms with similar circumstances can rely on an existing no-action letter.
 - Involving the industry in the process of training inspectors to give the inspector a broader understanding of industry practices and perspectives.
 - Creating self regulatory organizations (SROs) to assist in the regulatory process.
- 5.7 **Registration of the Asset Management Company:** Registration of the AMC with SEBI will place statutory responsibility and accountability on the AMC apart from contractual responsibility.
- 5.8 **Individual Supervisory Responsibility:** Apply sanctions to AMC and fund personnel for failure to adequately supervise their staff.

6. NEXT STEPS

6.1 *Develop an Inspection Manual* which sets forth and details the following

- Pre-Inspection Process
- Standard Request List
- Areas of Inspection
- Inspection Report
- Deficiency Letter and Follow up

A Mutual Fund Inspection Manual Outline is attached as Exhibit A.

6.2 *Modify SEBI Regulations to enhance the standing of a SEBI Inspector* so that a firm that misrepresent facts to an Inspector is penalized. The objective is for firms to recognize that accurate information must be communicated to SEBI Inspectors regardless of whether such information is communication is under oath.

6.3 *Provide Initial and Ongoing Training to SEBI Inspectors* on the conduct of compliance inspections, testing methods and current industry practices that raise regulatory concerns.

These recommendations intended to continue the process that SEBI has begun to strengthen market surveillance practices in India. PW/FIRE is willing to support SEBI's efforts in this area by providing assistance in any way SEBI finds desirable.

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