

PN-ACC-430

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

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

**July, 1997**

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



July 22, 1997

Mr A P Kurian  
Chairman of AMFI  
Advisor to Apple Asset Management Ltd  
38/39, Rajgir Chambers  
Opp Old Customs House  
Shahid Bhagat Singh Road, Fort  
Mumbai - 400 023

Dear Mr Kurian,

At the request of the Association of Mutual Funds in India ("AMFI"), 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 ("SEC") and an expert in mutual funds. Mr Mendelson made his fourth visit to India between March 24 and April 19, 1997. As you are aware, his assistance which began in July and August 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 an AMFI Investor Awareness Campaign, including providing drafts of brochures to be used in the campaign. During March and April 1997, among other things, Mr Mendelson concentrated on training AMFI leaders and the Mutual Fund Industry, preparation of AMFI guidelines, Code of Ethics and Compliance Manual and strengthening the regulatory framework applicable to Mutual Funds. Mr Mendelson was assisted in India by Mr R N K Prasad.

This assistance is carried out under the US Agency for International Development Financial Institutions Reform and Expansion ("FIRE") Project which is administered by PW.

### **I PURPOSE OF ASSISTANCE**

The purpose of Mr Mendelson's visit was to help AMFI to continue to implement and develop its program to improve the credibility of the mutual fund industry and the public's acceptance of mutual funds. Specific goals included

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Chairman of AMFI  
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- further implementing the Action Plan for strengthening AMFI,
- completing the AMFI Investor's Guide Making Mutual Funds Work For You, the AMFI Sales Agents' Handbook Selling Mutual Funds Made Easy, and the AMFI Code of Ethics,
- launching the AMFI Investor Awareness Campaign,
- drafting proposed Valuation Guidelines for valuing non-listed, non-traded securities,
- providing specifications for drafting Model AMFI Advertising Guidelines
- arranging training in the United States for a select group of AMFI Leaders and regulators, and with FIRE's Training Consultant, presenting initial recommendations for structuring AMFI's domestic training programs,
- monitoring progress on  
AMFI's Model Compliance and Operations Manual, and  
CRISIL's study of mutual fund performance, and
- recommending the preparation of a comprehensive Mutual Fund/UTI Law as part of a broader recommendation to a SEBI Committee on Amendment of the Securities Laws

## II CONTENTS OF REPORT

The report reviews progress in implementing the AMFI Comprehensive Strategic Plan and the AMFI Investor Awareness Campaign. It focuses on three areas

- training for AMFI's leaders and by AMFI for the Mutual Fund Industry,
- preparation of AMFI Guidelines, Manuals and Codes to provide higher standards, greater uniformity, clarity and transparency to the mutual fund industry, and
- measures designed to strengthen the regulatory framework for mutual funds, including the Unit Trust of India ("UTI")



### III NEXT STEPS

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

- strengthening AMFI, including conferring with AMFI's leadership and members on improving AMFI's internal structure and administration, prioritising goals, hiring staff and enlisting a broader range of members to participate in committees and thereby increasing their level of involvement in and support for AMFI and helping to achieve AMFI's objectives,
- supporting AMFI's Investor Awareness Campaign by reviewing and perfecting the strategy and materials to be used in its Investment Awareness Campaign and designing courses and materials necessary for training brokers, sub-brokers and other sellers of fund scheme units,
- raising industry levels of professionalism and compliance by assisting in structuring and planning initial training of fund trustees, directors, compliance officers and other employees of AMC's, and creating other compliance mechanisms, such as an AMFI Model Compliance Manual and internal reporting forms and schedules,
- helping to structure an AMFI regulatory and legislative programme by assisting in
  - creating a Model AMFI Advertising Code, and
  - identifying legislative goals and working with SEBI, the Ministry of Finance, the Reserve Bank of India, and other concerned Government Departments to increase the industry's impact on regulatory matters that affect its vital interests and those of its unitholders, and
  - analysing the differences between UTI's structure, operations and regulation and those of the funds fully regulated by SEBI and outlining the steps necessary to restructure UTI to bring it under full SEBI regulation, and

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- promoting changes in the operation of the industry by preparing legislative strategies for broadening the range of products and investment techniques offered by the fund industry

#### 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 co-operation which AMFI, its Board Members and particularly its Investor Awareness and Code of Conduct Committees have provided to Mr Mendelson and our staff.

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**  
**PRINCIPAL CONSULTANT CAPITAL MARKETS**

Enclosure

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

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1	"Making Mutual Funds Work For You" - AMFI Investor's Guide
2	AMFI Guidelines on "good faith" Valuation of non traded securities
3	Schedule for AMFI Leadership Training Program
4	Recommendations to Committee for Amendment of the Securities Laws

## I EXECUTIVE SUMMARY

This report summarizes the continuing technical assistance provided to the Association of Mutual Funds in India (“AMFI”) during March and April 1997, as part of the FIRE Project’s and its Mutual Fund Consultant, Lewis J Mendelson’s, continuing effort to help the mutual fund industry strengthen its credibility and gain increased public acceptance

**Codes, Guidelines and Manuals** During March and April FIRE took significant steps to help AMFI to implement its Comprehensive Strategic Plan by assisting in upgrading professional standards through the development of Codes, Guidelines and Manuals, including

- Reviewing the proposed draft AMFI Code of Ethics with the AMFI Board of Directors and representatives of the Unit Trust of India (“UTI”)
- Submitting a draft AMFI Valuation Guideline to the AMFI Board
- Outlining requirements for proposed AMFI Advertising Guidelines and contracting with Credence, a firm of Indian mutual fund analysts to prepare a first draft, and
- Initiating drafting of a proposed Compliance Manual

**The AMFI Investor Awareness Campaign** FIRE also promoted the AMFI Investor Awareness Campaign by

- Helping to organize the launching of AMFI’s Concise Guide to Investing in Mutual Funds, “Making Mutual Funds Work For You”
- Commenting on the final draft of AMFI’s sales agents’ handbook, “Selling Mutual Funds Made Easy”
- Monitoring progress on CRISIL’s updated study of mutual fund performance in anticipation of its preparation of a brochure on “Understanding Mutual Fund Performance”

**Training** In cooperation with FIRE’s Consultant for Training, Dr Tessie San Martin, FIRE submitted for comment a memorandum to AMFI regarding “**Training Support for the Mutual Fund Industry Initial Recommendations**” which related to

- Investor Awareness and Education
- Sales Agent Training
- Compliance and Operations Training
- Other Training for Trustees and Senior Executives

FIRE also organized a **Leadership Training Program** in the United States for Members of AMFI's Board of Directors, Industry Representatives, SEBI and the Ministry of Finance which was conducted in May 1997. It included

- the regulatory structure for mutual funds, including major institutions such as the
  - Securities and Exchange Commission ("SEC"),
  - the Investment Company Institute ("ICI"),
  - the National Association of Securities Dealers, Inc ("NASD"),
  - National Securities Clearing Corporation ("NSCC"),
  - Depository Trust Company ("DTC"), and
  - the New York Stock Exchange ("NYSE")
- the roles of officers, independent directors, compliance and legal departments, outside counsel, accountants and auditors, and
- alternative marketing strategies and distribution methods for mutual funds and
- approaches to presentations of fund performance

Attendance at the ICI General Membership Meeting and in-depth meetings with five mutual fund investment advisory organizations were major features of the program

**Securities and Mutual Fund Laws** FIRE also submitted recommendations for new securities and mutual fund laws to SEBI's Committee for the Amendment of the Securities Law chaired by Justice D R Dhanuka

FIRE reiterates its fundamental recommendations to the mutual fund industry that to achieve greater credibility and wider public acceptance the industry must

- improve and expand its products, services and sales techniques
- strengthen SEBI and the regulatory framework
- strengthen AMFI

Specific recommendations for immediate steps which relate directly to stemming the erosion of the industry's credibility include

- Closing out all existing guarantees of returns and redemption prices and eliminating any guarantees in the future,
- Controlling self-dealing through transactions with affiliates,

- Eliminating the disparities in regulation between UTI and the rest of the industry by bringing UTI's Mutual Fund activities under SEBI's full jurisdiction,
- Strengthening SEBI, particularly its enforcement ability and regulation of mutual fund activities,
- Adopting comprehensive uniform accounting and valuation standards for mutual funds and their AMCs by the Institute of Chartered Accountants of India, and
- Developing an AMFI Business Plan, budgeting and staffing AMFI to provide leadership and resources for the fund industry

## II BACKGROUND

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

- 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 and provided drafts or outlines of the basic documents required for the Campaign. To date AMFI has published one such document AMFI's Concise Guide to Investing in Mutual Funds, "Making Mutual Funds Work For You"

AMFI has advised FIRE that

- a final draft of AMFI's sales agents' handbook, "Selling Mutual Funds Made Easy" has been prepared and turned over to Ogilvy & Mather, its creative consultant for production,
- an AMFI Membership Directory has been prepared by the UTI Institute, and
- both will be ready for publication in the immediate future

AMFI's Code of Ethics Committee is continuing efforts to resolve issues raised by UTI regarding certain provisions of the proposed AMFI Code of Ethics

CRISIL has completed the research required for preparation of an AMFI brochure on understanding mutual fund performance, but a draft brochure based upon updated performance data still needs to be drafted for AMFI

SEBI and AMFI have agreed to meet on a regular basis to discuss issues of common concern. The first such meeting was held in April 1997

In June 1997, Mr G A Shenai resigned as Chairman and a Director of AMFI. He was succeeded as Chairman by Mr A P Kurian, Chairman of the AMFI Investor Awareness Committee. Mr K N Vaidyanathan, Vice President, Morgan Stanley Asset Management Ltd, was inducted on the Board of AMFI in place of Mr Shenai

### III FIRE RECOMMENDATIONS

#### A Improve and Expand Products, Services and Operations

##### 1 Expand the Product Mix

FIRE, in its April Report on Assistance to Mutual Funds, set forth nine concrete steps for improving and expanding the industries' products, services and operations. Key recommendations included expanding the product mix to stress the "family of funds" concept, investing for a lifetime and introducing "Money Market Funds," which can become the gateway to stronger fund-client relationships and open the door to a wider range of investments.

##### 2 Eliminate Guarantees

Making good on existing guarantees and eliminating future guarantees, whether of returns or redemption prices, remains one of FIRE's foremost recommendations.

The FIRE Project believes that guaranteeing a return on a mutual fund scheme consisting of a portfolio of securities is harmful not only to individual unit holders, but also to funds, their AMC's and sponsors, the mutual fund industry, India's capital markets and SEBI because

- Guarantees have not been fulfilled and unit holder expectations have been frustrated,
- Pending guarantees create continuing uncertainty for existing unit holders,
- Failed guarantees undermine respect for SEBI and the Government,
- Advertising of guarantees is inconsistent with the SEBI Advertisement Code, which prohibits advertisements containing information which to any extent depends on assumptions,
- A guarantee by a sponsor or an AMC which is not properly accounted for with proper reserves is illusory, and calls into question current accounting standards for the mutual fund industry,
- Guarantees can subject Sponsors and AMC's to huge losses, and
- Selling on the basis of a guarantee, either of returns or of a redemption price, distorts the investment process because investors need to understand that all investments in securities involve a degree of risk,

The continuing failure of the public sector funds to meet outstanding guarantees erodes public confidence and significantly undermines the industry's credibility. The problems created by failed and continuing guarantees cannot be resolved without a strong government initiative. Government institutions as sponsors of public sector funds which have outstanding unfulfilled guarantees or which have pending guarantees which may not be met, had a large role in creating and perpetuating the current situation. They must bear

major responsibility for the current plight of the unit holders of these funds and its impact on the credibility of the mutual fund industry

Existing long-standing guarantees extend to May 2001. The possibility of future failures to meet these guarantees threatens the ability of the fund industry to develop credibility and to educate investors. The continuing sale of funds on the basis of guarantees prevents funds being sold on a sound basis of understanding and managing risk and therefore distorts the selling process not only for the fund industry, but for the entire securities market. Only when all outstanding fund guarantees are eliminated can the industry begin to improve its credibility and build reasonable expectations.

The current regulatory approach to guarantees is inconsistent and unsatisfactory. UTI recently offered a fund with five year guaranteed returns and redemption prices, using unit holders' assets from other funds as the reserve behind its guarantee. This not only puts those assets at risk and uses them for UTI's benefit without compensating the unit holders of the schemes furnishing the guarantees, but also creates a competitive imbalance which puts pressure on the rest of the industry to issue "guaranteed" funds.

SEBI, in attempt to "level the playing field" has permitted "fully guaranteed" returns, guaranteed by sponsors or asset management companies [Par 38, Regulations (Mutual Funds) 1996], as long as the guarantor's name and the manner the guarantee will be met are stated in the offer document. Such "guarantees" may be meaningless if the "guarantors" are not required to set up separate reserve accounts which are accrued daily to offset possible contingent liabilities. As we have seen in the Canara Bank case, the amount of such guarantees can be staggering, far exceeding the resources of the "guarantor." If SEBI continues to tolerate "guarantee funds," it should review the accounting, reserve and disclosure requirements which pertain to them in order to avoid disappointing investors and to develop appropriate protections.

Although SEBI's Advertisement Code [Sixth Schedule, Regulations (Mutual Funds), 1996] prohibits forecasts which are untrue or misleading and advertisements which contain information the accuracy of which is to any extent dependent upon assumptions, SEBI nevertheless permits a fund to advertise guarantees if the resources backing such guarantees are stated. SEBI also permits mutual funds to advertise so called "*indicative*" returns which it has not defined, but, like guaranteed funds, are based on assumptions of future performance. Although such returns must be accompanied by a broad range of disclaimers, they can be confusing to investors. We recommend that SEBI or AMFI, through its Advertising Guidelines, permit fund schemes to advertise only historical returns, over uniform periods and on a standardized basis.

FIRE recommends that no future guarantees be permitted. Pending the total elimination of guarantees, FIRE recommends that guarantors of existing guarantees properly account for and reserve against outstanding guarantees.

## **B Strengthen SEBI and the Regulatory Framework**

### **1 Strengthen SEBI**

Although SEBI has made excellent progress in regulating mutual funds since its creation in 1992, it would benefit by immediate additional steps including

- revisions to the regulatory structure to re-enforce SEBI's role as the primary regulator of the securities market and to encourage greater "functional regulation" which would allow it more sweeping jurisdiction over funds and avoid gaps or confusion over which agency has primary responsibility and authority over mutual funds and the securities their schemes invest in,
- internalizing the inspection function, which is currently contracted out to auditors, in order to develop more standardized practices, greater in-house expertise, continuity and cross fertilization and, most important, to establish greater accountability for follow-up,
- increasing transparency regarding fund portfolio investments and affiliated transactions,
- strengthening enforcement capability, including conducting investigations and applying a broad range of sanctions to violators

### **2 Prevent Self Dealing**

The FIRE Project strongly advocates placing greater controls over "affiliated" or "associated" transactions which involve purchases, sales or joint ventures between or among schemes their AMC's, sponsors or directors and companies or entities controlling, controlled by or under common control with them. Until the industry eliminates opportunities for overreaching through the use of scheme assets to benefit affiliates, associates and their related persons, such transactions will continue to

- diminish fund performance,
- promote disrespect for fiduciary obligations among trustees, AMC's, their officers, directors and employees, and
- engender suspicion and distrust among investors

FIRE's specific recommendations include

- broadening the definition of "associated" transactions to include second tier entities,
- prohibiting all such transactions, except for certain kinds which may be generally exempted by SEBI and others which may be exempted on a case by case basis upon a demonstration that they are in the public interest and do not adversely affect unit holders, and
- increasing the transparency surrounding any such transactions as well as fund portfolio investments generally

### 3 Eliminate Regulatory and Competitive Imbalances

UTI has played and continues to play a dominant role in the establishment of the mutual fund industry in India and in the growth and acceptance of the market for equity securities. Without UTI, India's fund industry would be relatively tiny and the concept of investing equity securities much less firmly established.

Because of UTI's historical role in the fund industry, it now enjoys regulatory and competitive advantages over the private sector funds. Many of its schemes, including its largest and oldest, US 64, are permitted to engage in practices, to own greater percentages of issuers' securities and to do business in ways which otherwise would have been curtailed by SEBI in the interest of protecting unit holders. This two-tiered regulatory structure and the competitive imbalances it engenders is inhibiting the growth of the industry by reducing industry standards to those which UTI can tolerate.

The FIRE project recommends that every effort be made immediately to bring all of UTI's mutual fund operations voluntarily under SEBI's full jurisdiction and that SEBI, the Ministry of Finance and UTI, organize a high level committee to

- analyze and compare the differences in treatment of UTI and the protections received by its unit holders from the treatment of private sector funds and the protections afforded their unit holders, and
- recommend changes in the laws and regulations which will eliminate disparities and result in uniform application of a single law across the entire fund industry which affords the highest level of protections to all unit holders and requires all funds to follow the best practices

## C Strengthen AMFI

AMFI, at SEBI's strong urging and upon its own initiative, has undertaken an ambitious and difficult role in representing the industry and promoting high standards among its members. AMFI relies only on its directors and volunteer committee members, all of whom have other important primary responsibilities to carry out its program. AMFI lacks the resources, the budget, the strong support of its members which are necessary to hire a strong professional staff and draw up a work plan which will allow it to carry out its role.

At present AMFI is an association of AMCs. For it to fulfill its role as an effective representative of the fund industry and its unit holders, the FIRE project recommends that it expand to include funds among its members. It also needs to enlist greater support from its members both as to their active participation in AMFI committees and in providing financial support and expertise. AMFI can engage in a number of activities which would strongly benefit its members and also provide income to AMFI. These could include providing

- training materials and programs
- educational materials
- holding general meetings and conferences at which providers of services to the fund industry take out ads and set up promotions for which fees are paid to AMFI for access to its members and others attending

FIRE suggests that AMFI immediately draw up a work-plan and budget for its next year of operations and job descriptions for its key staff members and immediately begin to organize a professional staff.

#### IV NEXT STEPS

**A Strengthen AMFI's Organisation and Structure** AMFI's new Chairman has begun involving representatives of more funds as board members, committee chairmen and committee members and is expanding the number of projects AMFI is undertaking. Giving all funds a role in the organization should help to energize AMFI and provide broad based support for its programs. However, for AMFI to realize its full potential as an effective force for the development of the industry, AMFI needs to

- draw up a business plan and budget for its next year of operations,
- draft job descriptions for its key staff members, and
- immediately begin to hire and organize a professional staff

**B Complete On-going Projects** Significant effort must be directed toward completing on-going projects including

- For the **AMFI Investor Awareness Campaign** completing and launching the
  - AMFI Sales Agents' Handbook "Selling Mutual Funds Made Easy"
  - AMFI Membership Directory "Mutual Funds of India"
  - CRISIL Analysis "A Second Look at Mutual Performance" and
  - related investor and sales agent training programs,
- For the **AMFI Professional Standards Program** the
  - AMFI Code of Ethics
  - AMFI Advertising Guidelines
  - AMFI Compliance Manual
  - AMFI Valuation Guidelines

**C Commence a Broad Based Sustained Training Program.** Broad based Mutual Fund Training Programs should be begun shortly, in accordance with the program prepared with the assistance of FIRE Project Training Director Dr Tessie San Martin and as follow-up to the recently completed Leadership Training Program. Target audiences and programs would include

- AMFI Directors and Committeemen
  - The Role of AMFI Policy and Leadership Issues
- AMC officers, directors and staff -- Best Practices
  - Code of Ethics,
  - Compliance and Operations,
  - Advertising Guidelines,
  - Valuation Guidelines,

- Trustees
  - Fiduciary duties, protecting unit holders' interests,
  - Operating effectively under SEBI Regulations and the laws
- Investors – Investing in Mutual Funds
- Selling Agents—
  - Selling Mutual Funds,
  - Ethical Selling Practices and Qualification Standards,
- Mutual Fund Accountants and Auditors
  - Meeting International Mutual Fund Accounting/Auditing Standards
  - Valuation
  - Reserves Against Guarantees
- SEBI
  - Inspecting a Mutual Fund
  - Investigating Violations of Mutual Fund Regulations
  - Advertising Guidelines
  - Guarantee Funds

**D Strengthen The Regulatory Framework** SEBI has made significant progress in enhancing the regulatory environment in which mutual funds operate through the adoption of SEBI 's (Mutual Funds) Regulations 1996 and through the establishment of a program of continuing liaison through regular meetings between AMFI and SEBI However, additional systemic progress can be made by

- adoption of a new securities law and a comprehensive mutual fund law which, among other things would clarify SEBI's role as the primary securities market regulator and eliminate any regulatory gaps and resolve any conflicts over regulatory responsibilities,
- subject all aspects of UTI's mutual fund operations to full SEBI jurisdiction with the same unit holder protections and regulatory requirements applicable to all registered mutual funds,
- issuance of additional guidelines and interpretations by SEBI to clarify any remaining ambiguities in its regulations,
- building up SEBI through regular training and enhanced enforcement capacity,
- internalizing the SEBI mutual fund inspection program, and
- adoption by the Association of Chartered Accountants of comprehensive uniform accounting and valuation standards for mutual funds and their AMCs

The FIRE Project submitted a memorandum to SEBI's Committee for the Amendment of the Securities Law ("Dhanuka Committee") in April. Its recommendations are awaited. FIRE representatives would be pleased to offer continued assistance in this effort.

In addition to these systemic changes, unit holders, the fund industry and SEBI would benefit from specific immediate steps which relate directly to stemming the erosion of the industry's credibility including:

- Closing out all existing guarantees of returns and redemption prices and eliminating any guarantees in the future
- Controlling self-dealing through transactions with affiliates
- Conducting a vigorous SEBI investigation followed by a full report on the scandal involving the CRB Mutual Fund and its related companies containing recommendations to bolster the statutory and regulatory frameworks and fund, trustee, auditors, and inspection processes to protect against such scandals in the future

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TEN ADVANTAGES OF INVESTING IN MUTUAL FUNDS

- ▲ Professional Management
- ▲ Diversification
- ▲ Convenient Administration
- ▲ Return Potential
- ▲ Low Costs
- ▲ Liquidity
- ▲ Transparency
- ▲ Flexibility
- ▲ Choice of Schemes
- ▲ Well Regulated

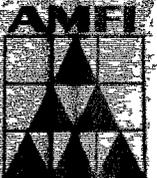
# MAKING MUTUAL FUNDS WORK FOR YOU



The  
Investor's  
Concise  
Guide

Creative Consultants

**Ogilvy & Mather**  
*Financial & Business Communications*



**Dear Investor:**

We at the Association of Mutual Funds in India are devoted to a singular cause - making Mutual Funds available to you to achieve your investment goals. But first, let's read about us.

AMFI was incorporated in August 1986 as a non-profit organisation to promote and protect the interests of investors and their unitholders, increase public awareness of Mutual Funds and define and maintain high ethical and professional standards in the industry. Almost all Mutual Funds including Unit Trust of India are members of this association.

AMFI is governed by a Board of Directors who meet frequently to discuss various issues relating to the Mutual Fund industry. Recognising that proper investor understanding of Mutual Funds is vital to the success of the industry, AMFI has produced a number of investor awareness programmes. The first of these, the "Mutual Fund Guide" has been produced by the Association of Mutual Funds in India and is being prepared by Mr. K. R. Arora, Chairman, AMFI, and Mr. K. H. Arora, Secretary, AMFI. Mr. K. H. Arora is also the Chairman of the Committee on Mutual Fund Reform and Expansion. He has made a valuable contribution to the industry in their time and effort.

This guide on the Mutual Fund industry does not only help you understand the Mutual Fund industry but also helps you to invest in Mutual Funds.

Please contact your Mutual Fund investment agent for more information.

This guide is available with all Mutual Fund members of AMFI or can be obtained directly from Association of Mutual Funds in India at T4/6 The Arcade World Trade Centre Cuffe Parade Mumbai 400 005 Tel 215 4165 Fax 218 1497

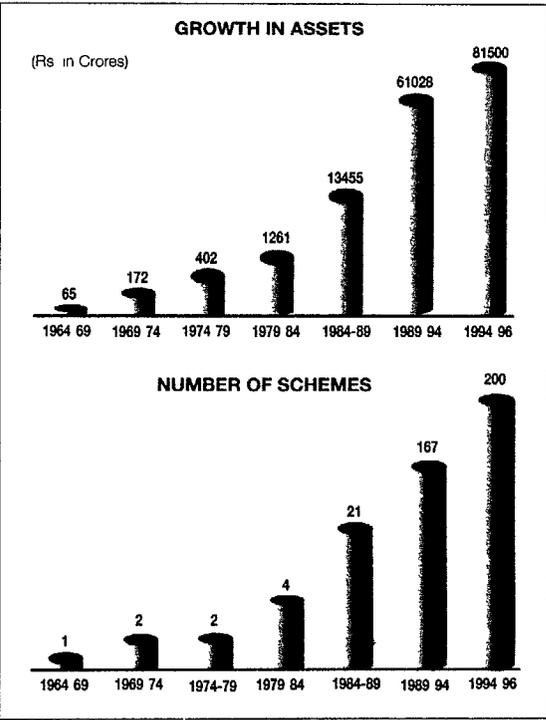
Produced by AMFI in association with Price Waterhouse LLP/FIRE Project funded by USAID and Ogilvy & Mather Financial & Business Communications

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**MUTUAL FUND - A GLOBALLY PROVEN INVESTMENT**

Worldwide the Mutual Fund or Unit Trust as it is called in some parts of the world has a long and successful history. The popularity of the Mutual Fund has increased manifold. In developed financial markets like the United States Mutual Funds have almost overtaken bank deposits and total assets of insurance funds. As of date in the US alone there are over 5 000 Mutual Funds with total assets of over US \$ 3 trillion (Rs 100 lakh crores)

In India the Mutual Fund industry started with the setting up of Unit Trust of India in 1964. Public sector banks and financial institutions began to establish Mutual Funds in 1987. The private sector and foreign institutions were allowed to set up Mutual Funds in 1993. Today there are 36 Mutual Funds and over 200 schemes with total assets of approximately Rs 81 000 crores. This fast growing industry is regulated by the Securities and Exchange Board of India (SEBI).



Source: UTI Fact Book and Cnsil's study



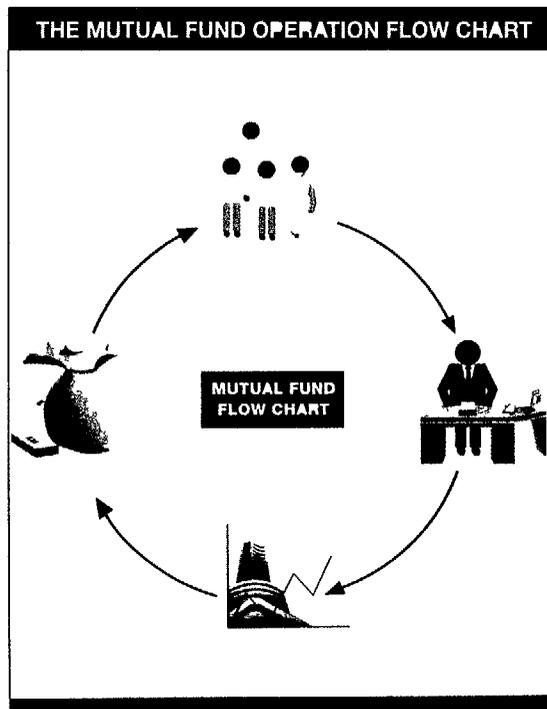


What you should expect from a Mutual Fund depends on what stage of life you are in

## WHAT IS A MUTUAL FUND?

A Mutual Fund is a trust that pools the savings of a number of investors who share a common financial goal. Anybody with an investible surplus of as little as a few thousand rupees can invest in Mutual Funds. These investors buy units of a particular Mutual Fund scheme that has a defined investment objective and strategy.

The money thus collected is then invested by the fund manager in different types of securities. These could range from shares to debentures to money market instruments, depending upon the scheme's stated objectives. The income earned through these investments and the capital appreciation realised by the scheme are shared by its unit holders in proportion to the number of units owned by them. Thus a Mutual Fund is the most suitable investment for the common man as it offers an opportunity to invest in a diversified professionally managed basket of securities at a relatively low cost.



## TYPES OF MUTUAL FUND SCHEMES

There are a wide variety of Mutual Fund schemes that cater to your needs whatever your age, financial position, risk tolerance and return expectations. Whether as the foundation of your investment programme or as a supplement, Mutual Fund schemes can help you meet your financial goals.

### (A) By Structure

#### Open-Ended Schemes

These do not have a fixed maturity. You deal directly with the Mutual Fund for your investments and redemptions. The key feature is liquidity. You can conveniently buy and sell your units at net asset value (NAV) related prices.

#### Close-Ended Schemes

Schemes that have a stipulated maturity period (ranging from 2 to 15 years) are called close ended schemes. You can invest directly in the scheme at the time of the initial issue and thereafter you can buy or sell the units of the scheme on the stock exchanges where they are listed. The market price at the stock exchange could vary from the scheme's NAV on account of demand and supply situation, unit holders' expectations and other market factors. One of the characteristics of the close ended schemes is that they are generally traded at a discount to NAV, but closer to maturity the discount narrows.

Some close ended schemes give you an additional option of selling your units directly to the Mutual Fund through periodic repurchase at NAV related prices. SEBI Regulations ensure that at least one of the two exit routes are provided to the investor.

#### Interval Schemes

These combine the features of open ended and close ended schemes. They may be traded on the stock exchange or may be open for sale or redemption during pre determined intervals at NAV related prices.





Starting out in life?  
Invest in funds that will give  
you lump sum returns after  
a few years

## **(B) By Investment Objective**

### *Growth Schemes*

Aim to provide capital appreciation over the medium to long term. These schemes normally invest a majority of their funds in equities and are willing to bear short term decline in value for possible future appreciation.

These schemes are not for investors seeking regular income or needing their money back in the short term.

Ideal for

- Investors in their prime earning years
- Investors seeking growth over the long term

### *Income Schemes*

Aim to provide regular and steady income to investors. These schemes generally invest in fixed income securities such as bonds and corporate debentures.

Capital appreciation in such schemes may be limited.

Ideal for

- Retired people and others with a need for capital stability and regular income
- Investors who need some income to supplement their earnings

### *Balanced Schemes*

Aim to provide both growth and income by periodically distributing a part of the income and capital gains they earn. They invest in both shares and fixed income securities in the proportion indicated in their offer documents. In a rising stock market, the NAV of these schemes may not normally keep pace or fall equally when the market falls.

Ideal for

- Investors looking for a combination of income and moderate growth

## *Money Market Schemes*

Aim to provide easy liquidity, preservation of capital and moderate income. These schemes generally invest in safer short term instruments such as treasury bills, certificates of deposit, commercial paper and inter bank call money.

Returns on these schemes may fluctuate depending upon the interest rates prevailing in the market.

Ideal for

- Corporates and individual investors as a means to park their surplus funds for short periods or awaiting a more favourable investment alternative

## **Other Schemes**

### *Tax Saving Schemes*

These schemes offer tax rebates to the investors under tax laws as prescribed from time to time. This is made possible because the Government offers tax incentives for investment in specified avenues. For example, Equity Linked Savings Schemes (ELSS) and Pension Schemes.

Recent amendments to the Income Tax Act provide further opportunities to investors to save capital gains by investing in Mutual Funds. The details of such tax savings are provided in the relevant offer documents.

Ideal for

- Investors seeking tax rebates

### *Special Schemes*

This category includes index schemes that attempt to replicate the performance of a particular index such as the BSE Sensex or the NSE 50 or industry specific schemes (which invest in specific industries) or sectoral schemes (which invest exclusively in segments such as A Group shares or initial public offerings).

Index fund schemes are ideal for investors who are satisfied with a return approximately equal to that of an index.



Married?  
Invest in funds that will give  
you regular income to  
supplement your salary to  
match your growing needs

Sectoral fund schemes are ideal for investors who have already decided to invest in a particular sector or segment

Keep in mind that any one scheme may not meet all your requirements for all time. You need to place your money judiciously in different schemes to be able to get the combination of growth, income and stability that is right for you.

Remember, as always, higher the return you seek, higher the risk you should be prepared to take.

A few frequently used terms are explained here below:

#### **Net Asset Value ("NAV")**

Net Asset Value is the market value of the assets of the scheme minus its liabilities. The per unit NAV is the net asset value of the scheme divided by the number of units outstanding on the Valuation Date.

#### **Sale Price**

Is the price you pay when you invest in a scheme. Also called Offer Price. It may include a sales load.

#### **Repurchase Price**

Is the price at which a close ended scheme repurchases its units and it may include a back end load. This is also called Bid Price.

#### **Redemption Price**

Is the price at which open ended schemes repurchase their units and close ended schemes redeem their units on maturity. Such prices are NAV related.

#### **Sales Load**

Is a charge collected by a scheme when it sells the units. Also called Front end load. Schemes that do not charge a load are called 'No Load' schemes.

#### **Repurchase or 'Back-end' Load**

Is a charge collected by a scheme when it buys back the units from the unitholders.

## **WHY SHOULD YOU INVEST IN MUTUAL FUNDS?**

The *advantages* of investing in a Mutual Fund are:

**1 Professional Management** You avail of the services of experienced and skilled professionals who are backed by a dedicated investment research team which analyses the performance and prospects of companies and selects suitable investments to achieve the objectives of the scheme.

**2 Diversification** Mutual Funds invest in a number of companies across a broad cross section of industries and sectors. This diversification reduces the risk because seldom do all stocks decline at the same time and in the same proportion. You achieve this diversification through a Mutual Fund with far less money than you can do on your own.

**3 Convenient Administration** Investing in a Mutual Fund reduces paperwork and helps you avoid many problems such as bad deliveries, delayed payments and unnecessary follow up with brokers and companies. Mutual Funds save your time and make investing easy and convenient.

**4 Return Potential** Over a medium to long term Mutual Funds have the potential to provide a higher return as they invest in a diversified basket of selected securities.

**5 Low Costs** Mutual Funds are a relatively less expensive way to invest compared to directly investing in the capital markets because the benefits of scale in brokerage, custodial and other fees translate into lower costs for investors.

**6 Liquidity** In open ended schemes you can get your money back promptly at net asset value related prices from the Mutual Fund itself. With close ended schemes you can sell your units on a stock exchange at the prevailing market price or avail of the facility of direct repurchase at NAV related prices which some close ended and interval schemes offer you periodically.

**7 Transparency** You get regular information on the value of your investment in addition to disclosure on the specific investments made by your scheme, the proportion invested in each class of assets and the fund manager's investment strategy and outlook.





*Parenthood?  
Invest in funds that give  
you growth now and  
regular income later in line  
with your children's needs*

**8 Flexibility** Through features such as regular investment plans regular withdrawal plans and dividend reinvestment plans you can systematically invest or withdraw funds according to your needs and convenience

**9 Choice of Schemes** Mutual Funds offer a family of schemes to suit your varying needs over a lifetime

**10 Well Regulated** All Mutual Funds are registered with SEBI and they function within the provisions of strict regulations designed to protect the interests of investors. The operations of Mutual Funds are regularly monitored by SEBI

### UNDERSTANDING AND MANAGING RISK

All investments whether in shares debentures or deposits involve risk share value may go down depending upon the performance of the company the industry state of capital markets and the economy generally however longer the term lesser the risk companies may default in payment of interest/ principal on their debentures/bonds/deposits the rate of interest on an investment may fall short of the rate of inflation reducing the purchasing power

While risk cannot be eliminated skillful management can minimise risk Mutual Funds help to reduce risk through diversification and professional management The experience and expertise of Mutual Fund managers in selecting fundamentally sound securities and timing their purchases and sales help them to build a diversified portfolio that minimises risk and maximises returns

### HOW TO INVEST IN MUTUAL FUNDS

**Step One** Identify your investment needs

Your financial goals will vary based on your age lifestyle financial independence family commitments level of income and expenses among many other factors Therefore the first step is to assess your needs Begin by asking yourself these questions

**1 What are my investment objectives and needs?**  
Probable Answers I need regular income or need to

buy a home or finance a wedding or educate my children or a combination of all these needs

**2 How much risk am I willing to take?**

Probable Answers I can only take a minimum amount of risk or I am willing to accept the fact that my investment value may fluctuate or that there may be a short term loss in order to achieve a long term potential gain

**3 What are my cash flow requirements?**

Probable Answers I need a regular cash flow or I need a lump sum amount to meet a specific need after a certain period or I don't require a current cash flow but I want to build my assets for the future

By going through such an exercise you will know what you want out of your investment and can set the foundation for a sound Mutual Fund investment strategy

**Step Two** Choose the right Mutual Fund

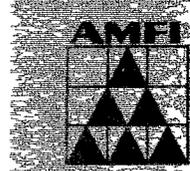
Once you have a clear strategy in mind you now have to choose which Mutual Fund and scheme you want to invest in The offer document of the scheme tells you its objectives and provides supplementary details like the track record of other schemes managed by the same Fund Manager Some factors to evaluate before choosing a particular Mutual Fund are

- the track record of performance over the last few years in relation to the appropriate yardstick and similar funds in the same category
- how well the Mutual Fund is organised to provide efficient prompt and personalised service
- degree of transparency as reflected in frequency and quality of their communications

**Step Three** Select the ideal mix of Schemes

Investing in just one Mutual Fund scheme may not meet all your investment needs You may consider investing in a combination of schemes to achieve your specific goals

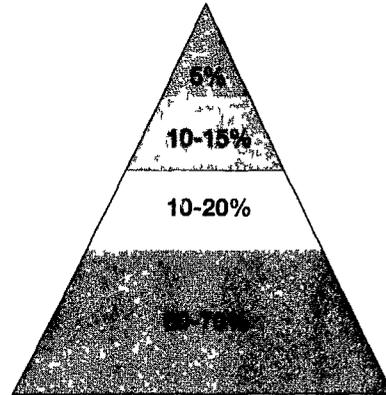
The following charts could prove useful in selecting a combination of schemes that satisfy your needs





Children's higher education?  
Invest in funds that will give  
you lump sum returns when  
your children enter college

### AGGRESSIVE PLAN

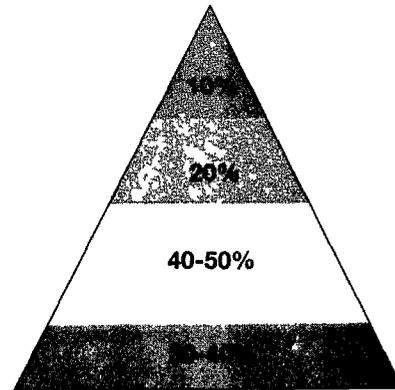


This plan may suit

- Investors in their prime earning years and willing to take more risk
- Investors seeking growth over a long term



### MODERATE PLAN

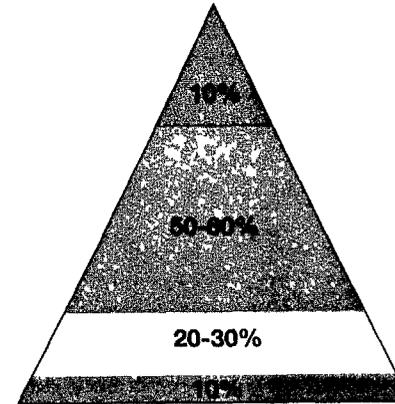


This plan may suit

- Investors seeking income and moderate growth
- Investors looking for growth and stability with moderate risk



### CONSERVATIVE PLAN



This plan may suit

- Retired and other investors who need to preserve capital and earn regular income



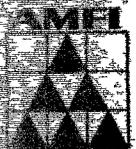
#### Step Four Invest regularly

For most of us the approach that works best is to invest a fixed amount at specific intervals say every month. By investing a fixed sum each month you buy fewer units when the price is higher and more units when the price is low thus bringing down your average cost per unit. This is called rupee cost averaging and is a disciplined investment strategy followed by investors all over the world. With many open ended schemes offering systematic investment plans this regular investing habit is made easy for you.

#### Step Five Keep your taxes in mind

If you are in a high tax bracket and have utilised fully the exemptions under Section 80L of the Income Tax Act investing in growth funds that do not pay dividends might be more tax efficient and improve your post tax return.

If you are in a low tax bracket and have not utilised fully the exemption available under Section 80L selecting funds paying regular income could be more





*Ready to retire?  
Invest in funds that will  
supplement your pension*

**Mutual Funds are truly  
investments for a lifetime**

tax efficient Further there are other benefits available for investment in Mutual Funds under the provisions of the prevailing tax laws

You may therefore consult your tax advisor or Chartered Accountant for specific advice

**Step Six** Start early

It is desirable to start investing early and stick to a regular investment plan If you start now you will make more than if you wait and invest later The power of compounding lets you earn income on income and your money multiplies at a compounded rate of return

**Step Seven** The final step

All you need to do now is to get in touch with a Mutual Fund or your agent/broker and start investing Reap the rewards in the years to come Mutual Funds are suitable for every kind of investor whether starting a career or retiring conservative or risk taking growth oriented or income seeking

**YOUR RIGHTS AS A MUTUAL FUND UNITHOLDER**

As a unitholder in a Mutual Fund scheme coming under the SEBI (Mutual Funds) Regulations ( Regulations ) you are entitled to

- 1 Receive unit certificates or statements of accounts confirming your title within 6 weeks from the date of closure of the subscription or within 6 weeks from the date your request for a unit certificate is received by the Mutual Fund
- 2 Receive information about the investment policies investment objectives financial position and general affairs of the scheme
- 3 Receive dividend within 42 days of their declaration and receive the redemption or repurchase proceeds within 10 days from the date of redemption or repurchase
- 4 Vote in accordance with the Regulations to a either approve or disapprove any change in the fundamental investment policies of the scheme which

are likely to modify the scheme or affect your interest in the Mutual Fund, (as a dissenting unitholder you would have a right to redeem your investments)

- b change the asset management company
- c wind up the schemes

5 Inspect the documents of the Mutual Funds specified in the scheme s offer document

In addition to your rights you can expect the following from Mutual Funds

- To publish their NAV in accordance with the regulations daily in case of most open ended schemes and periodically in case of close ended schemes
- To disclose your schemes portfolio holdings expenses policy on asset allocation the Report of the Trustees on the operations of your schemes and their future outlook through periodic newsletters half yearly and annual accounts
- To adhere to a Code of Ethics which require that investment decisions are taken in the best interests of the unitholders



## I INTRODUCTION

SEBI (Mutual Funds) Regulations, 1996, Chapter VI, Section 47, require Mutual Funds to compute and carry out valuation of their schemes' investments in accordance with the valuation norms specified in the Eighth Schedule to the Regulations ("Investment Valuation Norms") which sets forth valuations norms for "traded" and "non-traded" securities. Asset Management Companies ("AMCs") are required to value non-traded securities "in good faith" (herein after generally described as "fair valuation") on the basis of appropriate valuation methods based on the principles approved by the Board of the AMC. The said Schedule sets forth principles which are required to be adopted by the AMC.

The Association of Mutual Funds in India (AMFI), has requested that the Price Waterhouse/FIRE Project examine the issue of valuation "in good faith" of non-traded securities and provide detailed guidelines which can be followed uniformly by all AMCs. The FIRE Project recommends the following guidelines which are designed to

- i meet the requirements of the Eighth Schedule,
- ii reflect internationally accepted principles and standards, and
- iii present a "true and a fair" view of the accounts

## II GENERAL PRINCIPLES

The essence of fair valuation is good judgement. Fair valuation cannot be reduced to a set of universally acceptable formulae which apply uniformly since fair value will depend upon the individual circumstances of each case. However, in order to be fair and reasonable valuation should follow certain principles to approximate market values.

- 1 **Mark to Market** Securities must be marked to market in order that the NAV reflect their *current* value
- 2 **Select an appropriate benchmark** Whenever securities are valued by appraisal methods there must be a strong correlation between the benchmark securities and the securities in the portfolio
- 3 **Obtain bids from independent brokers** Fair valuation may also be based upon bids submitted by independent brokers. Independent brokers are those which have not done any business with the mutual fund/AMC
- 4 **Use one method consistently** Any method once chosen should be consistently followed

- 5 **Adequately support your valuation** Board minutes are necessary to document the decision of the Board regarding the valuation of any non traded security In addition, Fair valuation must be supported by necessary work papers containing
- ◆ fundamental analytical data relating to the investments
  - ◆ the nature and duration of restrictions on the transferability of securities
  - ◆ an evaluation of the market forces influencing the securities
  - ◆ current financial position and documented management reports
  - ◆ existence of merger proposals or tender offers
  - ◆ prices and volumes of trading on an exchange in similar securities

### III RECOMMENDED GUIDELINES

#### A EQUITY SHARES

##### A1 IN THE CASE OF PROFIT MAKING COMPANIES

- 1 The "price" may be estimated based upon the earning per share, capitalised using the industry (or comparable security) price earning multiple or the average of the capitalised earnings as above and the net asset value per share "NAV" for these purposes means, the net worth of the company as defined by the Companies Act, 1956, divided by the number of shares issued and paid up

The Schedule does not specify whether the earnings for valuation purposes are future or past earnings If the earnings are interpreted to mean past earnings, whether they should be audited, or unaudited has not been specified If a Fund limits itself to using only audited accounts, then the earnings considered for the valuation could be as old as 15 months in almost all cases This would not reflect the "true" current value of the share If a Fund uses unaudited accounts, then the authenticity of earnings remains in doubt Further, there is no requirement under the Companies Act, 1956 or any other legislation governing non traded securities, that monthly or quarterly earnings be disclosed to shareholders Given these limitations, it may be preferable to use the following method for those securities for which broker quotations can be obtained

- 2 Where the audited annual accounts are not available or where the estimation as aforesaid fails to reflect the current true value of the security, then such securities may be valued at the average of bid prices received from two "independent" brokers

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- 3 Where the annual accounts are not available and independent brokers' quotations cannot be obtained, then such securities may be valued at their cost duly adjusted for any premiums/discounts received on such securities when they were purchased

## A2 IN THE CASE OF LOSS MAKING COMPANIES

The "price" for non traded securities of loss making companies may be based upon the net asset value per share as per the last audited annual accounts (which shall not be more than 15 months old) "NAV" for these purposes means, the net worth of the company as defined by the Companies Act, 1956, divided by the number of shares issued and paid up

## B DEBT SECURITIES

- B1 Money market instruments such as treasury bills, commercial paper, certificates of deposit etc , may be valued at the average of the bids received from two independent brokers. In exceptional cases and where a scheme is likely to hold these securities till maturity, they may be valued at cost plus interest accrued on a daily basis
- B2 Unlisted/Non-traded debt instruments may be valued on a yield to maturity ("YTM") basis. "Yield" may be based upon a Benchmark Rate with a mark-up on that rate (depending on the interest rate movements) such that the security to be priced may approximate the market value. However, the Benchmark should have a correlation with the security to be priced. In this connection, one can use the following as Benchmark Rates
- the weighted average of the government securities traded with a residual tenor equal to the security being priced, or
  - the Primary Lending Rate (PLR) of the State Bank of India or the Minimum Lending Rate (MLR) of IDBI/ICICI, or
  - the yield offered by a security which is traded and has credit rating equivalent to that of the security being priced
- B3 As an exception to the above, short term debt securities having a residual tenor of less than 90 days may be valued by the "amortised cost" method (ie the cost of such instruments plus interest accrued on a daily basis)

## *Price Waterhouse LLP*



April 18, 1997

Mr G A Shenai  
Chairman of AMFI  
Managing Director Canbank Mutual Fund  
Orient House  
Ballard Estate  
MUMBAI-400 038

Re AMFI Leadership Training Program

Dear Mr Shenai

In AMFI's letter to the FIRE Project of March 6, 1997, among other things, AMFI requested training which would enable its leaders to acquire first-hand knowledge of the ICI, in order to better understand its structure, organization, funding and specific ICI activities in the fields of

- training
- research
- investor education
- promoting professional standards, and
- ensuring regulatory compliance

In response to this request, FIRE will sponsor a three week USA based program from May 9-31, 1997. The program is designed to familiarize AMFI's Leaders and others who are in a position to play a significant role in the development of the Indian mutual fund industry with the operation of the U S mutual fund industry, including the roles of the Securities and Exchange Commission ("SEC"), the NASD and the Investment Company Institute in developing high standards of professionalism and maintaining public confidence in the mutual fund industry. A tentative schedule open to revision, is attached.

Six persons are invited to participate in the program, including four representatives of AMFI

- Mr K N Atma Ramani, Managing Director, Tata Asset Management Ltd, a Member of AMFI's Board of Directors and Chairman of its Committee on Regulation,
- Mr A P Kurien, adviser to Apple Asset Management Ltd, a Member of AMFI's Board of Directors and Chairman of its Investor Awareness Committee,
- Mr S V Prasad Chief Executive Officer JM Mutual Fund and a member of the AMFI Compliance Committee, and

**Mr. G. A. Shenai**  
**Chairman of AMFI**  
**April 18, 1997**  
**Page 2**

- **Mr R G Sharma, Chief Executive Officer, Jeevan Bima Sahayog Asset Management Company, LTD, Adviser to LIC Mutual Fund**

A high ranking staff member of the Securities and Exchange Board of India ("SEBI") and a representative of the Indian Ministry of Finance will complete the participants They will be accompanied by Mr R N K Prasad of the PW FIRE Project and myself

Please have each participant personally notify Mr R N K Prasad of his acceptance of this invitation not later than Wednesday, April 23, in order that we may complete arrangements for the Program He will provide each participant with detailed instructions to prepare for the Program I look forward to receiving your acceptances and to welcoming each participant to the United States

Sincerely yours,



**Lewis J. Mendelson**  
**Mutual Fund Consultant**

Enclosure Tentative Schedule

cc **Mr K N Atma Ramani**  
**Mr A P Kurien**  
**Mr S V Prasad**  
**Mr R G Sharma**

1997

# May

1997

SUNDAY	MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY	SATURDAY
				1	2	3
4	5	6	7	8	9	10
					Depart by Delta Airlines app at 01.30 am	Arrival Dulles Airport Georgetown Suites
11	12	13	14	15	16	17
TINA PHAM Sight Seeing Tour	SEC	SEC	ICI Conference Noon Registration Opening Session Washington Hilton Hotel Exhibition Hall 2pm to 6.30 p.m.	ICI Conference 9 00 am through Dinner 8 00 pm	ICI Conference 9 00 am to Noon  PM Free	Sightseeing TINA
18	19	20	21	22	23	24
Brunch Barbecue JEW + EDIE & TINA PHAM	NASD Clark Hooper	NASD Clark Hooper	ICI	ICI  T Rowe Price PM (?)	T Rowe Price AM (?) Vanguard PM To NYC	NYC Peter Greenough
25	26	27	28	29	30	31
Peter Greenough Sight Seeing	Peter Greenough Memorial Day  Sightseeing	NYSE AMEX Depository	Merrill Lynch	Fund Distribution  Charles Schwabb Dreyfus	Depart	Arrival India

## *Price Waterhouse LLP*



April 11, 1997

Committee for Amendment of the Securities Laws  
Securities Exchange Board of India  
Mittal Court "B" Wing,  
224, Nariman Point,  
Bombay 400 021

**Attn: Ms. D. N. Raval**

Dear Ms Raval

This responds to your letter of March 18, 1997 requesting comment on deficiencies in the Securities and Exchange Board of India Act (SEBI Act), the Securities Contracts (Regulation) Act, 1956 (SC(R)Act) and the Depositories Act, 1996, and asking for recommendations in respect thereto

Since the initiation of the Fire project, we have from time to time commented anecdotally on various aspects of the Indian securities laws and we appreciate the opportunity to make further comment at this time. In addition to responding to various of the questions posed in the Annexure to your letter, we shall specifically address the following subjects

- \* SEBI's lack of independence;
- \* the lack of civil remedies available to SEBI;
- \* SEBI's disciplinary, investigative and remedial authority;
- \* SEBI and/or Central Government authority to name up to three persons to the stock exchange Boards,
- \* the concept of self regulation,
- \* the need for a comprehensive Mutual Fund/Unit Trust Law, and
- \* key Depository Act modifications

April 11, 1997

Committee for Amendment of the Securities Laws

Securities Exchange Board of India

Page 2



**- 1. INDEPENDENCE OF SEBI AS A REGULATORY BODY**

SEBI should be made an independent agency and be relieved of the necessity of having to seek Ministry of Finance (MoF) approval of its rules and other activities. It should be free to act on its own in the public interest and for the protection of investors within parameters prescribed by statute and should be freed from the changing political side of the government. Unless it is a free standing agency, the possibility of it being subjected to political influence is strong. This will detract from its effectiveness and if such influence prevails, will seriously impact its credibility. As an independent agency its composition would have to be modified by eliminating authority for Central Government representation thereon. SEBI should be recreated as a full time working Board of three or five persons with staggered terms of significant length, i.e., five years, and be protected by statute from the political side of the government. Its only function should be regulation of the securities industry and that should be the only business of the Board's members.

Moreover, the many requirements which call for Central Government approval before effectiveness, and others which call for the Central Government to initiate action in the first instance, make regulation of the Indian securities industry cumbersome. In this respect see Sections 11(2)(j), 16, 17, 20 and 31 of the SEBI Act, among others. Section 11(2)(j) specifies that the extent of SEBI's authority under the SC(R) Act, which provides for the registration of stock exchanges and other things, shall only be those functions and powers "as may be delegated to it by the Central Government." The statute should assign SEBI, as an independent agency, its powers and it should be permitted to carry them out in the manner it deems most effective in the public interest and for the protection of investors. It is recognized that the Central Government in Notifications dated July 30, 1996, and September 13, 1994, has delegated portions of its authority under the SC(R) Act to SEBI but it is not complete and the power to delegate is the power to withdraw. It is also recognized that the Securities Laws (Amendment) Act, 1995, (1995 Act), redirected certain authority to SEBI.

Section 16 further detracts from SEBI's effectiveness in that it directs that SEBI shall, in the performance of its functions under the Act, "be bound by such directions on questions of policy as the Central Government may give in writing to it from time to time" provided it gives an opportunity to SEBI to express its views before any direction is given. It expressly also states that the decision of the Central Government whether a question is one of policy or not shall be final. This obviously includes matters of policy involving the securities industry and delimits the authority given to SEBI in Section 11(2) of the SEBI Act on matters of securities industry policy. Section 16 should be repealed.



Section 20 allows for appeals from orders made by SEBI under the Act, or the rules and regulations thereunder to be made by aggrieved persons to the Central Government. This is unnecessary and further undermines SEBI's authority as regulator of the Indian securities market. Appeals from its determinations should be permitted only to the judicial system, or the Securities Appellate Tribunal created by the 1995 Act, to insure that the action taken is within SEBI's authority under the law. Section 20A, adopted by the 1995 Act, furthers the problem with this Section by denying jurisdiction to any Civil Court as to any "order" of SEBI which it is empowered by the Act to pass and prohibits the granting of an injunction in respect thereto.

Section 31 is further illustrative of cumbersome regulation. That section requires all rules and regulations made under the Act to be laid before each House of Parliament for a period of 30 days during which their provisions may be changed. The authority to make rules should be SEBI's pursuant to criteria spelled out in the Act by Parliament. If it is not acting in a manner consistent therewith, the courts should have the authority to overrule it when asked pursuant to valid lawsuits.

As an independent agency of the government, SEBI's actions in all respects should be final subject of the right of aggrieved persons to appeal to the court system, or the Securities Appellate Tribunal, but not to the Central Government which enables unnecessary political interference in the regulation of the securities market.

## 2. SEBI CIVIL REMEDIES AND ITS EXAMINATION, INVESTIGATIVE AND ENFORCEMENT FUNCTIONS

### Proposed Modifications To The Law

SEBI should have broader jurisdiction over all aspects of the securities market, all persons dealing therein, and all potential violators of the securities laws if it is to provide the kind of regulation which is expected of it. Thus, it should have greater authority to impose civil penalties for violations which fall short of criminal conduct and the right to impose cease and desist orders against any person. This should include authority to order respondents to refrain from future violations, to take steps to effect future compliance, to require accounting of investor money to disgorge ill-gotten gains, and to penalize securities firms for failure to properly supervise their personnel in respect to their securities dealings. SEBI should also have authority to issue an order without prior notice and opportunity for hearing if it determines that notice and hearing prior to entry is impracticable or contrary to the public interest. A subsequent hearing should of course be provided for. Court enforcement of SEBI imposed cease and desist orders and imposition of civil money penalties for failure to comply should also be provided for.

April 11, 1997

Committee for Amendment of the Securities Laws  
Securities Exchange Board of India

Page 4



SEBI should also have additional administrative jurisdiction over non-licensed persons and entities including issuers, officers, directors employees and anyone else who caused or could have prevented securities law violations

New judicial and administrative remedies of the types suggested are needed to deter violations and to increase SEBI's flexibility to tailor remedies more precisely to a particular violation thereby maximizing the effectiveness of its enforcement actions and enhancing the deterrent effect of the enforcement program

#### Existing Law

Under Section 15A through H of the SEBI Act, various civil penalties are delineated as to various types of improper action or inaction up to and including insider trading for which the prescribed penalty is up to, but not exceeding five lakh rupees. Under those sections, only fines are permitted for the violations covered. Criteria are spelled out in Section 15J to which an Adjudicating Officer in adjudging the quantum of the penalty must have due regard. Criminal penalties and procedures are addressed in Sections 23 et seq of the Act. These provisions specify jurisdiction to be in no court inferior to that of a presidency magistrate or a magistrate of the first class

These provisions are acceptable as far as they go but, in addition to the penalties specified, authority should specifically be granted to the Adjudicating Officer, in appropriate cases, to suspend or revoke the registrations of persons who are licensed with the Board in any category of registration. Presumably the Board can do this under the provisions of Section 12(3) of the SEBI Act which gives it authority to suspend or cancel a certificate of registration in such manner as may be determined by regulations but such would necessitate an additional hearing thereby resulting in further delay. Also, if suspension or cancellation are added as additional penalties in connection with the Section 15A through H violations, such would negate the potential argument that since penalty provisions were specifically prescribed for those activities they are the only ones that can be imposed.

But even getting to the point of imposing those penalties is complex. Under Section 15-I the Board is required to appoint an "adjudicating officer" who is authorized to hold an inquiry "in the prescribed manner" after giving the person concerned a reasonable opportunity of being heard for the purpose of imposing the penalty which is limited to fines. The Adjudicating Officer is given the power to summon and enforce attendance of any person acquainted with the facts and circumstances of the case and to give



evidence or to produce any document which in the opinion of the adjudicating officer may be useful or relevant to the subject matter of the inquiry. Thus it would appear that he has the authority to conduct a meaningful and far reaching inquiry as a prelude to reaching a conclusion.

If the Adjudicating Officer concludes that a person is in violation, he may impose such penalty as he thinks fit in accordance with the penalty provisions spelled out which, as stated, are limited to fines. Broader penalties should be provided. For instance, in insider trading cases, in addition to the fines authorized, the Adjudicating Officer should be able to relieve the perpetrator of the insider trading the amount of his gain, or the amount of loss avoided, in addition to the penalties of suspension or cancellation of registration if they are warranted. In the case of Insider Trading, suspension or cancellation should almost always be warranted if licensed persons are involved.

Appeals from the Adjudicating Officer's determination is to a Securities Appellate Tribunal rather than to the Board which would seem more appropriate. This tribunal has been given same powers which are vested in a civil court under the Code of Civil Procedure, 1908. The Act also specifies that no civil court shall have jurisdiction as to any matter which an Adjudicating Officer or Securities Appellate Tribunal has jurisdiction and no injunction can be granted by any court in respect to any action taken or to be taken in pursuance of any power covered by the Act. In securities matters, therefore, its jurisdiction is complete and exclusive. A person aggrieved by a determination of the Securities Appellate Tribunal may appeal to the High Court.

These are appropriate provisions but there should be additional civil remedial authority in SEBI before this tribunal gets involved. This authority should be along the lines suggested above. In addition, perhaps the first level of appeal from the Adjudicating Officer's determination should be to the Board itself. Appeals from the board would go to the Securities Appellate Tribunal. These additions to the law would enable SEBI to be more directly involved in the disciplinary process over those who chose not to obey the securities laws. See Attachment 3, "Building a Securities Market Regulator in an Emerging Market" which, among many other things, outlines the four powers consistently recognized that a regulator must be able to exercise as the principal ingredients of successful securities regulation in emerging markets. They are at page 111 as follows:

- \* establish rules and regulations
- \* control access to the market by licensing and revoking the licenses of all market participants
- \* monitor the behavior of market participants
- \* enforce standards and rules



If the suggestions made above are adopted, SEBI will have a greater ability to perform these functions than it has today

### 3. REPRESENTATION BY THE CENTRAL GOVERNMENT OF UP TO THREE PERSONS ON BOARDS OF STOCK EXCHANGES

Section 4(2) of the SC(R) Act permits "representation of the Central Government on each of the stock exchanges by such number of persons not to exceed three as the Central Government may nominate". This provision should be repealed. In the Notification dated September 13, 1994, the Central Government delegated this power to SEBI. Section 10 of the Securities Contracts (Regulation) Rules, 1957, authorizes SEBI to nominate up to three persons as members of the governing body of all stock exchanges. These apparently may or may not be government or SEBI personnel.

Government involvement in the operation of exchanges is antithetical to the concept of a free market and could stifle initiative and creativity. SEBI should clearly have an oversight role (and exchanges should work closely with it in a system of cooperative regulation) but neither SEBI nor the Central Government should participate in the operation of the organization.

### 4. SELF REGULATION AND SELF REGULATORY ORGANIZATIONS

SEBI has on more than one occasion expressed its support for self regulation and has stated that self regulation is "the cornerstone of the regulatory framework advocated by SEBI". Unfortunately, however, there are no regulations or other writings delineating what self regulation is meant to be in India, what organizations should be considered self regulatory organizations (SRO's), precisely what is expected of them or what the relationship should be between a self regulatory organization and SEBI in the development and enforcement of the SRO's rules. These areas should be clarified. There are 23 stock exchanges in India. Are all of them self regulatory organizations? Should they be? What are their self regulatory responsibilities? What are their self regulatory capabilities? What about sub-brokers? If there is to be self regulation, should not they in addition to other elements of the industry that are not stock exchange members also be subject thereto?

It seems to be commonly assumed in India that the stock exchanges are self regulator organizations and in terms of the regulation of their marketplaces and trading thereon they are. However, in the international context the term "self regulation" has a broader meaning.

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Self regulatory organizations may be organizations which are market operators and those which are not. There could be one self regulatory organization in a country or more than one. If there were only one such organization in a country, its responsibility would cover the whole industry from a self regulatory standpoint and it probably would not operate a marketplace but would closely coordinate its activities with marketplace operators (exchanges). If there were to be more than one self regulatory organization, their individual self regulatory responsibilities would be limited to, say, members of an exchange, merchant bankers or the over the counter market. The advantage of a sole self regulatory organization is that it would be cheaper for the industry to operate one, rather than more than one or several such organizations, and the possibility for having uniformity of regulation would be greater. The degree of regulation should not be greater or lesser in one part of the country than another or as administered by one organization than another.

Whatever the system, if there is to be self regulation, the entire industry should be covered rather than only a part. The idea behind self regulation is that it would provide day to day regulation as a complement to a government securities regulator's broader responsibilities dealing with policy and egregious violations of law. A self regulator would, therefore, develop a system of ethical standards and conduct and sales practices rules. Among other things, it would conduct periodic on site inspections of its members' activities no less than once per year to determine compliance or non-compliance with the law, rules adopted thereunder and its own rules. It would closely monitor the capital adequacy of member firms by, perhaps, requiring periodic filings of financial reports in addition to closely reviewing such in the on site inspections. It would also concern itself with the keeping of accurate records by members, their sales practices and other areas of conduct. It would have an effective disciplinary mechanism to impose sanctions on those who violate its rules or the law. It is doubtful that all of the exchanges have the wherewithal to operate a properly constructed surveillance program. Self regulation would, therefore, also involve the concept of a designated regulatory authority for firms that were members of an exchange not designated a self regulatory organization. All intermediaries engaged in the securities business would be required to belong to a self regulatory organization, or at least to an organization regulated by one. This would include sub-brokers, merchant bankers and others. If only part, rather than all, of the industry is brought under self regulation, there would not be a level playing field.

In a self regulatory system, a self regulatory organization is subject to the oversight of the government securities regulator from which it receives the right to act as such in the first



place. The government regulator closely oversees the activities of self regulatory organizations and has authority to withdraw an organization's designation as such if it doesn't properly discharge its regulatory responsibilities. Irrespective of all this, there should be an established scheme to guide application of the concept.

The term self regulatory organization is mentioned only twice in the Act, see Section 11(2)(d) and (i), but it is not defined and no responsibilities or obligations are assigned. For the self regulatory concept to be maximized it should have a legal framework established by a statute or regulation. SEBI may have authority under the SEBI Act to develop a self regulatory structure but the concept would be better supported by a statutory scheme establishing and defining the functions, authority and limitations on the SRO's regulatory authority and laying out the relationship between the SRO and SEBI. Close SEBI oversight of SRO's should be provided for in the statute. Such will not only add to the credibility of SRO's but also, and importantly, would guard against self interest in the discharge by them of their regulatory responsibilities. The regulatory activities of the government and the self regulators should in many ways complement each other and they should work together in a spirit of cooperation.

The FIRE project has previously made recommendations to SEBI to create a regulatory structure for self regulation and self regulatory organizations. See Attachments 1 and 2.

##### 5. MUTUAL FUND/UNIT TRUST LAW

India needs a separate comprehensive Mutual Fund Unit Trust Law which takes into account the unique regulatory challenge posed by "mutual funds" or "unit trusts" because of the special positions of trust or "fiduciary duties" their managers (asset management companies (AMC's), their officers and directors), individual and corporate trustees bear. These fiduciaries, who generally are personally unknown to the mutual funds' unitholders, almost invariably are sponsored by larger enterprises engaged in other businesses. Their sponsors and their related businesses stand to benefit from control over huge amounts of highly intangible liquid assets which are difficult to value. The regulatory structure must be strong enough to control the conflicts of interest and prevent the enormous potential for self-dealing which is inherent in this structure. Despite the dramatic improvements and protections made by SEBI's (Mutual Funds) Regulations, 1996 (the "Regulations"), the current regulatory framework is insufficient to provide the protections necessary for a sound mutual fund industry.



The existing regulatory framework has three fundamental flaws

**UTI's Mutual Fund Operations Are Not Subject To The Same Regulations As Other Mutual Funds.**

The Unit Trust of India ("UTI"), currently representing approximately 85 percent of fund industry assets, for historical reasons operates under its own statute, the Unit Trust of India Act, 1963. That statute lacks the structural protections essential to protection of mutual fund investors. Operating under its own rules under the imprimatur of the government of India, UTI enjoys competitive advantages and the unitholders in its schemes suffer from the lack of protections which other funds are required to provide. Moreover, certain UTI practices can simulate sometimes unhealthy responses from other funds (e.g. guaranteed returns and assurances against losses) which undermine the industry's credibility. The complete integration and harmonization of UTI's operations with those of the rest of the fund industry would strengthen the entire industry and rationalize the entire regulatory framework.

**Trustees Do Not Have The Power Or The Ability To Oversee Fund Operations, Control Conflicts Of Interest And Self-Dealing.**

SEBI's Regulations place the main burden of protection of unitholders interests upon mutual fund trustees who are appointed by fund sponsors. However, as mutual funds are currently operated, trustees lack the independence, the involvement, the tools, the staff, the training, the power and the incentives to carry out the broad responsibilities which the law gives them. For example, trustees are responsible for the fairness to schemes and their unitholders of portfolio transactions between fund schemes and their associates such as sponsors and the companies controlled by them but, under the Regulations need not learn about such transactions until they have been completed. The existing mutual fund regulatory system has sources both in the British system of regulation of Unit Trusts which relies on trustee oversight and in the U.S. system of separate corporate funds with both interested and disinterested directors providing oversight, resulting in multi-layered oversight or perhaps unnecessary duplication.

**Fund Sponsors Are Not Sufficiently Accountable To Fund Investors.**

Sponsors organize funds, appoint trustees, set up AMC's and directly or indirectly control their operations. Often mutual fund schemes are bought on the basis of the sponsor's reputation. Under current regulations sponsors may "fully guarantee" returns promised in their fund schemes offer documents if they state the manner in which such guarantees



are to be met. Sponsors or their associates also may act as brokers, effecting transactions in securities of up to 5 percent of the daily gross business of a fund, or as distributors so long as that fact and the brokerage or commission paid is disclosed semi-annually. They may also own as much as 49.9 percent of their fund's custodian. Any new mutual fund law should explicitly recognize a private right of action by unitholders against AMC's, officers, directors, trustees, and sponsors for breaches of duties to fund schemes and their unitholders. The accountability of sponsors to unit holders should be commensurate with sponsors' powers.

In addition to remedying these defects, a new mutual fund law should provide seven major areas of protections for investors. It should

**a. Prohibit Self-Dealing And Other Conflicts Of Interest.**

To ensure that trustees and disinterested AMC directors have a full opportunity to fulfill their responsibilities, a number of internal safeguards are needed, including advance review procedures, to enable trustees and disinterested directors to carefully evaluate and authorize the fairness of proposed transactions. Such transactions also should be disclosed in advance to investors and subject to approval by an independent third party such as SEBI. Care also should be taken not to permit any ancillary source of profit to those affiliated with mutual funds so significant that it detracts from the single minded loyalty demanded of fiduciaries (e.g., permitting an AMC to speculate in fund shares).

**b. Provide Economic Regulation Of Remuneration Of Affiliates.**

The new law, like SEBI's Regulations, should set maximum fees that may be charged by AMC's for advisory services, define what expenses must be borne by the AMC and limit total fund expenses as a percentage of total assets. They should also set parameters for selling expenses and sales loads that may be borne by unit holders and provide a specific right to bring lawsuits against mutual funds if fund advisory fees are unreasonable.

**c. Prevent Unsound Capital Structures.**

Mutual funds must make sense as an investment for the common man. Liquidity and simplicity should be among a fund's most attractive features. A sound mutual fund capital structure should prevent, "pyramiding" (cross investing in other schemes of the same or



another AMC), excessive leveraging (borrowing), underwriting, and protect the integrity of the mutual fund as a concept by avoiding features which simulate bank accounts guaranteed debentures or government securities

**d Require Clear Disclosure Of Investment Objectives And Policies.**

Fund schemes should be required to disclose their investment objectives and policies in Offer Documents and advertisements and any changes in them should be made only with the approval of fund unit holders

**e. Protect The Physical Integrity Of Fund Assets.**

An independent custodian can not only protect the physical safety of fund assets, but can also help to assure the efficient administration of the fund through the record keeping procedures built into its operations

**f. Assure Fair Valuation Of Investor Purchases And Redemptions**

Fairness requires that net asset value be calculated on a uniform basis and that thinly traded and unlisted securities be valued "in good faith" by the AMC based on recognized valuation norms approved by its board. "Historical pricing," (using the last quoted price) should be prohibited. It can result in dilution of the interests of existing unitholders. Forward pricing (using the next quoted price) should be required of all funds and the interval between valuations should be narrow

**g Require Accurate Periodic Reports About Funds And Their Investments.**

Require that funds provide unitholders continuous relevant information about their investments portfolios, costs and expenses, performance, portfolio turnover ratios repurchase programs, and any changes in management or operational procedures

The Price Waterhouse FIRE Project has considered means of improving the regulation of mutual funds in various presentations over the course of its assistance to the Association of Mutual Funds in India (AMFI) We are pleased to attach four such presentations for the Committee's consideration. See Attachments 4 through 7



## 6. THE DEPOSITORY ACT

We believe there are two amendments which should be made to the Depository Act as soon as possible. These are as follows: the language which requires the depository to arrange "for indemnifying the beneficial owners for any loss that may be caused to such owners by the wrongful act, negligence, or default of its participants or any employee of (a) participant," and the language making the depository the principal and its participants its agents. If these provisions are eliminated the Act will have been significantly improved.

The proper relationship of the depository and its participants is the reverse of the present legislative language. We believe the depository could be mortally wounded by an early incident based on this language. We also believe that NSDL's efforts to protect itself from the effects of this language by suggesting wording affecting foreign custodians and their customers is causing foreign custodians to delay use of the depository. NSDL felt compelled to do this but it is no way to break the bottleneck delaying foreign portfolio investment in India.

Prompt modifications should be made in this legislation as suggested.

## RESPONSES TO QUESTIONS POSED IN ANNEXURE

The following responses are offered to the questions posed in the Annexure to your letter:

1. We have addressed above the ways in which we think the SEBI Act, the SC(R) Act, and the Depositories Act should be improved. We have also advocated enactment of a comprehensive Mutual Fund/Unit Trust Law. Our recommendation in this respect recognizes the dramatic improvements and protections made by SEBI's (Mutual Fund) Regulations, 1996, but the current regulatory framework is insufficient to provide the protections necessary for a sound mutual fund industry. As to the Companies Act, we have neither seen nor reviewed the study and recommendations of the Working Group appointed by the Government of India.

2. The referenced laws provide significant protections for the interests of investors but they can be improved at least as outlined in the above discussions. SEBI's adequacy under the referenced laws to regulate could also be substantially improved if the suggestions made are adopted.

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3 Yes, but we are unaware of the involvement of all of the entities listed. All securities industry matters should to the extent possible be under the sole jurisdiction of SEBI. Matters involving money market mutual funds, for instance, should not have to go through the Reserve Bank of India. RBI should be limited to its statutory responsibilities over bank financial instruments. Regulatory matters should be the internal responsibility of SEBI without the involvement of, or access to, the Central Government. Appeals to the court system should be permitted. Criminal matters should on referral by SEBI be handled by the public prosecutors. However, SEBI administrative authority should be sufficient to address many of these matters administratively, also. Such would result in more expeditious action against perpetrators of these crimes and would not preclude subsequent criminal action. We are not aware of the extent of involvement of Consumer Forums in the securities industry's processes though if they provide assistance to investors their activities are undoubtedly worthwhile.

4 We spoke to SEBI's investigation and enforcement responsibilities above. We defer on the question of whether the investigation and enforcement provisions are adequate and well balanced in securities laws having a value consistent with the principles of criminal jurisprudence and the constitutional framework of India.

5 and 6 These questions appear to be identical. We have addressed above ways in which we believe the SC(R) Act should be amended.

7 We have addressed above the issue of SEBI and/or Central Government representation on stock exchange Boards of Directors. We think these requirements should be changed.

8 As noted above, we understand the Working Group has made recommendations in this area. We look forward to reviewing the report when it is available.

9 We have not reviewed the Working Group's report and we will comment when it is available.

10 This question postures what penalties should be applied as to a variety of improper practices and criminal activities. Administratively, SEBI should have the general authority to censure, fine, suspend or cancel the licenses of all licensed persons and to bar them from further participation in the securities industry, or to impose any other fitting sanction. Today, for instance under Section 15G of the SEBI Act, SEBI can only impose a fine of five lakh rupees for insider trading. This is not enough though, if it is a licensed person under other provisions of the SEBI Act it can cancel the license. It should also have authority, in addition to the fine, to relieve the perpetrator of the gain received or the



loss avoided as a result of the insider trading SEBI should also be able to prohibit further participation by that person in any aspect of the securities industry, including from being associated with a public company We addressed above other civil remedies which SEBI should have, such as, cease and desist authority, among others

As to non-licensed persons, such as, company directors and other company officials, SEBI should have the authority to bar them from further participation in the management of a public company, and from future participation in any aspect of the securities industry in addition, perhaps, to authority to fine them. Additionally, since virtually all of the conduct described in the question appears to rise to the level of criminal activity, appropriate criminal penalties should be provided for

11. It is not clear how the term "securities audit" is being used, that is, does it mean a count or pricing of the securities held as principal by broker for capital adequacy, or other purposes, or of customers securities held by the broker, or does it have some other meaning?

12. Accounting standards should be made uniform in accordance with Internationally Accepted Accounting Standards. Efforts in this direction should be undertaken by the Institute of Chartered Accountants of India (ICAI) We recommend that any consideration of legislation include granting SEBI authority to establish mandatory accounting standards for all capital market financial institutions in conjunction with the ICAI.

13. If the transactions are truly private placements within the internationally accepted understanding of the term, they should not be regulated by SEBI which should be concerned with transactions in which the public is involved A bona fide private transaction would be outside the scope of such interest. The anti-fraud provisions of the securities law should cover private placements, however

14. India should be concerned with enforcing its securities laws within its jurisdictional boundaries. Improper activity in other countries should be addressed by those countries

15 and 16 We have addressed the principal ways which we believe the Depositories Act should be amended in the discussion above

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17 We are not familiar with the rules of evidence or the burden of proof as to securities offenses in India. However, as a general rule such procedures should be guided by the concept of fairness. Charges should be required to be in writing, a copy thereof should be supplied to the person or entity being accused, there should be a right to respond and to have a hearing, there should be a right to representation by counsel, the right to present evidence on behalf of the accused, and a requirement that there be a written determination on the charges brought within a reasonable time after the hearing. The burden of proof should always be on the accuser. As to fairness in investigative proceedings generally, see Attachment 3, page xiv

18 and 19 seem to pose the same question re should there be compensation funds for victims of fraud, though question 18 adds victims of malpractice to those of fraud. Initially, it should be noted that defrauded investors and those victimized by malpractice have available to them the right to bring a lawsuit to recover their losses from those who victimized them. No new legislation or regulatory action is needed for this. We suggest above that SEBI should have the power require disgorgement. Such authority would also assist victims of fraudulent activity in recovering their losses.

In addition to the funds maintained by clearing corporations, funds maintained by markets are, generally, of two types: those that compensate for fraud or other improper activity by securities intermediaries which result in losses to customers, and those which compensate for losses to customers resulting from the financial failure of securities firms. A number of markets in the developing countries have compensation funds of the former type. The more developed markets tend to have the latter type. They are all expensive and the cost benefit of such should be explored before adoption though we understand that some of the exchanges in India do today have compensation funds of the former type. Compensation funds should never purport to compensate for market risk.

An alternative to a compensation fund for fraud and malpractice would be a requirement that all securities firms have fidelity bonds covering officers and employees and which insure against loss, and have agreements covering, at least the following in specified minimum amounts: fidelity, on premises, in transit, misplacement, forgery and alteration (including check forgery), securities loss (including securities forgery) and fraudulent trading.

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Minimum coverage in relation to required capital should also be provided for. If fidelity bonds are available in India with the correct protections, they are a good alternative to compensation funds for fraud and malpractice. This approach should be explored.

20 We have no further comments though Attachments 8, 9 and 10 include comments from Price Waterhouse consultants which have worked extensively in India as part of the Fire project.

Sincerely yours,

A handwritten signature in black ink, appearing to read 'Dennis Grubb'.

**DENNIS GRUBB**  
**PRINCIPAL CONSULTANT CAPITAL MARKETS**

## ATTACHMENTS



1. **Self Regulation in the Securities Industry** by Frank J Wilson, Price Waterhouse Regulatory Consultant.
2. **Outline for Development of Self Regulation in India** by Frank J Wilson
3. Price Waterhouse document entitled **"Building A Securities Market Regulator in An Emerging Market"** (Draft), June 3, 1996.
4. **Realizing Mutual Fund Potential for Developing the Capital Markets**, Memorandum of Lewis J. Mendelson, Price Waterhouse Mutual Fund Consultant, to the Association of Merchant Bankers of India ("AMBI"), November 15, 1996, Section II, pp 5-10
5. **Reflections on Regulation: The Role of Industry**, Keynote Address by David Silver, Price Waterhouse, Special Mutual Fund Consultant, before the UTI/AMFI Thiro Annual Seminar on Mutual Funds, January 20, 1997
6. **An Assessment of The Regulatory Environment for India's Mutual Funds, An Assessment As of January 1997**, by David Silver.
7. **"Reforms That Will Improve the Securities Markets and Provide New Opportunities for Investors,"** by Lewis J. Mendelson, Panelist, at the Seventh Technical Session of the UI/AMF seminar, "Mutual Funds Through 2000 "
8. Comments of J Clifford Kennedy, Price Waterhouse Regulatory Consultant.
9. Comments of Thomas Keyes, Price Waterhouse Training Consultant.
10. Comments of Paul Litteau, Price Waterhouse Qualifications Consultant.