Impact of Regulatory Changes on Mutual Fund Industry: Global Comparisons

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1. Principles of Regulation

Driving an automobile can be risky. It can be fatal for the occupants of the car or can cause collateral damage to completely unconnected people. But, it provides savings of time, immense convenience and comfort compared to the earlier horse-drawn carriages. Advancements have been made in the design of the car to ensue that it is safe. Standards of road-worthiness are provided to see that unworthy vehicles are not on the road. Traffic rules are made to ensure safety, orderliness in right of passage and to minimise collateral damage. Authorities decide whether the car can drive on the left or the right, it can honk the horn in any area or not, speed limit within which it must drive and when it must stop to allow passage to others.

Advancements in technology, human enterprise and innovations which provide huge benefits to humanity, also need collective wisdom of regulation to balance the interest of various segments and constituents. While innovation had to be encouraged, uncontrolled, unregulated innovations unmindful of interest of segments of society were frowned upon and hence controlled and regulated. Nations and societies gave powers to law makers to do so. The basic principle of regulation is rule of law. It involves fair treatment for all, wider consultation while enunciating the law, a review of the action, operation and process of the law and allowing redressal at superior appellate bodies. In the financial sector, the guiding philosophy world over has been to protect the interest of uninformed small customers from the avarice and speculative tendency of the larger players of the financial markets. The worry also has been that it is not only a question of protecting one individual but also that large episodes of misconduct in any segment of financial market can have a serious deleterious impact on the health of the entire economy, even the global economy.

2. Mutual Fund Industry – Global Examples

The Mutual Fund industry world over has grown on the back of the trading activities in the shares of the joint stock companies and coming together of stock exchanges. While some people credit the origin of mutual fund industry to Netherlands in 1774, it is generally accepted that the industry started in the second half of the 19th century in England. In order to appreciate the environment in India and its impact on the industry, it will be useful to go through examples of some other parts of the world. The most important would be to look at the USA which has the largest size in the industry and has paved the way for growth in other parts of the world.

2.1 Early Developments

Compared to Europe, the USA was late to start and the first Fund came into existence in 1924. Three firms had started in Boston in 1924. Their main features were: no leverage, daily redemption and sales at NAV. At the same time, close-ended funds started in New York, promoted mainly by security firms. The crash of 1929 gave a serious blow to the industry and the demand for regulation became vocal. The debate went into several directions, including whether the Federal Government or the State Government should regulate it. At one stage there was a report (Pujo Report) arguing that since the Federal Government had the power to regulate mails under the Constitution, the regulation can be given to the Postal Department ! The Landis-Cohen Bill of 1933 (Securities Act), the enactment of Securities Exchange Act in 1934 and the passing of Revenue Act 1936 gave a firm framework within which the industry had to operate. But the need for a separate legislation to regulate the mutual fund industry led to creation of the Investment Companies Act, 1940, of which the main object was "to prevent abuse of position, fraud and conflict of interest that had occurred in prior periods" For example, in order to prevent leveraging, the Act prevented mutual funds from issuing senior securities and also limited bank borrowings. It also banned dumping of shares which was prevalent in the close ended funds. It provided for specific 'dos and don'ts' to remove any uncertainty as to rights and duties. The enactment coupled with the market boom of 1940-60 led to massive growth of the industry. Between 1940 and 1960, the AUM grew from $450 million to $ 17 billion and in 1970 touched $ 48 billion. The number of investors grew from less than 300,000 in 1940 to about 5 million in 1960.

2.2 Inter-regulatory Issues

Mutual funds helped in democratising finance and in taking the specialised world of 'Wall Street' within the reach of everyone who had money to buy shares. The growth, obviously led to conflict with industries like insurance and banking. Insurance industry came up with new products like Variable Annuity (similar to ULIPs). It is interesting to note, in the current ongoing debate between IRDA and SEBI, that it was held by the US Courts that variable annuities were securities under the Securities Act and that pools of assets were liable to be registered as investment companies under the Investment Companies Act. The dispute that banking industry started, when there was a massive growth in the money market funds post 1972, was that reserve requirement similar to banks should be imposed for investment companies offering money market funds. However, the same was not accepted and the money market funds continued to grow when the stock market was quite choppy.

2.3 Amendment of IC Act, 1970

The next level of regulatory development in the USA happened with the amendment to Investment Companies Act in 1970. An earlier report in SEC had recommended that fees should be "reasonable". It did not provide for any specific limit on fees but a fiduciary duty while charging fees. As such, if the same was not found "reasonable", then the investment company could be taken to Court. It also allowed reasonable compensation for sales personnel, broker dealers and underwriters.

Different sections of the Act provided for categories like no-load funds, load funds, contractual plans and Section 12(b)(1) plans – where the fund itself acts as its distributor. Different share classes eg. A, B, C, D with varying combinations of front end load, no load etc. came into existence. Some fund houses famously started "no load" funds but with 12(b)(1) component. The choice of selecting the share class is on the investor depending upon his investment horizon and whether or not she requires any investment advice. While there is no cap on management fees, market pressures have put downward pressure on fees. Generally, the 1970 amendment is considered as an attempt to regulate rates of fees. However, in reality the amendment provided for some basic principles in rates regulation for transparency and led to the competition driving down prices.

2.4 Pension Reforms

The next round of developments in the US mutual fund industry came on account of developments in the Pension Plans. Before 1962, self-employed workers were not covered. As such, the Self Employed Individuals Tax Retirement Act – SEITRA 1962 was enacted – (also called Keogh Plan). The major boost came with the Pension Reforms Bill of 1974 i.e. Employees Retirement Income Securities Act – ERISA, which enhanced the deductible income to $ 7500 or 15% of the income and also allowed investments in mutual funds. Earlier, most of the plans were 'defined benefit plans' where employers bore the risk. This paved the way for 'defined contribution plans' with tax benefits. ERISA also amended 403B of Internal Revenue Code allowing public school teachers, employees of non-governments institutions like colleges, hospitals etc. to invest their pension money in mutual funds. A tax dispute whether a bonus received by an employee during a year can be counted as cash income for tax during the year or it can be deferred if it is reinvested in a DC Plan, led to the famous 401K Plan under the Internal Revenue Code. It provided that if the pension plan was well diversified and there was no bias towards high income workers availing the facility, then the tax deferral can be allowed.

3.1 European Union

While individual countries in Europe have their own regulations and guidelines, the first directive on Undertaking for Collective Investment in Transferable Securities (UCITS) was issued in 1985. These have developed into a dynamic and highly successful global brand attracting investment from various parts of the world. Subsequently, these directives have evolved and new directives UCITS IV is to be implemented from June 2011. UCITS is a stamp of European Union-wide regulatory approval and a fund listed on one European exchange may be passported to and distributed to other states.

Some of the underlying ideas are reduction of cost as the need for running multiple management companies in different jurisdictions will not arise . It may also trigger a rethink on fund administration model and start a competition amongst them. The underlying approach in UCITS is on quality of disclosure, qualification of distributors, risk management, diversification of assets in a fund, restriction on exposure to a company etc.

3.2 United Kingdom

In the UK, mutual funds can have a front end charge and distributors are paid commission out of this. Additionally, distributors are paid a trail commission. Also, there is no regulatory cap on the management fees charged. All Fund Houses have to make the disclosure in their scheme document. The market forces determine the AMC fees charged by the Fund Houses. However, the way mutual funds are sold in the UK are about to change as the Financial Services Authority (FSA) proposed in 2009, a series of changes to the way financial services are sold. FSA has proposed a 'Retail Distribution Review', wherein there will a ban on the commission

payment from product providers and will enforce Distributors / Financial Advisors to agree on a fee payment directly with the investor. This will be across the financial sector and will cover not only mutual funds but also insurance and pensions and apply uniformly to all these sectors from the same day.

4. Indian Experience

4.1 Unit Trust of India is the mother of mutual fund industry in the country. The policy direction of the Government to mobilize household savings for the growth of the market and the Indian economy are available in the debates in the Parliament when the Unit Trust of India Act was passed. A close reading of the UTI Act will also throw light on the objectives of the Act and the safeguards provided for the investors.

With the creation of SEBI and multiple mutual funds, came the Mutual Fund Regulations. The interesting thing has been the regulation of activities rather than the regulation of asset management companies. There are separate regulations for activities like mutual fund, portfolio management services, offshore funds, FIIs etc. SEBI, in conjunction with AMFI, has developed a series of 'dos and don'ts' through regulations, notifications or circulars on matters like valuation of securities, expense ratio, fees to be charged, disclosures to be made, advertisements, conduct of fund management, key personnel, role of trustees, compliance standards, reporting mechanism, publication of scheme information, avoidance of concentration risk and a host of other related areas for investor protection.

4.2 However, one important missing link in the existing framework has been the articulation of the policy on mutual funds. The Investment Companies Act of 1940 provides a bedrock in the USA and the UCITS guidelines provide the same for Europe. In India, the preamble of the SEBI Act includes "to protect the interests of investors in securities" and "to permit the development of and to regulate, the securities market". In the last two decades of liberalisation, there have been successive policy announcements and setting up of regulators in areas like electricity distribution, insurance, telecom, airlines, ports etc. What has worked successfully in these areas is the enunciation of the Government policy providing for objectives, role and obligations of the players. This has been followed by enactment of specific laws/regulations.

The situation for the mutual fund industry has become more challenging as two new industries viz. insurance and pension have emerged in the last decade. Both these operate in activities strikingly close to the mutual fund industry. However, the rules are vastly different. As such, in order to contextualise the role of the mutual fund industry, one may have to go back five decades to read the debate in the Parliament while discussing the passage of the UTI Act. Member after member, including the then Finance Minister, T.T.Krishnamachari, highlighted that the aim is to mobilize household savings for the growth of the Indian economy and industry and for the benefits of the growth of the economy to be passed on to the ordinary investors.

The mutual fund industry is now being accused of doing only short term money, being captive to distribution industry and not doing enough to reach out to retail. Yet, there are no regulatory encouragements for fund houses which are actually following these broad objectives. On the other hand, there are other industries where things are less transparent, yet they have the support of policies and legislations.

4.3 Recent Changes in India

According to a reputed analyst, the regulator has effected, on an average, one regulatory change every two weeks in the last twelve months, including the one banning entry loads effective August, 2009. It is still too early to make a scientific assessment of the impact of the changes on the mutual fund industry but the macro data is indeed telling:

Rs.in crores

	2007-08	2008-09	2009-10	Apr 09 to Jul 09	Aug 09 to Mar 10
Net equity sales in MF	46933	4024	2149	7549	(-)5400
Sensex returns	19.68	-37.94	80.54		
Net ULIP sales	70603	44691	59847		

In a year like 2009-10, when the stock market has given a return of 80.5% (Sensex), the mutual fund industry recorded negative sales, whereas even in a tumultuous year for the market like 2008-09, the sales were positive. The industry has lost 3.92 lakh equity folios in the period November 2009 to May 2010.

5. Way Forward

An industry can function or long term commitment can be given only in a wider policy environment. Post liberalization, the Government has been successful in many areas where private competition was encouraged

and the Government reduced its commercial role. The obligations imposed on the industry have been honoured with a high success rate. All policies have to be developed keeping in mind the long term needs of the economy and of its citizens, other alternative products on offer, the operating environment for the same and also by taking advantage of the developments in other parts of the world.

But for the Securities Exchange Act of 1940, the tax breaks, pension reforms like ERISA, favourable tax treatments and a strong supervision by the regulators, the US mutual fund industry would not have grown and the confidence of the citizens in the industry would not have been generated. Inspite of the negative development of the last two years in the global market, Europe is also trying to make its regulations more transparent and cost effective. Unless the desire for investor protection and genuine needs for the growth of the industry in the given policy environment are balanced, the mutual fund industry in India is likely to see a challenging time in the foreseeable future.

Pedestrians, cyclists and car owners have different needs. But all of them have to perambulate on the same road. Rules of traffic have to be drafted taking into account their genuine needs in a fair manner.