Ease of Doing Business Initiatives for Mutual Funds: SEBI Invites Public Comments

written by King Stubb & Kasiva | March 5, 2024

Introduction

Mutual funds (MFs) are professionally managed investment vehicles that pool the funds of multiple investors to acquire a diverse portfolio of securities, such as shares, bonds, and other assets. Even with lower investment amounts, they offer investors an easy way to gain access to the financial markets while benefiting from professional experience.

The “Ease of Doing Business” concept focuses on creating a regulatory environment that encourages enterprise growth and progress. In the case of MFs, this entails streamlining processes, cutting red tape, and allowing for greater regulatory flexibility. This not only accelerates the foundation of new funds, but also alleviates the administrative workload of existing ones. This could result in lower fund expenses, increased investment efficacy, and potentially lower investor fees. Furthermore, a positive business climate encourages innovation and healthy competition in the MF industry, providing investors with a wider range of products and services from which to choose.

Recognizing the need to enhance the ease of doing business in the MF industry, SEBI recently released a **Consultation Paper on Ease of Doing Business Initiatives for Mutual Funds.**[1] This paper seeks public feedback on several proposed initiatives aimed at streamlining regulations and reducing the administrative burden on industry participants. This article aims to analyse the proposals and their impact in the following manner:

- Background and Context
- Key Proposals in the Consultation Paper
- Analysis of Potential Implications

Background and Context

Current Regulatory Landscape for Mutual Funds

The Indian MF industry operates under a comprehensive regulatory framework established by SEBI. Key regulations include:

- **SEBI (Mutual Funds) Regulations, 1996**: These regulations govern the entire life cycle of a MF scheme, from launch and operation to winding up. They define the roles and responsibilities of various stakeholders, including sponsors, trustees, Asset Management Companies (AMCs), and custodians.[2]
- **SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015**: These regulations govern the listing of MF units on stock exchanges and ensure proper disclosure of information to investors.[3]
- **SEBI (Prohibition of Insider Trading) Regulations, 2015**: These regulations prohibit insider trading in securities, including mutual fund units, to protect investor interests.[4]

Challenges Faced by Industry Participants

Despite the established framework, the industry still faces certain challenges:

- **Multiple regulations and complex compliance requirements**: Navigating various regulations and their interpretations can be time-consuming and resource-intensive for AMCs.
- **Duplication of procedures and reporting**: Different regulations may require redundant information submissions, increasing administrative burdens.
- **Limited flexibility**: Existing regulations might restrict product innovation and hinder the development of new investment strategies.

Concept and Significance of Ease of Doing Business

In the MF context, ease of doing business aims to streamline regulations, reduce administrative burdens, and foster an environment conducive to growth and innovation.

A business-friendly environment can benefit the industry in several ways:

- **Reduced compliance costs**: Streamlining processes and eliminating redundancies can lead to cost savings for AMCs, potentially translating into lower expense ratios for investors.
- **Enhanced efficiency**: Simplifying regulations can enable AMCs to dedicate more resources towards core investment activities and product development.
- **Increased innovation**: A more flexible regulatory framework can encourage AMCs to launch new and innovative investment products, catering to a wider range of investor needs.
- **Improved market participation**: By lowering entry barriers and facilitating participation, a conducive environment can attract new players and enhance overall market competition.

Recent SEBI Initiatives

Recognizing the importance of ease of doing business, SEBI has undertaken several initiatives in recent years:

- Introduction and updating a Risk Management Framework for Mutual Funds.[5]
- Implemented a centralized KYC (Know Your Client) system to streamline investor onboarding processes.[6]
- Introduced online filing portals for various regulatory submissions, reducing paper-based processes.

Key Proposals in the Consultation Paper

Objective and Background

This consultation paper aims to gather public comments and suggestions on proposed ease-of-doing-business initiatives for MFs. The objective aligns with the Finance Minister's directive in the FY 2023-24 budget to simplify compliance and reduce costs for participants in the financial sector through a consultative approach.[7]

In response to the budget announcement, SEBI formed a Working Group (WG) to review compliance requirements for MFs. The WG, focusing on the SEBI (Mutual Funds) Regulations, 1996, and related circulars, aims to enhance the ease of doing business for MFs. Public feedback was also sought through a press release dated October 4, 2023, regarding various regulations, including MF Regulations.[8] The WG's interim recommendations cover aspects such as appointing a single fund manager, relaxing nomination requirements, and streamlining prudential norms for passive schemes within AMC's group companies. This consultation paper details these recommendations, seeking further input from the public.

Proposal 1: Appointment of Single Fund Manager

- **Current Requirements**: The Master Circular for Mutual Funds, dated May 19, 2023, mandates the appointment of dedicated fund managers for commodity-based funds and overseas investments.[9]
- **Challenges Identified by WG**:
  - Additional costs for Asset Management Companies (AMCs) due to employing two fund managers.Transactions in overseas securities are comparatively less, potentially rendering a separate fund manager unnecessary.
  - AMCs already employ research analysts for each security/sector, regardless of domestic or overseas investment.

- **WG's Recommendation**: Make the appointment of dedicated fund managers optional, contingent upon AMCs ensuring the competency of the chosen fund manager, meeting expertise and experience criteria. The Board of AMCs would be responsible for compliance, reporting to trustees periodically.

Proposal 2: Nomination for Mutual Fund Units

- **Current Requirement**: Clause 17.16 of the Master Circular stipulates the necessity for nomination/opting out of nomination for individual unit holders by June 30, 2024, to prevent folios from being frozen for debits.[10]

- **Concerns Highlighted by WG**:
  - Surviving joint holder(s) taking precedence over the nominee during unit transmission in jointly held folios.
  - Delays in the nomination process when all holders are not available simultaneously.

- **WG’s Recommendation**: Make the requirement for nomination optional in the case of jointly held folios.

Proposal 3: Streamlining Prudential Norms of Passive Schemes

- **Current Limits**: Regulations limit mutual fund schemes’ investment in the listed securities of sponsor group companies to 25% of net assets. However, for sectoral/thematic passive funds, a single stock/issuer can have a weight of up to 35% in the underlying index.
- **WG’s Recommendation**: Relax the 25% limit for equity-oriented ETFs/Index Funds based on widely tracked and non-bespoke indices to allow investments in line with the constituent weightage of the underlying index, reducing unintended tracking errors.

Analysis of Potential Implications

Proposal 1

The proposal suggests making the appointment of dedicated fund managers for commodity and overseas investments optional. This move aims to alleviate operational challenges and reduce costs for AMCs. While this consolidation enhances efficiency and expertise, concerns arise regarding concentration risk and potential conflicts of interest.

Mutual fund houses may benefit from improved efficiency but must implement robust risk management and conflict mitigation strategies. Investors may gain from concentrated expertise but need stringent regulatory oversight for risk protection. Regulators face the task of emphasizing risk management frameworks for AMCs.

Proposal 2

The recommendation to make the requirement of nomination optional for jointly held folios simplifies the nomination process, offering convenience for investors and facilitating smoother succession planning. However, challenges include the potential for misuse and the need for awareness campaigns to educate investors about the revised procedure.

Investors stand to gain in terms of convenience and clarity in succession planning, but regulators must establish safeguards against fraudulent activities and promote investor education.

Proposal 3

The proposal advocates relaxing exposure limits to a single stock for equity-oriented ETFs and index funds based on widely tracked indices. This change aims to enhance flexibility for passive fund managers and reduce regulatory burden. However, challenges include increased concentration risk and concerns about investor protection.

Mutual fund houses may benefit from increased flexibility but must implement robust risk management frameworks. Investors may have the potential for higher returns but need to carefully assess risk-return profiles. Regulators face the task of calibrating regulations to balance flexibility with investor protection.

Conclusion

The proposals outlined in the SEBI consultation paper seek to streamline regulations and reduce the burdens on mutual funds. These proposals have the potential to improve flexibility, convenience, and efficiency. Concerns about investor protection, conflicts of interest, and concentration risk, on the other hand, necessitate a thorough investigation and effective mitigation measures. Open to public feedback, this consultation process paves the way for collaborative efforts to foster a business-friendly environment that prioritizes both growth and investor safeguards in the Indian mutual fund industry.

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[1] https://www.sebi.gov.in/reports-and-statistics/reports/feb-2024/consultation-paper-on-ease-of-doing-business-initiatives-for-mutual-funds_81722.html.

[2] https://www.sebi.gov.in/legal/regulations/aug-2022/securities-and-exchange-board-of-india-mutual-funds-regulations-1996-last-amended-on-august-3-2022-_61683.html.

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[4] https://www.sebi.gov.in/legal/regulations/nov-2022/securities-and-exchange-board-of-india-prohibition-of-insider-trading-regulations-2015-last-amended-on-november-24-2022_65864.html.

[5] https://www.sebi.gov.in/legal/circulars/sep-2021/risk-management-framework-rm

f-for-mutual-funds_52943.html.

[6] https://www.sebi.gov.in/legal/master-circulars/oct-2023/master-circular-on-know-your-client-kyc-norms-for-the-securities-market_77945.html.

[7] https://www.indiabudget.gov.in/doc/bspeech/bs2023_24.pdf.

[8] https://www.sebi.gov.in/media-and-notifications/press-releases/oct-2023/working-groups-to-recommend-on-simplification-ease-of-compliance-and-reduction-in-cost-of-compliance-suggestions-invited_77632.html.

[9] https://www.sebi.gov.in/legal/master-circulars/may-2023/master-circular-for-mutual-funds_71438.html.

[10]https://investor.sebi.gov.in/market-nomination.html#:~:text=Earlier%20the%20deadline%20for%20nomination,demat%20account%20will%20be%20frozen.

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