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Greater Mutual Fund Transparency in India

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NOTES

Greater Mutual Fund Transparency in India: Enhanced Disclosure Protection for India's Mutual Fund Unitholders in a Time of Market Volatility

ABSTRACT

India has been one of the darlings among emerging market economies over the past decade. It has experienced dizzying economic growth that has lifted great numbers of Indians out of poverty and changed the economic outlook of much of its populace. For the first time, many Indians have excess funds to save or invest, and the Indian mutual fund industry has enjoyed an explosion in popularity as a result of this economic boom, particularly among first time mutual fund investors.

One of the most important mechanisms for investor protection in any capital market is the provision of information to investors by market participants. The Securities and Exchange Board of India (SEBI), India's mutual fund regulator, has developed an information disclosure regime that, for the most part, has evolved along with the industry's explosive growth. However, SEBI's requirements have failed to keep pace with the industry's torrid growth in certain key areas. Changes to this regime are particularly important given the market turmoil that has occurred in India recently, the likes of which many first time Indian mutual fund investors have likely never have experienced before. To that end, this Note proposes substantial modifications to the Indian mutual fund regulatory regime's information disclosure requirements in certain key areas in order to maximize protections for Indian mutual fund investors, as well as to assuage their collective concerns.

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I. INTRODUCTION

The Indian economy has enjoyed unprecedented explosive economic growth since the late 1990S and, at least thus far, has not been nearly as badly impacted by the world's current economic situation as some other emerging markets.[1] This rapid growth has resulted in an increased standard of living and greater material prosperity for many of India's billions of people.[2] This economic surge has also changed the monetary outlook of many Indians and the uses to which the Indian populace has begun to put its savings.[3] Formerly content to let their savings accrue nominal rates of interest in a bank account, an increasing number of Indians have turned to other avenues in their search for greater returns than a savings account can provide.[4] The result has been a large rise in the level of assets under management in the Indian mutual fund industry and a new wave of enthusiasm for and interest in Indian mutual fund products.

For the most part, the Indian regulatory scheme has evolved at a steady pace along with the increased popularity of mutual funds among Indian citizens. The Indian mutual fund regulator, the Securities Exchange Board of India (SEBI), was created in 1988.[5] The first set of comprehensive regulations governing the mutual fund industry were promulgated by SEBI in 1993 and substantially revised in 1996.[6] SEBI has continued to periodically modify and streamline those regulations in an attempt to keep the investor protections that are at the heart of the Indian regulatory framework current as the industry continues to evolve and become more complex.[7] For the most part, SEBI's efforts to maintain the maximum level of investor protection possible have been well-thought

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1. *See* Heather Timmons, *India Maintains Sense of Optimism and Growth*, N.Y. TIMES, Mar. 2, 2009, at B1 ("While most of the world grapples with a crippling financial crisis and a recession, optimism reigns in much of India as its economy continues to grow.").

2. *See infra* Part II.A (discussing falling poverty levels and the creation of a new middle class).

3. Rama Lakshmi, *India's Savers Turn to Investing: Mutual Funds Take Off Among Middle Class*, WASH. POST. Apr. 14, 2008, http://www.washingtonpost.com/wp-dyn/content/article/2008/04/13/AR2008041302073.html.

4. *Id.*

5. RESEARCH DIV., SEC. & EXCH. BD. OF INDIA, GLOSSARY OF CAPITAL MARKET 5 (2003), *available at* http://www.sebi.gov.in/bulletin/glossarycover.pdf.

6. *Infra* Part II.F.

7. *See Annual Report 2007–2008*, 2008 SEC. & EXCH. BD. OF INDIA 1, 1, *available at* http://www.sebi.gov.in/annualreport/0708/Annrepo08.html ("SEBI continued its endeavor to remain committed to achieve the . . . protection of the interests of the investors . . . .").

out and effective. However, there are several areas in which the Indian securities regulatory apparatus needs substantial modification and improvement, particularly in light of the ownership structure and nature of the Indian mutual fund industry.

Information disclosure figures prominently in the Indian mutual fund regulatory regime in a variety of forms. Every Indian mutual fund is required to file an offer document with SEBI before selling units to the public and every mutual fund scheme is required to make a number of mandatory yearly and half-yearly disclosures.[8] SEBI has specifically prescribed disclosure of a number of important pieces of information and characteristics by every mutual fund in an Annual Report.[9] Among these requirements is a report by the fund trustees on fund performance and expenses over the course of the year.[10] SEBI has received praise from a number of quarters for its disclosure requirements, but has also faced criticism from several constituencies for not mandating enough of the right kinds of disclosure of information crucial to Indian investors.[11]

SEBI has not fully utilized disclosure as an effective tool for investor protection. SEBI has failed to utilize disclosure as effectively as is necessary, particularly considering the fact that India has so many first time mutual fund investors.[12] Although the economic turmoil currently occurring in India is less pronounced than in other markets, even the muted economic downturn in India is likely causing considerable anxiety among novice investors who are completely unused to market downturns. SEBI should immediately begin to take steps to provide for an enhanced Indian mutual fund disclosure regime. Several additional disclosure requirements are needed in order to maximize the effectiveness of disclosure as a method for protecting Indian investors. This Note will advocate nine essential reforms to the Indian mutual fund regulatory regime that should be immediately enacted by SEBI.

Part II of this Note describes India's economic history in the second half of the twentieth century and notes its impressive economic growth towards the later stages of that period. Part II also provides background information on the Indian mutual fund industry, describing the structure and characteristics of Indian mutual funds, reviewing their rapid increase in popularity during the

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8. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, paras. 28, 54–55, 59, 59A, Gazette of India, pt. II, § 3(ii).

9. *Id.* paras. 54–56.

10. *Id.* para. 54.

11. *Annual Report 1997–1998*, 1998 SEC. & EXCH. BD. OF INDIA 1, 17, *available at* http://www.sebi.gov.in/annualreport/9798/ar9798.html; Rajesh Gajra, *Investing in Transparency: Sebi Needs to Act Fast on Mutual Fund Disclosure Standards*, BUSINESSWORLD, Nov. 21, 2008, http://www.businessworld.in/index.php/Markets-Finance/Investing-In-Transparency.html; *infra* Part IV(b).

12. Lakshmi, *supra* note 3.

past twenty years and some of the reasons for that increasing popularity and then describing the Indian mutual fund regulatory framework. Part III describes the specific disclosure requirements with which Indian mutual funds must currently comply. Part IV provides a critical evaluation of these disclosure requirements, and Part V provides nine specific recommendations for enhanced mutual fund disclosure in India that should immediately be enacted by SEBI. Those specific recommendations are (i) disclosure and independent verification of the asset management company's (AMC) annual returns, (ii) the banning of assured return schemes, (iii) an increased standard of adequacy, (iv) increased enforcement, (v) enhanced risk disclosures, (vi) fee transparency, (vii) greater data access, (viii) greater use of languages other than English for fund disclosures, and (ix) mandatory disclosure of large fund shareholders. Part VI concludes by offering some remarks on the ease and utility of adopting the nine specific proposals that are presented in this Note.

II. BACKGROUND

A. *India's Economic Rise and Its Results for India's People*

After gaining independence from Britain in 1947, India had a centralized, highly controlled economy with particularly onerous exchange and capital controls that enabled the government bureaucracy to retain tight control over the country's economy for many years.[13] As is often the case in the developing world, a financial crisis in 1991 precipitated the Indian government's decision to liberalize its formerly stringently planned economy.[14] A balance of payments crisis became so severe that India was forced to request an emergency loan from the International Monetary Fund (IMF).[15] The stringent conditions imposed on the loan eventually led to the adoption of much-needed extensive liberalization measures.[16] Many consider the 1991 restrictions imposed by the IMF as the starting point of a revolutionary series of reforms that led to India's economic boom[17]—reforms that included cutting taxes and scrapping a system of industrial controls known as the "license raj."[18]

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13. Gerald Epstein et al., *Capital Management Techniques in Developing Countries: Managing Capital Flows in Malaysia, India, and China*, *in* CAPITAL MARKET LIBERALIZATION AND DEVELOPMENT 139, 154 (José Antonio Ocampo & Joseph E. Stiglitz eds., 2008).

14. *Id.* at 154–55.

15. *Id.* at 155.

16. *Id.*

17. P. Hanumantha Rao & Vijay Kr. Mishra, *Mutual Fund: A Resource Mobilizer in Financial Market*, 12 VIDYASAGAR U. J. COM. 109, 109 (2007) (India).

18. *Storm-Clouds Gathering*, ECONOMIST (London), Dec. 13, 2008, at 8.

As a result of the structural reforms introduced in the early 1990s, India has experienced an economic rise that has been nothing short of miraculous. While it experienced an annualized gross domestic product (GDP) growth of just 1.25% in the thirty years after it gained independence in 1947, India has witnessed a dizzying rate of growth in GDP ever since, with a growth rate of 7.5% as late as 2007.[19] This explosive growth has shown little sign of slowing down, with several commentators predicting that growth could exceed "5% for the next 30 years and close to 5% as late as 2050 if development proceeds successfully."[20]

Even the onset of a global recession seems to have barely affected the Indian economy's rapid growth rate.[21] Indeed, some commentators believe that the country will hardly be affected by current economic conditions as compared with the rest of the world, due largely to the fact that the Indian bureaucracy's iron grip over the economy, operating in conjunction with the country's protectionist policies, have largely shielded the country from the economic disaster that has devastated much of the rest of the world.[22] Indian officials predicted in March 2009 that the country's 2009 GDP would grow more than 7%.[23]

One of the more positive results of India's unprecedented economic expansion has been its effect on Indian citizens. The OECD found in its 2007 country report that India's economic boom has trickled down to the lower classes and that poverty among the Indian population has fallen in absolute terms.[24] Another positive result of India's continued economic expansion has been the creation of a new middle class.[25]

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19. *OECD Economic Surveys: India*, 2007 ORG. ECON. CO-OPERATION & DEV. 1, 9.

20. Dominic Wilson & Roopa Purushothaman, *Dreaming with BRICS: The Path to 2050*, at 5 (Goldman Sachs, Global Economics Paper No. 99, 2003).

21. *See* Timmons, *supra* note 1 ("While most of the world grapples with a crippling financial crisis and a recession, optimism reigns in much of India as its economy continues to grow.").

22. *Id.* ("The country's bureaucracy and its protectionist policies have kept it insulated from the fallout of the global downturn.").

23. *Id.*

24. *OECD Economic Surveys: India*, *supra* note 19, at 9, 12 ("Increased growth since the mid-1980s has helped substantially reduce the national poverty rate to 22% of the population in 2004, with the speed of poverty reduction appearing to increase between 1999 and 2004.").

25. Tetsuya Kamiyama, *India's Mutual Fund Industry*, 10 NOMURA CAP. MARKET REV. 57, 57 (2007) (Japan); Dominic Wilson, Roopa Purushothaman & Themistoklis Fiotakis, *The BRICS and Global Markets: Crude, Cars and Capital* 4 (Goldman Sachs, Global Economics Paper No. 118, 2004) (predicting that the number of Indians with incomes over $3,000, a threshold that the authors considered consistent with entering the middle class, could increase by a factor of fourteen in the next decade).

B. *Structure of Indian Mutual Funds*

Before exploring the history of the mutual fund in India, it would be worthwhile to define the term and consider the basic structure and nature of Indian mutual funds. At its most basic level, a mutual fund is an investment vehicle that "pools the savings of the community and invests these funds in a fairly large and well diversified portfolio of sound investments."[26] India's main mutual fund regulations offer a similar definition of a mutual fund: "a fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments [or gold or gold related instruments]."[27]

Indian mutual funds are legally constituted as trusts under the Indian Trusts Act of 1882,[28] and the trust must be registered under the Indian Registration Act of 1908.[29] These trusts are not legal entities, however, but are merely legal arrangements.[30] An Indian mutual fund is not quite like those commonly offered to U.S. or European investors, but is instead one step removed from the typical fund offered to retail investors in either the U.S. or Europe.[31] In India, the actual finalized product in which an investor places his money is typically called a scheme.[32] The main difference is that the fund "is a pass-through vehicle that does not make decisions or have the status of a juridical person" so that what in India is called a mutual fund "is similar to what is known as a fund family in the [United States]."[33]

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26. Subrata Sarkar, *Mutual Funds in India—Structure and Regulatory Framework*, *in* INSTITUTIONS GOVERNING FINANCIAL MARKETS 130, 132 (Shubhashis Gangopadhyay ed., 1997) (India).

27. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, para. 9, Gazette of India, pt. II, § 3(ii).

28. Anna Ilyina, *The Unit Trust of India and the Indian Mutual Fund Industry*, *in* INDIA AT THE CROSSROADS: SUSTAINING GROWTH AND REDUCING POVERTY 122, 126 (Tim Callen et al. eds., 2001).

29. AMITABH GUPTA, MUTUAL FUNDS IN INDIA: A STUDY OF INVESTMENT MANAGEMENT 62 (2002) (India).

30. Sarkar, *supra* note 26, at 147 ("A trust is merely a legal arrangement; it is not a legal entity.").

31. Kamiyama, *supra* note 25, at 61; *see also* Sarkar, *supra* note 26, at 134 n.7.

> Mutual funds denote only the institutional arrangement under which a specific group of persons, known as trustees, have custody of the resources mobilised from the investors. Mutual fund schemes are specific investment plans, that are authorised by the trustees, and managed by professional companies called Asset Management Companies. A mutual fund can float many alternative schemes.

Id.

32. Kamiyama, *supra* note 25, at 61.

33. *Id.* at 61–62.

There are several important entities associated with the operation of Indian mutual funds. The sponsor is the entity that establishes the fund, puts together the board of trustees, and organizes the AMC.[34] A sponsor must own a minimum of 40% of the AMC and have a solid track record,[35] which means that a sponsor must have been in the financial services business for at least five years, must have made a profit in three of those five years, and must also possess a general reputation of fairness and integrity in all business transactions.[36]

The fund's board of trustees has broad discretion to oversee fund activities, but most importantly it "shoulders all of a mutual fund's liabilities, retains oversight of the asset management company, and has the role of protecting the rights and interests of the final investors."[37] In terms of its concrete duties, the board of trustees names the AMC (after receiving prior approval of its selection by SEBI) and approves each mutual fund scheme that will be offered to investors.[38] The trustees also sign an investment management agreement with the applicable AMC.[39] Two-thirds of the trustees are required to be independent, which means that a trustee has no association or ties with the fund sponsor.[40]

The AMC is the entity that actually engages in managing the day-to-day affairs of the mutual fund.[41] Upon obtaining approval from both the fund trustees and SEBI, the AMC establishes and manages the various schemes that will be offered by the mutual fund.[42] It also helps to ensure that every AMC has adequate capital to cover any obligations or liabilities that may arise in the course of managing the fund.[43] Any AMC managing a mutual fund in India must at all times have a net worth greater than 100 million rupees.[44] This requirement is thought by some to be an impediment to the entry of smaller private sector actors into the Indian mutual fund marketplace,[45] but is wise in making sure that every Indian mutual

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34. *Id.* at 61.

35. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, para. 7(a)–(c), Gazette of India, pt. II, § 3(ii).

36. *Id.*

37. *Id.* para. 18; Ilyina, *supra* note 28, at 126; Kamiyama, *supra* note 25, at 62.

38. Kamiyama, *supra* note 25, at 62.

39. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, para. 18(1), Gazette of India, pt. II, § 3(ii); Kamiyama, *supra* note 25, at 62.

40. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, para. 16(5), Gazette of India, pt. II, § 3(ii).

41. Ilyina, *supra* note 28, at 126.

42. Kamiyama, *supra* note 25, at 62.

43. *See id.* ("The asset management company must maintain at all times a net worth of Rs 100 million.").

44. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, para. 21(1)(f), Gazette of India, pt. II, § 3(ii); Kamiyama, *supra* note 25, at 62.

45. Sarkar, *supra* note 26, at 139.

fund is offered by an experienced AMC. As one commentator has put it, the regulations lay down such "detailed eligibility criteria for both the members of the board of trustees and the asset management companies so as to ensure only efficient financial intermediaries gain entry into the mutual funds market."[46] The other relevant body worth mentioning in connection with the operation of mutual funds in India is the custodian, which is responsible for the handling and safekeeping of the fund's property.[47]

C. *History of the Mutual Fund in India*

Despite the rigid nature of India's early planned economy, India's mutual fund industry has had a long history. The framework for Indian mutual funds was established through an Act of Parliament in 1963 for the purpose of mobilizing small household savings.[48] That year the Reserve Bank of India, the country's central bank, created Unit Trust of India (UTI)[49] "with a view to encouraging saving and investment."[50] UTI then launched its first fund in 1964, Unit Scheme 1964, which as of the late 1990s was still UTI's largest scheme.[51] Until 1987, when public sector banks and financial institutions were permitted to organize and sponsor funds, the only mutual fund available to Indian investors was the UTI,[52] and UTI offered less than a dozen schemes for investors to choose.[53] A public sector bank, State Bank of India, made history in June of 1987 by exercising its newly given right to organize and offer a mutual fund, SBI Mutual Fund, to Indian investors.[54]

Further changes to the mutual fund marketplace came quickly after 1987. As a part of the economic reforms sweeping the country after the 1991 economic crisis, the Indian government opened up the business of mutual funds to the private sector in 1992 "so as to introduce competition, transparency and fair play into the capital markets."[55] The government now permitted private companies to

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46. *Id.* at 147.

47. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, para. 7(g), Gazette of India, pt. II, § 3(ii).

48. Ilyina, *supra* note 28, at 125–26; Kamiyama, *supra* note 25, at 60.

49. Kamiyama, *supra* note 25, at 60.

50. The Unit Trust of India Act, 1963, No. 52 of 1963, India Code (1993), pmbl., *available at* http://indiacode.nic.in/.

51. Ilyina, *supra* note 28, at 126.

52. M.M. SURY, INDIAN ECONOMY IN THE 21ST CENTURY: PROSPECTS AND CHALLENGES 261 (2004) (India).

53. GUPTA, *supra* note 29, at 104; Sarkar, *supra* note 26, at 137.

54. Kamiyama, *supra* note 25, at 60.

55. Aparna Viswanathan, *Indian Capital Markets: An Introduction to Regulation of Mutual Funds*, *in* DOING BUSINESS IN INDIA: CRITICAL LEGAL ISSUES FOR U.S. COMPANIES 117, 119 (Practising Law Inst. ed., 2007).

offer mutual funds.[56] The first private company-sponsored fund, Kothari Pioneer, was launched in July 1993.[57] At present, the Indian mutual fund marketplace currently consists of four main players: the UTI, public sector banks, public sector financial institutions, and private sector entities.[58]

D. *A Rapid Increase in Popularity*

By all accounts, the Indian market for mutual funds has exploded, going from assets under management (AUM) of 470 billion rupees at the end of 1993 to 3.3 trillion rupees as of March 2007.[59] This impressive explosion in growth mostly occurred over the past decade, with India's AUM growing 772% between 2004 and 2007.[60] The consulting firm McKinsey & Co. reported that the asset management industry in India is growing faster than more mature markets like the United States and Great Britain, and other emerging markets like Brazil.[61] In May 2008, a forecast by financial research firm Cerulli Associates concluded that "assets of Indian mutual funds will more than double to $302 billion by 2012 powered by strong economic growth and better distribution."[62]

Much of the increased mutual fund popularity in India is due to the efforts of the mutual fund industry itself. One of the most important recent trends in the industry has been the "aggressive expansion of the foreign owned mutual fund companies" at the expense of the older "companies floated by nationalized banks and small private sector players."[63] From 2002 through 2007, the assets managed by public-sector asset management companies grew at a 4% annual rate while the comparable rise for private-sector asset managers was 34%.[64] Better, more innovative mutual fund products have also enabled fund managers to deliver higher returns than

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56. KAUSAL SHAH & ASSOCS., THE FALL AND RISE OF MUTUAL FUNDS IN INDIA 4 (2007) (India), *available at* http://ksaattorneys.com/saspcms/userfiles/file/mf.pdf.

57. *Id.*; Kamiyama, *supra* note 25, at 60.

58. GUPTA, *supra* note 29, at 2.

59. Kamiyama, *supra* note 25, at 58, 60.

60. Lakshmi, *supra* note 3.

61. *Id.*

62. Nishant Kumar & Jeffrey Hodgson, *Mutual Fund Companies in India Face Post-Boom Profit Crunch*, MINT (Delhi), July 31, 2008, at 15, *available at* http://www.livemint.com/2008/07/31171652/Mutual-fund-companies-in-India.html?atype=tp.

63. S. Mohanan, *Mutual Fund Industry in India: Development and Growth*, 8 GLOBAL BUS. & ECON. REV. 280, 285 (2006). This expansion went from 34.53% of total resource mobilization (annual *new* sales not taking into account legacy assets) for private sector firms in 1998–1999 to 90.5% in 2003–2004, with numbers of 7.37% in 1998–1999 and 5.35% in the latter period for public sector firms (excluding UTI), while the numbers for UTI for those two periods were 58.1% and 4.06%. *Id.* at 286.

64. Kamiyama, *supra* note 25, at 67.

investors could get from alternative savings avenues like bank accounts.[65]

The mutual fund industry has also become increasingly creative in its efforts to reach Indian investors. For example, some industry players send out regular messages to each customer's cell phone with details about the value of the investor's account.[66] Advertising by the mutual fund industry has also seen dramatic increases, with a five-fold increase in television advertisements between 2004 and 2007.[67] Other creative means of reaching out to customers have included periodic newsletters, quarterly reports and statements, and quick resolution of any investor complaints and grievances.[68] These efforts have increased the geographic areas of the country in which potential investors are being courted.[69]

The increasingly widespread nature of mutual fund distribution networks in India has also contributed to the availability of these investments to individual retail investors.[70] Some industry participants use the postal system to penetrate the rural market,[71] with Indian Post, which runs the Post Office Savings Bank, India's largest domestic bank, serving as a distributor for three of the largest industry players beginning in January 2001.[72] Although sales through this distribution network currently are very small, this distribution channel looks to be an area that could see substantial growth in the future.[73]

E. *More Room to Grow?*

As impressive as the growth has been in the assets of the Indian mutual fund market and in the number of mutual fund investors,[74] these investment vehicles are not as widely owned as might be expected. According to one study, stocks and mutual funds only accounted for 4.9% of personal financial assets in the country as of

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65. Aarati Krishnan, *The Fall and Rise of Mutual Funds*, HINDU BUS. LINE, Jan. 28, 2004, http://www.blonnet.com/bl10/stories/2004012800300800.htm.

66. Lakshmi, *supra* note 3.

67. *Id.*

68. GUPTA, *supra* note 29, at 118.

69. Lakshmi, *supra* note 3. Lakshmi quotes one industry participant as stating, "In 2004, the mutual funds phenomenon was restricted to the top 10 Indian cities, but now it has expanded its presence and penetration in the markets of 30 Indian cities." *Id.*

70. Ilyina, *supra* note 28, at 126.

71. Mohanan, *supra* note 63, at 285.

72. Kamiyama, *supra* note 25, at 67.

73. *See id.* ("Although no official date exists, mutual fund sales by the post office are said to be on a very small scale. Some view the post office's nationwide network as having substantial sales potential, however, and this makes it a sales channel that may bear watching in the future.").

74. *Supra* Part II.D.

March 2007.[75] A study that found that the comparable percentage in the United States in 1998 was 44% puts the Indian number in perspective.[76] As of March 2009, individual investors constituted 96.75% of total mutual fund investors and held 37.03% of total Indian mutual fund assets,[77] which seems like a small figure for a country of 1.16 billion people.[78]

However, the explosive growth of Indian mutual funds will likely continue. Perhaps the principal driver of this explosive growth of Indian mutual fund AUM has been India's economic expansion, and this expansion is likely to result in even greater popularity for mutual funds. The creation of a new Indian middle class will result in an increase in the number of potential consumers of mutual fund products.[79] India also has a relatively young population, with a median age of 25.3 years.[80] Where older Indians have generally been content to let their excess cash sit in bank accounts, many younger Indians are willing to take more risk in the hopes of obtaining higher returns.[81]

Indians also have a strong penchant for savings: a 2007 study found that 81% of the country's households save regularly, with more than half of those households keeping their savings in bank accounts and a third of households storing their cash savings at home.[82] One scholar has even noted that India has the highest savings rate in the world and that the only necessary step to vastly increasing Indian mutual funds' AUM is "channelising these savings in [the] mutual fund sector."[83] Furthermore, mutual fund assets in India constituted only 11% of bank deposits according to a 2006 paper, which presents a marked contrast with the United States, in which the asset base of mutual funds was actually higher than the aggregate amount of bank

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75. Kamiyama, *supra* note 25, at 57.

76. Leora Klapper et al., *The Development of Mutual Funds Around the World*, 5 EMERGING MARKETS REV. 1, 2 (2004).

77. Anupam Mitra, *Mutual Funds—Are They for Mutual Benefit?*, NSE NEWSL., Sept. 2009, at 1, 10 tbl.8 (citing SEBI website).

78. Central Intelligence Agency, The World Factbook, India, https://www.cia.gov/library/publications/the-world-factbook/geos/in.html (last visited Jan. 4, 2010) (reporting July 2009 estimate).

79. Kamiyama, *supra* note 25, at 57 ("In India, the owners of mutual funds include not only the wealthy, but also regular retail investors, and because of this growth in the middle-class should further broaden the market of potential mutual fund investors.").

80. Central Intelligence Agency, *supra* note 78.

81. *See* Lakshmi, *supra* note 3 (quoting A.P. Kurien, chairman, Association of Mutual Funds in India, as stating, "Traditionally, you were looked down on in India if you wanted to get rich quick. But that mindset is now changing. Indians now want to climb the ladder of life quickly, and there is nothing wrong with it. This is the way the world lives." (internal quotation marks omitted)).

82. Lakshmi, *supra* note 3.

83. Mohanan, *supra* note 63, at 288.

deposits in that year.[84] In addition, as of 2001 only 9% of Indian households were invested in mutual funds.[85] Taken together, the Indian savings rate and the extremely low penetration rate of mutual funds in India, as compared with the U.S., point toward a likely increase in demand for the types of returns that mutual funds can provide.[86] As a result, Indian consumers may yearn for greater returns than a savings account can provide.

The torrid growth rate of Indian mutual funds will likely continue because mutual fund ownership also offers a number of advantages for smaller investors in India. For one, mutual funds offer an opportunity to gain exposure to an asset class that smaller Indian investors would not be able to access on their own.[87] Mutual funds also enable Indian investors to enjoy a well-diversified portfolio despite the relatively small amount of money most have at their disposal,[88] instead of being forced into buying a position in a single security.[89] Indeed, one of the government of India's purposes in creating the UTI in 1963 was to protect the needs of smaller investors.[90]

When a mutual fund pools smaller investors' resources a professional manages unitholders' money: this would not be possible for each investor individually.[91] It is also often beyond the means of small investors to take the time and energy necessary to make thorough, informed decisions about how to manage their money.[92] Mutual funds also play an important role in reducing the amount of risk that small investors face when investing as compared with

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84. *Id.*
85. GUPTA, *supra* note 29, at 101.
86. *See* Kamiyama, *supra* note 25, at 72 (noting that "recent growth in the economy and in individual assets suggests that India's market has huge potential").
87. Viswanathan, *supra* note 55, at 119.

> Mutual funds have enabled small investors to access the stock market as they would otherwise have been unable to effectively participate in the capital markets by investing on their own. Mutual funds are seen as agents for growth and stability of the capital markets as well as a vehicle for mobilisation of savings from the small and household sectors for investment in the stock market.

Id.

88. KAUSAL SHAH & ASSOCS., *supra* note 56, at 7.
89. GUPTA, *supra* note 29, at 16.
90. *Id.* at 102. Indeed, the Finance Minister at the time stated: "UTI would provide an opportunity for the middle and lower income groups to acquire without much difficulty, property in the form of shares . . . This institution is intended cater mainly to needs of individual investors whose means are small." *Id.* (alteration in original) (internal quotation marks omitted) (footnote omitted).
91. *See* KAUSAL SHAH & ASSOCS., *supra* note 56, at 7 (explaining that by pooling their resources, small investors in mutual funds get the benefit of expert management).
92. GUPTA, *supra* note 29, at 15.

making a direct investment in the stock market.[93] They also allow small investors to share the fixed costs inherent in investing through economies of scale.[94]

Other factors also make investments in mutual funds beneficial for Indian investors. Over the last decade SEBI has made "a concerted effort to discourage small investors from directly participating in the complex and emerging stock market"[95] by lowering the percentage of their stock that public companies are allowed to sell in the market, raising the minimum subscription amount, and introducing a proportionate allotment scheme.[96] In addition, the assured return schemes promoted by some mutual fund sponsors typically have offered higher yields than an investor can get from a bank account.[97] Tax benefits also provide an incentive to shift from a bank account into a mutual fund because income from mutual funds is treated more favorably than other personal income, like interest income, under the Indian tax code.[98] Mutual funds also provide for easy liquidity, because investors can easily add to or liquidate their holdings.[99] They are also easy to administer because investors can set up different regular investment or withdrawal plans and access information regarding their holdings on a regular basis.[100]

F. *Regulation of Indian Mutual Funds*

Mutual funds need a "robust and effective regulatory framework for their successful operation and development."[101] The advent and early growth of the Indian mutual fund industry came before the development of a regulatory structure for the industry.[102] When the UTI was created in 1963, it was regulated under the provisions of the UTI Act of 1963 and the Regulations promulgated thereunder.[103] When the industry first opened to public sector banks and financial institutions in 1987, no regulations were in effect for so-called public sector funds.[104] That changed when the Reserve Bank of India ordered such funds to get pre-clearance before launching any new funds.[105] The Reserve Bank of India then issued a series of

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93. Sarkar, *supra* note 26, at 133.
94. KAUSAL SHAH & ASSOCS., *supra* note 56, at 8.
95. Sarkar, *supra* note 26, at 131.
96. *Id.*
97. Ilyina, *supra* note 28, at 126.
98. *Id.* at 127.
99. GUPTA, *supra* note 29, at 16.
100. *Id.* at 16–17.
101. Mohanan, *supra* note 63, at 282.
102. GUPTA, *supra* note 29, at 58.
103. *Id.*
104. *Id.*
105. *Id.* at 58–59.

guidelines only applicable to the public sector mutual funds.[106] After a government commission recommended strengthening the mutual fund regulatory apparatus, the Indian Ministry of Finance issued a set of guidelines.[107] The guidelines were similar to those previously passed by the Reserve Bank of India for insurance company-sponsored mutual funds, since the Reserve Bank did not have the authority to regulate insurance companies and the financial products that they offered.[108]

SEBI was created in April 1988 and gained the power to regulate mutual funds in March 1991.[109] SEBI issued its first regulations related to mutual funds in October 1991, when it published guidelines for the formation of asset management companies.[110] The government of India introduced another set of guidelines for insurance company-sponsored funds in 1992, at which point there were three different sets of mutual fund regulations: those pertaining to UTI set forth in the UTI Act of 1963; those promulgated by the Reserve Bank of India covering public sector funds; and those covering insurance company-sponsored funds promulgated by the government of India.[111] The multiple sets of regulations created problems because the various regimes contradicted each other in some areas and failed to adequately cover every aspect of mutual fund operations.[112] Then, the government of India appointed a committee to suggest a set of comprehensive mutual fund guidelines applicable to the entire range of the industry.[113] The committee made a series of recommendations that became an integral part of India's first "formal and comprehensive regulatory framework for mutual funds,"[114] leading to Indian mutual fund regulation in its current form.

The first comprehensive regulatory scheme for all Indian mutual funds was introduced in 1993, and it charged SEBI with regulating the industry.[115] That same year, SEBI promulgated a comprehensive set of mutual fund regulations that required all non-UTI funds to register with SEBI[116] and set out eligibility criteria for mutual fund sponsors.[117] Notably, however, the initial set of regulations did not

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106. *Id.* at 59.
107. *Id.*
108. *Id.*
109. *Id.*
110. *Id.*
111. *Id.* at 59–60.
112. *Id.* at 60–61.
113. *Id.* at 61.
114. *Id.*
115. Ilyina, *supra* note 28, at 127.
116. Kamiyama, *supra* note 25, at 60.
117. Ilyina, *supra* note 28, at 127.

cover UTI.[118] Indeed, even the current regulations do not apply to certain UTI schemes, which are instead subject to rules promulgated by the government of India.[119] As the industry grew, these initial regulations proved inadequate in some respects, so SEBI revised the initial regulations.[120] The new set of regulations released in 1996 further tightened accounting and disclosure requirements and enhanced the role of fund trustees in overseeing the fund sponsor.[121] The overhaul had two objectives: "improving investor protection . . . and increasing diversity in the design of fund schemes."[122]

Current regulations in India require that the fund sponsor apply to SEBI for registration of a mutual fund, which then issues a certificate to the sponsor if the application is approved.[123] The regulations also restrict the types of investments that mutual funds may make, set specific guidelines for pricing funds offered to the public,[124] create procedures and rules for winding up funds and detail the required method of fund portfolio valuation.[125] SEBI has also created procedures for the maintenance of fund books and records, yearly inspections of such books and records by fund auditors, and limitations on the fees and expenses attributable to the issuance of schemes.[126] The many disclosure requirements for Indian mutual funds constitute the focus of this Note and will be covered in detail in the next section.

III. THE USE OF INFORMATION TO PROTECT INVESTORS: INDIA'S MUTUAL FUND DISCLOSURE REQUIREMENTS

The Indian mutual fund regulatory scheme includes specific obligatory disclosure requirements that are intended to protect investors by providing them with important information related to their investments.[127] This Note focuses on the required disclosures from the time that initial subscriptions for investment are made until

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118. KAUSAL SHAH & ASSOCS., *supra* note 56, at 4.

119. *Id.*

120. GUPTA, *supra* note 29, at 61.

121. Ilyina, *supra* note 28, at 127.

122. *Id.* at 127–28; *see* Kamiyama, *supra* note 25, at 60 ("These regulations were completely overhauled in 1996, and now it is the SEBI (Mutual Funds) Regulation 1996 that regulates mutual funds.").

123. *See* Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, paras. 3–9, Gazette of India, pt. II, § 3(ii) (outlining process for registration of a mutual fund).

124. Ilyina, *supra* note 28, at 128.

125. *Id.* paras. 39–42, 44, 47, 49.

126. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, paras. 50, 52, 55, Gazette of India, pt. II, § 3(ii).

127. *See, e.g.*, *id.* at paras. 54–60, sched. 11 paras. 1–6, sched. 12 (describing various disclosure duties).

investors exit a fund by selling their fund units. It will not focus on all disclosures required of Indian mutual funds, but will instead concentrate only on the most important mandatory disclosures.

A. *Specific Disclosure Requirements*

1. Disclosures Prior to and at the Time of the Initial Investment

Typically an Indian investor will invest in a mutual fund scheme by completing an application form provided by the AMC and sending the completed application to the AMC.[128] However, an AMC must also provide certain disclosures to the prospective investor before the sale of fund units actually takes place—while the investor is still a prospective investor instead of an actual investor.[129] However, the Indian regulatory scheme provides that no scheme may be launched by an AMC unless the scheme has been approved by the trustees and a copy of the scheme offer document has been filed with SEBI.[130] An offer document is a document by which the AMC invites the public to subscribe for units of a scheme.[131] The offer document must contain disclosures that are adequate to enable an investor to make an informed investment decision.[132] Under SEBI regulations, no one is permitted to issue an application form for units of a mutual fund scheme unless a memorandum containing information specifically provided by SEBI (also known as a Key Information Memorandum (KIM))[133] accompanies the form.[134]

Before SEBI's recent revisions to India's mutual fund regulations, funds had to provide investors with an offer document.[135] However, SEBI recently changed the offer document process in order

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128. *See* Securities and Exchange Board of India, SEBI Investor Education Programme (Investments in Mutual Funds), http://www.sebi.gov.in/faq/mf_faq.html (last visited Oct. 25, 2009) (describing the typical application process for investment).

129. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, para. 28, Gazette of India, pt. II, § 3(ii).

130. *Id.* para. 28(1).

131. *Id.* para. 2(r).

132. *Id.* para. 29(1).

133. Letter from Ruchi Chojer, Deputy Gen. Manager, Inv. Mgmt. Dep't, Sec. & Exch. Bd. of India, to All Mut. Funds Registered with Sec. & Exch. Bd. of India and Ass'n of Mut. Funds in India, para. 7(i) (May 23, 2008), *available at* http://www.sebi.gov.in/circulars/2008/mfdcir0508.html [hereinafter May 23 Chojer Letter].

134. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, para. 29(4), Gazette of India, pt. II, § 3(ii).

135. *See* Securities and Exchange Board of India, SEBI Investor Education Programme (Investments in Mutual Funds), *supra* note 128 ("An abridged offer document, which contains very useful information, is required to be given to the prospective investor by the mutual fund.").

to make the offer document and KIM more reader-friendly.[136] SEBI now requires that offer documents be split into a Statement of Additional Information (SAI) and a Scheme Information Document (SID).[137] In promulgating these requirements, SEBI observed that offer documents are often unavailable to investors purchasing fund units through mutual fund distributors and investor service centers and that such investors had a hard time obtaining copies of these documents.[138] SEBI specifically put the onus on fund trustees and AMCs not only to ensure that the new document requirements are satisfied by all of a particular fund's distributors and investor service centers, but also to confirm that this is the case for the trustee's half-yearly report.[139]

To ensure investors receive the information, the KIM must accompany the scheme application form, while the SAI must be uploaded to the fund's website and the AMFI website and must also be made available to investors upon request.[140] There is a specific format prescribed for each of the SAI, SID, and KIM.[141] The KIM must include, *inter alia*, the fund's investment objective, its asset allocation pattern, its risk profile, the fund's returns, and fund expenses.[142] The SID goes into greater detail by requiring a discussion of the scheme's standard and specific risk factors, the scheme's fundamental attributes, and information regarding any pending litigation or regulatory actions against the fund sponsor, AMC, or fund trustees, among other things.[143] The SAI must include, *inter alia*, information regarding the fund sponsor, AMC, and trustee companies, along with information on key personnel and service providers to the fund, condensed financial information on any scheme launched by the fund, the fund's investment valuation norms, and tax and legal information.[144]

These documents must be updated regularly; the SID must be updated at least once a year or immediately if any of the fundamental

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136. *See* May 23 Chojer Letter, *supra* note 133, para. 2 ("AMFI had set up a committee to examine the ways of simplification of OD and KIM to make it more reader friendly.").

137. *Id.*

138. *Id.* para. 9.

139. *Id.*

140. *Id.* paras. 6(i), 7(i).

141. *Id.* para. 1.

142. *See* Key Information Memorandum (KIM) Format (May 23, 2008), *available at* http://www.sebi.gov.in/circulars/2008/kim.pdf (setting forth information required from applicants).

143. *See* Scheme Information Document (SID) Format (May 23, 2008), *available at* http://www.sebi.gov.in/circulars/2008/sid.pdf (listing required elements of SID in standardized format).

144. *See* Statement of Additional Information (SAI) Format (May 23, 2008), *available at* http://www.sebi.gov.in/circulars/2008/sai.pdf [hereinafter SAI] (listing required elements of SAI in standardized format).

attributes of the fund change.[145] Every scheme must have adopted the new format within twelve months of the promulgation date of May 23, 2008, which means that its requirements are now mandatory for all schemes.[146] For other changes, the AMC must prepare an addendum to the SID and display this addendum on its website, circulate the addendum to all its distributors and investor service centers, and give public notices of the changes included in the addendum in one English language daily newspaper with nationwide circulation, as well as a newspaper published in the language of the region where the fund's main office is located.[147] The KIM must also be updated at least once annually.[148]

2. Annual Reports

Each fund or asset management company must prepare an Annual Report and annual statement of accounts and funds.[149] An auditor, selected by the fund's trustees, who is not associated in any way with the AMC's auditor, must audit each fund's statement of accounts.[150] The auditor prepares a report, forwards it to the trustees, who then include it in the fund's Annual Report.[151] The auditor's report must state that the auditor obtained all information and explanations necessary for the audit, that the fund's Balance Sheet and Revenue Account give a fair and true view of the scheme, its state of affairs and surplus or deficit for the applicable period, and that the fund's account statement was prepared in accordance with the accounting policies and standards specifically required by SEBI.[152]

An Annual Report or an abridged summary thereof must be mailed to each investor in the respective fund within four months of the fund's year-end,[153] although the abridged summary can be sent via email, and the Annual Report must also be displayed on the mutual fund's website.[154] An abridged summary must be in a format

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145. May 23 Chojer Letter, *supra* note 133, para. 5(i)–(ii).
146. *Id.* para. 4(v).
147. *Id.* para. 5(ii)(b).
148. *Id.* para. 5(iv).
149. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, para. 54, Gazette of India, pt. II, § 3(ii).
150. *Id.* para. 55.
151. *Id.* para. 55(3).
152. *Id.* para. 55(1)–(4).
153. *Id.* para. 56(1).
154. Letter from Ruchi Chojer, Deputy Gen. Manager, Inv. Mgmt. Dep't, Sec. & Exch. Bd. of India, to All Mut. Funds Registered with Sec. & Exch. Bd. of India and Ass'n of Mut. Funds in India, para. A(3) (July 24, 2008), *available at* http://www.sebi.gov.in/Index.jsp?contentDisp=Department&dep_id=4.

specified by SEBI.[155] Within four months of the close of the fiscal year, each mutual fund must provide SEBI with a copy of its Annual Report and other information on the details of the fund's investment and deposits.[156] The Annual Report must also include a host of other specific information, as well as "such other details as are necessary for the purpose of providing a true and fair view of the operations of the mutual fund."[157]

The most important disclosures required in an Annual Report are as follows:

- A report by the trustees on the operation of the various schemes of the fund, the fund as a whole during the year, and the future outlook for the fund.[158]
- A Balance Sheet and Revenue Account prepared specifically in accordance with requirements laid out by the regulations.[159]
- A brief statement by the trustees on the investment objective of each scheme that makes up the fund[160] and the basis and investment policy underlying each scheme.[161]
- The trustees must comment upon, and provide full justification for, the performance of the scheme.[162] They must also make a statement putting the historical per unit statistics, like net asset value, net and gross income per unit, expenses per unit, expense ratio, and other important data points over the three previous years, in full perspective.[163]

3. Half-Yearly Disclosures

Twice a year each fund is also required either to send a complete statement of the scheme portfolio as well as its unaudited half-yearly financial results for that period to unitholders or to publish such information in one English-language daily newspaper that circulates throughout the entire country.[164] This information must also be placed in a newspaper published in the language of the region where the main office of the fund is located,[165] and the unaudited half-yearly results must be posted to the AMC's website.[166] The mandatory half-yearly disclosure must take the specific form prescribed in the

155. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, para. 56(2), Gazette of India, pt. II, § 3(ii).
156. *Id.* para. 57.
157. *Id.* para. 56(2).
158. *Id.* sched. 11, para. 1(i).
159. *Id.* sched. 11, para. 1(ii).
160. *Id.* sched. 11, para. 1(iv)(b).
161. *Id.* sched. 11, para. 1(iv)(c).
162. *Id.* sched. 11, para. 1(iv)(e).
163. *Id.* sched. 11, para. 1(v).
164. *Id.* paras. 59–59(A).
165. *Id.*
166. July 24 Chojer Letter, *supra* note 154, para. C(2).

regulations and is also required to provide information on any fund dividends, profits or losses from the sale of investments, and other sources of income or losses as well as management, administrative, and other operating expenses.[167] In addition, the half-yearly report must also include any other details necessary to provide a true and fair view of fund operations.[168]

4. Other Disclosures

Funds have additional disclosure duties. In extraordinary situations the fund, asset manager, trustee, custodian, or fund sponsor is required to make any disclosure or submit any document that SEBI instructs such person or entity to make.[169] Every fund is required to calculate and publish its Net Asset Value (NAV) in two daily newspapers at least weekly.[170] Closed-end schemes calculate their NAV on a daily basis and publish that figure in at least two daily newspapers with a circulation covering the entire country.[171] Fund trustees are also required to disclose any information to fund investors that might have an adverse bearing on the investors' fund holdings.[172] Funds are also required to submit certain other quarterly, half-yearly and other reports to SEBI.[173]

IV. A CRITICAL EVALUATION OF INDIA'S MUTUAL FUND DISCLOSURE REQUIREMENTS

A. *Praise for Indian Disclosure Requirements in Practice*

Use of disclosure as a tool for investor protection has unquestionably been strengthened since SEBI's first steps aimed at introducing greater protections for Indian mutual fund investors. As noted in SEBI's 1997–1998 annual report: "The SEBI has been taking steps towards improving the standards of disclosure for mutual funds, introducing prudential norms to prevent misuse of funds by the asset management companies and to afford a greater degree of protection to the investors."[174]

Some commentators have noted that, in conjunction with the enhanced disclosure initiatives championed by SEBI, the mutual fund

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167. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, sched. 12, para. 59, Gazette of India, pt. II, § 3(ii).
168. *Id.*
169. *Id.* para. 58(1).
170. *Id.* para. 48(1)–(2).
171. *Id.* para. 49(2).
172. *Id.* para. 60.
173. *Id.* para. 58(2)(a)–(d).
174. *Annual Report 1997–1998*, *supra* note 11, at 24.

industry itself is also contributing to the use of greater disclosure to protect fund investors.[175] For instance, some AMCs not only post their fund portfolios on their websites on a monthly basis but will also provide a portfolio breakdown to an individual investor upon request.[176] In addition, AMFI has taken to posting the NAV of every Indian mutual fund on its website daily.[177]

B. *Criticism and Other Issues*

However, despite the progress that SEBI has made, not everyone agrees that SEBI has no more work to do in mandating further disclosures to mutual fund investors. One commentator states: "The information gap is huge. The [SEBI] chairman needs to use the current bear run to make mutual funds more transparent so that investors can make informed decisions rather than grope in the dark."[178] Another commentator, while praising SEBI for the steps it has taken towards investor protection sounded a cautionary note: "The government has sought to ensure that the regulatory and supervisory framework governing mutual funds has kept pace with their growing importance. . . . but further improvements are needed to enhance governance and ensure the soundness and stability of the mutual fund industry."[179]

In addition to these concerns is the worry that relying upon the mutual fund industry itself to decide upon and implement the appropriate range of disclosure does not serve the best interests of investors. After all, industry players have a significant conflict of interest because they are in the business of managing mutual funds in order to make money, not necessarily to look out for the best interests of investors. There is no reason that the industry will protect shareholder interests rather than its own profitability, particularly when, as is currently the case, fund managers are struggling with lower profitability.[180] Indeed, two skeptical commentators have dismissed out of hand the notion that the mutual fund industry participants even take into account the interests of

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175. *See* Krishnan, *supra* note 65 ("Intensifying competition has ensured that the fund houses have kept two jumps ahead of the regulatory requirements, at least on disclosures and service standards.").

176. Aarati Krishnan, *Adding Value*, HINDU BUS. LINE, Sept. 30, 2003, at 2–3, *available at* http://www.blonnet.com/2003/09/30/stories/2003093001401700.htm.

177. AMFI, Investors Zone, Nav–All, http://www.amfiindia.com/navreport.aspx (last visited Jan. 4, 2010).

178. Gajra, *supra* note 11.

179. Ilyina, *supra* note 28, at 139.

180. *See* Kumar & Hodgson, *supra* note 62 ("India's fund management industry, in boom mode for the better part of a decade, is facing a major slump in profitability as investment flows shrink, competition mounts and operating costs stay stubbornly high.").

shareholders at all.[181] They point out that fund managers know that investors have little ability to tell whether the fund is actually performing well or not.[182]

The distribution and fee structure of Indian mutual funds also creates risks that fund manager interests might not align with those of their shareholders. Indian mutual funds are typically distributed through a set of individuals and firms, most of whom earn their money by collecting a fee from customers for selling the fund products, as well as collecting a fee from the AMC for selling scheme units.[183] The problem is that "[d]istributors tend to own customers and have a disproportionate influence on the decision making of customers."[184] This has caused several difficulties that negatively impact fund shareholders. For instance, because distributors earn a fee every time a customer switches into a new fund, distributors have a vested incentive to encourage customers to "churn," or frequently switch in and out of different schemes, to increase distributor fees without a corresponding benefit to the actual investor.[185] Such behavior results in decreased performance for mutual fund investors.[186]

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181. *See* AJAY SHAH ET AL., INDIA'S FINANCIAL MARKETS: AN INSIDER'S GUIDE TO HOW THE MARKETS WORK 190 (2008).

> The field of fund management in India is thus at a low-level equilibrium where a variety of factors have conspired to yield an intractable principal-agent problem. This low-level equilibrium involves fund managers who have poor incentives to deliver performance. Toxic sales strategies are used to round up funds from uninformed customers. It involves a race to the bottom where the generous tax breaks and the most egregious sales incentives to distributors are the path to large assets under management.

Id.

182. *Id.* ("Fund managers know that customers have little ability to discern performance. Hence, fund managers have incentives to do things which adversely affect the interests of the customer, knowing that the reduction in α [portfolio alpha, which measures the portfolio's returns] would not be discernable to the customer.").

183. *See* Will You Pay a Fee for Mutual Funds?, Posting of Harish Rao to LiveMint Blogs, http://blogs.livemint.com/blogs/simple_equation/archive/2009/07/29/will-you-pay-a-fee-for-mutual-funds.aspx (July 29, 2009, 17:23 EST) (explaining that advisors are compensated through commission from the AMC and investor fees). The investors ultimately pay the distributors twice, because the distributors are also paid directly by the funds, the proceeds of which come from exit loads charged by the AMC when an investor withdraws his funds from the scheme. Letter from Ruchi Chojer, Deputy Gen. Manager, Inv. Mgmt. Dep't, Sec. & Exch. Bd. of India, to All Mut. Funds, Asset Mgmt. Cos. and Ass'n of Mut. Funds in India, para. 2 (June 30, 2009), *available at* http://www.sebi.gov.in/circulars/2009/imd_cir_3009.pdf [hereinafter June 30 Chojer Letter]. Although SEBI has recently taken the admirable step of banning loads by mutual funds, commissions are still authorized to be paid by the investor directly to the distributor. Will You Pay a Fee for Mutual Funds?, *supra*.

184. SHAH ET AL., *supra* note 181, at 105.

185. *Id.*

186. *Id.*

In line with their incentive to encourage churning, distributors tend to encourage their customers to buy the products that pay them the highest fee, which has "generated a race to the bottom where mutual fund houses that are attracted to having a high rank are prone to pay very high fees to distributors."[187] However, to its credit, SEBI announced in 2007 that it would force funds to offer investors the choice of a direct distribution channel.[188] This would require the establishment by the fund of a mechanism through which the customer could bypass a distributor altogether to purchase fund shares directly through the Internet.[189]

V. SPECIFIC RECOMMENDATIONS FOR ENHANCED MUTUAL FUND DISCLOSURE IN INDIA

A. *Initial Considerations*

A functioning and strong regulatory regime is absolutely essential for the protection of a nation's investors. One study found that "in particular, strong legal and regulatory factors have a positive impact on the size of the mutual fund industry."[190] The authors of the same study concluded that nations that require fee and performance disclosures above what the authors considered to be the median level (meaning that these require more detailed fee and performance disclosures) have a fund sector 7.5% larger than nations that are below such median level.[191] The authors also argued that "nations with more stringent regulatory approval and disclosure requirements for funds, tend to have larger fund industries," which indicates "that stronger regulation that specifically protects fund investors may be beneficial to the fund industry."[192] More generally, the authors noted "that laws and regulations can explain differences in the pace of financial development" and that "applying this logic to the fund industry, we would expect that funds would prosper when laws and regulations make this sort of investment attractive to investors, for example by protecting investor rights."[193]

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187. *Id.*

188. *Id.* at 187; Press Release, Sec. & Exch. Bd. of India, Waiver of Entry Load for Direct Applications for Mutual Fund Investments (Dec. 31, 2007), *available at* http://www.sebi.gov.in/press/2007/2007325.html.

189. SHAH ET AL., *supra* note 181, at 187; Letter from Ruchi Chojer, Deputy Gen. Manager, Inv. Mgmt. Dep't, Sec. & Exch. Bd. of India, to All Mut. Funds Registered with Sec. & Exch. Bd. of India and Unit Trust of India (Dec. 31, 2007), *available at* http://www.sebi.gov.in/circulars/2007/mfdcir1007.html.

190. Ajay Khorana et al., *Explaining the Size of the Mutual Fund Industry Around the World*, 78 J. FIN. ECON. 145, 178 (2005).

191. *Id.* at 173.

192. *Id.* at 148.

193. *Id.* at 147.

SEBI was created "to protect the interests of investors in securities"[194] as well as for "calling for information from, undertaking inspection, [and] conducting inquiries and audits of . . . mutual funds."[195] SEBI has certainly made great strides towards fulfilling that mission in its short sixteen years of existence,[196] but it has also faced criticism for failing to take greater action to protect the interests of investors in securities.[197] Although SEBI has strengthened India's mutual fund disclosure requirements, several important steps must be taken in order to fully realize the potential of disclosure as a means for protecting Indian investors. To this end, this Note argues that SEBI should enhance its disclosure requirements to protect unitholders in Indian mutual funds, thereby increasing the allure of these investments in a country in which demand for such investment vehicles should continue to increase.[198] Now, more than any other time in the country's history, it is essential that SEBI act, as the Indian securities market fluctuates and the explosion in growth in the industry looks to continue.

India's public company disclosure regime has scored well in terms of its disclosure requirements in a number of international studies and surveys.[199] However, the Indian mutual fund disclosure regime is not nearly as strong as the country's public company disclosure regime.[200] In a cross-country study on the determinants of mutual fund performance, the strength of Indian fund disclosure obligations was only rigorous enough to put India in seventeenth

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194. The Securities and Exchange Board of India Act, No. 15 of 1992, India Code (1993), pmbl., *available at* http://indiacode.nic.in/.

195. *Id.* § 11(2)(i).

196. *Supra* note 174 and accompanying text.

197. *Supra* Part IV.B.

198. *See* Rao & Mishra, *supra* note 17, at 111 (reporting a predicted growth rate of twenty-one percent yearly through 2015).

199. Rajesh Chakrabarti et al., *Corporate Governance in India*, J. APPLIED CORP. FIN., Winter 2008, at 59, 68.

> *Doing Business 2008* gives India an investor protection score of 6, ahead of each of the other BRIC countries. An extremely important aspect of investor protection in any country is securities markets regulation. Using La Porta et al.'s newer (2006) framework that evaluates the disclosure and liability requirements as well as enforcement of the regulations in national securities markets, India scores an impressive 0.92 in the index of disclosure requirements, which is the third highest after the U.S. and Singapore.

Id.

200. *Compare id.* (ranking India third highest for public company disclosure requirements), *with* Miguel A. Ferreira et al., *The Determinants of Mutual Fund Performance: A Cross-Country Study* 40 tbl.3 (Swiss Fin. Inst. Research Paper Series, Paper No. 31-2006, 2007), *available at* http://www.fma.org/Barcelona/Papers/Mutualfunds_Nov_2006.pdf (ranking India third worst for mutual fund disclosure requirements).

place out of nineteen countries surveyed, beating only Thailand and South Korea.[201]

B. *Specific Recommendations for Enhanced Disclosure in India*

There are a number of specific disclosure reforms that SEBI should immediately enact in order to better protect Indian mutual fund investors.

1. Disclosure and Independent Verification of the AMC's Annual Returns

To begin with, SEBI should require that each AMC make a complete disclosure of its annual returns over the AMC's entire lifetime. Investors need to be able to easily understand the experience and track record of each AMC. Although the fund trustees have a number of important fund governance duties, the AMC and its personnel are selecting the investments that comprise each fund's portfolio and making the important decisions that have a direct impact on unitholder money. The AMC's actions are impacting the shareholders where it counts—in the wallet. A fund is therefore only as good as its AMC.

One commentator has suggested that SEBI require each AMC to make a complete disclosure of its annual returns with the Indian Registrar of Companies on the Registrar of Companies's website, because the AMCs remain relatively unknown financial entities to investors.[202] A further suggestion would be either to have SEBI put this information on its website because the Registrar of Companies makes it hard to access public information,[203] or to include this among the many pieces of helpful information that industry trade group AMFI currently provides on its website.[204] To be fair, AMFI's website does currently provide copies of each fund's AMC's financials, but getting to this information involves numerous clicks of a mouse,[205] when this information should be provided to the investor in a more conspicuous manner. Alternatively, a requirement could be enacted to compel the AMC to post the information to its own

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201. Ferreira et al., *supra* note 200, at 40 tbl.3.

202. Gajra, *supra* note 11.

203. Sandeep Parekh, P.H. Parekh & Co., *India: Disclosure Duplication a Waste of Time and Money*, MONDAQ, Apr. 15, 2005, http://www.mondaq.com/article.asp?articleid=32043.

204. *See* AMFI, *supra* note 177 (providing a variety of financial data for mutual funds in one clearinghouse).

205. For example, to access a financial report for Deutsche Mutual Fund, one would go to AMFI, Investors Zone, Accounts Annual, http://amfiindia.com/AccountsAnnual.aspx (last visited Jan. 4, 2010), select the fund from the dropdown menu, follow the provided link, and then select the report on the fund's own website.

website.[206] A number of AMCs already provide many helpful details, like copies of their annual reports, on their websites.[207] Requiring prominent disclosure of the AMC's annual returns across all its schemes would not be unduly burdensome. SEBI should take the aforementioned proposals even further and mandate that the AMC's annual returns over the relevant period be provided in the Annual Reports, SIDs, and KIMs of each fund that the AMC manages. This would ensure that investors know how good the relevant AMC is before making a purchase of fund units, as well as what the AMC's performance continues to look like while the investors hold their fund units.

The Indian government has recognized the need for investors to know more about the AMC and its track record. The Prime Minister's Council on Trade and Industry, a body established in 1998 to provide "an opportunity for a policy dialogue on important economic issues relevant to Trade and Industry,"[208] in its report "Reforms in the Financial Sector and Capital Markets" advocated requiring disclosure of a fund manager's track record.[209] An AMC's annual record of returns is arguably the most important piece of information to a beginning investor. After all, the easiest datum for an investor to understand in connection with different mutual fund schemes is each AMC's *actual* record of managing funds.

On a related note, a commentator suggested in 1997 that performance evaluations of funds at the time left much to be desired and recommended that independent rating agencies with professionally trained employees be set up to evaluate mutual fund performance ex post as well as to perform analyses of new fund offerings based on the documents that they filed with SEBI.[210] This is an excellent suggestion, and establishment of an Indian version of the U.S. mutual fund research organization Morningstar would likely result in better-informed customers. This means that "investors would have relevant information to make effective choices," and it "[would] ensure that inferior schemes are gradually weeded out of the

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206. Parekh, *supra* note 203.

207. *See, e.g.*, Benchmark Asset Management Company Private Limited, Financials, http://www.benchmarkfunds.com/static.pl?pg=financials (last visited Jan. 4, 2010) (providing access to a variety of financial reports); Franklin Templeton Investments, NAVs, Diversified Equity Funds, http://www.franklintempletonindia.com/GeneralAccess/Nav/gac_getmore.asp#Diversified_Equity_Funds (last visited Jan. 4, 2010) (providing access to financial data for a number of mutual funds).

208. Notification from Ashok Saikia, Joint Sec'y to the Prime Minster, Gov't of India, to All Members, Prime Minister's Council on Trade and Indus., para. 2 (Aug. 28, 1998), *available at* http://indiaimage.nic.in/pmcouncils/tic/noti1.htm.

209. PRIME MINISTER'S COUNCIL ON TRADE & INDUS., REFORMS IN THE FINANCIAL SECTOR AND CAPITAL MARKETS, § 8.3.7 (2000), *available at* http://indiaimage.nic.in/pmcouncils/reports/fin/c-reco.htm.

210. Sarkar, *supra* note 26, at 146.

market and only those with sound investment principles survive."[211] Other commentators have also supported this idea.[212] AMFI is an important source of information regarding Indian funds, but relying on the industry to provide every bit of information that investors want and need is not a good solution. Indeed, relying on funds to provide accurate critical evaluations is rife with conflicts of interest, because neither a fund nor the industry trade group is likely to voluntarily say negative things about itself or any of its members, and thus cause a drop in that fund's flows. Independent, professional evaluation of funds by an Indian version of Morningstar and the requirement of mandatory disclosure of AMC returns would help achieve this goal and benefit Indian mutual fund investors.

2. Ban Assured Return Schemes

SEBI should ban the assured return schemes that have been popular in India. Assured return schemes present both informational and general operational problems.[213] In terms of information, "operational transparency of mutual funds is reduced if they promise guaranteed rates of return, a practice that has been followed in some countries, most notably India, but is frowned upon by experienced practitioners and regulators."[214]

Under the current regulations, a guaranteed return scheme cannot be offered unless the promised returns are truly guaranteed and a statement appears in the offer document that informs investors who is guaranteeing the scheme and how that guarantee will be met.[215] However, India has had several past scandals involving guaranteed return schemes that call their viability into question.[216] In one instance, a fund sponsored by Canara Bank "failed to meet its commitments of paying at a NAV price as stated in its prospectus and ultimately had to be bailed out by its Sponsor," but only at the strenuous urging of the Reserve Bank of India and SEBI.[217] Other

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211. *Id.*

212. GUPTA, *supra* note 29, at 17.

> Evaluating historical performance of mutual funds is important both for investors as well as portfolio managers. It enables an investor to asses as to how much return has been generated by the portfolio manager and what risk level has been assumed in generating such returns. Further, an investor can also appraise the comparative performance of different fund managers.

Id.

213. *See* Klapper et al., *supra* note 76, at 2 n.3 (pointing to a reduction in transparency in assured-return schemes).

214. *Id.*

215. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, para. 38(a)–(c), Gazette of India, pt. II, § 3(ii).

216. *See* GUPTA, *supra* note 29, at 72 (describing several such scandals).

217. *Id.*

instances ended in the same result—the sponsor was forced to make up the shortfall.[218] Despite the fact that SEBI has strengthened its protections for guaranteed return scheme investors,[219] it should ban such offerings because of the ease with which they deceive investors. A ban would keep investors from "fall[ing] prey to the marketing gimmicks of mutual funds."[220] In addition, first time investors who believe that a scheme will offer a guaranteed return might pay even less attention to the information available on such a scheme if they conclude on first glance that there is no way they can lose money. Furthermore, the number of assured return schemes that cannot meet their stated return will likely increase in times of market volatility like the present.

3. Increased Standard of Adequacy

According to Indian mutual fund regulations, the offer document must contain disclosures that enable an investor "to make an informed investment decision."[221] In addition, investors must be given such disclosures as are "essential in order to keep them informed about any information which may have an adverse bearing on their investments."[222] Regulations also require that investors be given a "true and fair view of the operations of the mutual fund."[223] However, it is not entirely clear what triggers a duty to disclose under these standards and what constitutes a "true and fair" view of a fund's operations. For example, in at least one high profile example a fund completely and utterly failed to inform shareholders of material developments in a fund.[224] In 2003, there were rumors that Alliance Capital Mutual Fund was going to be sold, but the AMC and sponsor made no public statements on the matter so shareholders were left in the dark.[225] Only after media speculation on the lack of material disclosures by the fund regarding its intention did the fund go public with its desire to remain in business in India.[226] Eventually, however, SEBI charged the former Chief Investment Officer of the fund's AMC with a slew of charges, including insider trading and

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218. *Id.*
219. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, para. 38(a)–(c), Gazette of India, pt. II, § 3(ii).
220. GUPTA, *supra* note 29, at 72.
221. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, para. 29(1), Gazette of India, pt. II, § 3(ii).
222. *Id.* para. 60.
223. *Id.* para. 56(2).
224. S. RAMANATHAN, DISCLOSURE STANDARDS IN CORPORATE INDIA—SCOPE FOR IMPROVEMENT 2 (2003), http://www.icsi.edu/Programmes/NationalConvention/31NationalConvention/Souvenir/tabid/1553/Default.aspx.
225. *Id.*
226. *Id.*

price manipulation charges that arose while he was attempting an unsuccessful management buy-out of the fund,[227] and the fund was eventually acquired by a competitor.[228]

This unfortunate example highlights that small Indian investors are on the losing end of an informational asymmetry problem,[229] which SEBI needs to rectify. Alliance Capital investors were forced to speculate about the fate of their money until the fund's acquisition nearly a year later, without receiving any information except misleading statements from their AMC during that period.[230] SEBI should clarify the current disclosure standards to require the disclosure of *any* information that could have *any* bearing on the price of fund units, with a presumption that the AMC leaves information out at its peril. SEBI should back up this standard with steep penalties for non-compliance. The acquisition of a fund by a rival AMC is certainly a material development, as are charges against a member of the AMC's senior management team—fund houses should be required to disclose such information to their investors.

One commentator has also suggested that funds should provide information regarding why a fund manager picked a particular stock or what the fund's general philosophy is in picking stocks.[231] While requiring a disclosure as to why the fund manager selected each individual stock might be going a bit far, it would certainly benefit investors to know what philosophy the custodian of their savings will be using to grow those savings. Under the regulations, the fund, AMC, trustee, custodian, or sponsor has to make any disclosure or submit any document that SEBI calls upon it to furnish,[232] which would be a perfect vehicle for mandating these types of disclosures.

4. Increased Enforcement

There are also issues related to compliance with the regulations that India currently has in place. In the public company context, one

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227. Research Desk, *Alliance Sold, Finally*, VALUE RES., Oct. 18, 2004, http://www.valueresearchonline.com/story/h2_storyView.asp?str=7716.

228. *Id.*

229. *See* RAMANATHAN, *supra* note 224, at 2.

> Large institutional investors and corporate [sic] have the wherewithal to get prior information well in advance and they can navigate their decisions quite quickly in such circumstances. What about the common investor? Is it not the duty of the fund houses to keep them in confidence? There were no official disclosures on the subject till the media reported these developments in the Press [sic].

Id.

230. *Id.*

231. Gajra, *supra* note 11.

232. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, para. 58(1), Gazette of India, pt. II, § 3(ii).

commentator has noted that financial disclosure norms in India are generally better than in most other Asian countries, but noncompliance with such norms "had been rampant and even the failure of auditors' reports to conform to the law attracted only nominal fines and little punitive action."[233] There is also an issue relating to compliance with the spirit, but not the letter, of some of India's fund disclosure requirements. While funds might disclose everything required of them as it relates to risk and return, among other things, there is some doubt as to whether the funds then actually consider those disclosures binding upon them.[234]

SEBI should take great pains to make sure that there are teeth behind the tiger, so to speak. One commentator has lamented how weak SEBI's current enforcement powers are, saying that "no penal provisions are provided against officers, employees, key personnel or directors of an AMC or trustees of a mutual fund are found to be guilty of violating the provisions" and that "[i]n the absence of initiation of action against such erring persons who indulge in fraudulent and unfair practices, interests of the investors cannot be said to be safeguarded."[235] In addition, the monetary penalties that SEBI is able to levy against offenders under the SEBI Act of 1992 are miniscule.[236] One commentator specifically recommends not only linking the fines that SEBI is allowed to levy with the wrongdoing of the offender, but also to allow for prison terms for particularly egregious offenses.[237] SEBI should be given increased powers to fight for investor protection and should also step up its enforcement efforts to ensure that funds are complying with the spirit as well as the letter of all applicable norms and regulations.

SEBI should be given the opportunity to pursue criminal sanctions against AMC staff or any other persons or organizations that flout regulations as well as the ability to levy much larger fines against non-compliant funds and fund personnel. The penalties

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233. Chakrabarti et al., *supra* note 199, at 63.

234. *See* GUPTA, *supra* note 29, at 208 ("The results indicated that risk and return characteristics for the Indian mutual fund schemes are not in conformity with their stated objectives.").

235. *Id.* at 83.

236. *See id.*

> Under the SEBI Act, 1992 the penalties for capital market offences are a maximum of a fine of only Rs. 5 lac irrespective of the magnitude of the offence. Thus, there is not an enough [sic] deterrent on the market players who can make crores by manipulating the stock market norms or the law as such a fine is a mere pittance.

Id.

237. *See id.* ("Apart from the need to drastically raising [sic] the penalties in monetary terms and linking [sic] them with the magnitude of economic offences there should also be a provision for a prison term. SEBI should therefore be given more punitive powers to be a more effective market regulator.").

should be steepest for willful and knowing noncompliance because industry players will only comply if there are strong deterrents against certain actions.

5. Enhanced Risk Disclosures

SEBI should also specifically require greater disclosure in risks faced by both mutual fund schemes and the underlying securities in which they invest. SEBI should be congratulated for including both standard and scheme-specific risk factors among the information that must be provided in the SID, but there is still a risk that funds will use boilerplate language in complying with these requirements and that unsophisticated investors may not understand such boilerplate language. One study concluded that Indian mutual fund "risk and return characteristics are not in conformity with their stated objectives" and "the investor should be cautious and must keep this in mind while investing in mutual funds."[238] For example, that study found that tax-planning mutual fund schemes not only generated negative performance but also had the highest level of risk among all schemes in the sample,[239] despite the surface impression that such funds would likely be the least risky and offer the steadiest returns of all types of fund schemes.

Even industry participants have acknowledged the need for greater disclosure of a scheme's risk factors.[240] The Prime Minister's Council on Trade and Industry in 2000 also recommended that "[s]tandardized benchmarks and risk norms need . . . be specified for different types of fund[s] to be used as the yardstick of comparison of performance."[241] For instance, in the United States a mutual fund prospectus should "identify briefly the principal risks of investing in the particular fund and . . . emphasize those risks reasonably likely to affect the fund's performance."[242]

Due to the popularity of guaranteed return schemes in India, investors may be completely ignorant of the possibility that they risk losing money by investing in mutual funds. Enhanced risk

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238. *Id.* at 135–36.

239. *Id.* at 173–74.

240. *See* Editorial, *Mutual Fundamentals*, TIMES INDIA (Delhi), Jul. 29, 2001, http://timesofindia.indiatimes.com/articleshow/1987288626.cms. The editorial quotes an industry executive as saying "One area where the industry could focus is the need to go beyond the statutory risk factors in explaining the underlying roles of the products and helping the investor set realistic expectations." *Id.* (internal quotation marks omitted).

241. PRIME MINISTER'S COUNCIL ON TRADE & INDUS., *supra* note 209, § 8.3.7.

242. Registration Form Used by Open-End Management Investment Companies, Securities Act Release No. 7512, Exchange Act Release No. 39,748, Investment Company Act Release No. 23,064, 63 Fed. Reg. 13,916, 13,920 (Mar. 23, 1998).

disclosures would better enable investors to choose the right product for each investor's particular risk tolerance. In the United States, mutual fund prospectuses are required to prominently display a legend noting that investments in the fund may lose value and are not bank guaranteed,[243] an idea that would be excellent for SEBI to adopt. In addition, it would be ideal for SEBI to have the power to levy substantial penalties against noncompliant funds that do not adequately describe the risks associated with each of their various schemes, as well as funds that fail to conform with their stated risk and return characteristics.

6. Greater Fee Transparency

The Indian mutual fund regulatory structure could also be improved as it pertains to fees. In light of some of the unsavory sales practices engaged in by the industry,[244] mutual fund unitholders need to see exactly where their money is going. While "SEBI cannot ban the payment of a fee to an agent by the customer," it can insist on transparency.[245] Two commentators have described the necessity of a greater level of detail on mutual fund fees, noting that brokerage customers purchasing securities in the Indian stock market are routinely given such information.[246] Indeed, those same commentators have suggested, "statements sent by mutualfunds [sic] to their customers should clearly unbundle the fees and expenses charged by the mutual fund, as opposed to the core investment performance, in a standardized format."[247] The fees that a customer pays to the distributor are coming directly out of the money that he invests, which should be brought to his attention in a very conspicuous manner. Investors should know that if the scheme is beating the overall market but paying an outrageously high level of fees to distributors it is, in effect, robbing shareholders from the benefits of that fund's performance.

Granted, SEBI has recently taken steps to deal with the issue of mutual fund fees. On June 30, 2009, SEBI released a circular that banned entry loads by funds and, more importantly, required a

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243. *Id.* at 13,922.

> Form N-1A currently requires a fund that is advised by or sold through a bank to disclose on the cover page of its prospectus that the fund's shares are not deposits or obligations of, nor guaranteed or endorsed by, the bank, and that the shares are not insured by the Federal Deposit Insurance Corporation ("FDIC") or any other government agency.

Id.

244. *Supra* Part IV.B.
245. SHAH ET AL., *supra* note 181, at 209.
246. *Id.*
247. *Id.*

number of mandatory disclosures about fees: (i) scheme application forms must carry a disclosure that communicates that the upfront commissions paid to distributors by the customer "will be paid by the investor directly to the distributor" (a provision that includes language hinting that the investor can pay the distributor whatever fee he deems appropriate "based on his assessment of various factors including the service rendered by the distributor"), and (ii) distributors must disclose to the investor the commission that the distributor receives for each of the different mutual fund schemes that are "being recommended to the investor."[248] This goes a long way towards the problem of distributors pushing products to the investor that pay the highest fees to the distributor but are unsuitable for the investor.

SEBI would do well to take this one step further and mandate that every fund's Annual Report disclose the level of fees paid to each specific distributor used by that fund, as distributors are also remunerated by the AMC out of fund assets for selling scheme units to the investor.[249] After all, AMCs are permitted to charge fund schemes for marketing and selling expenses, a category that includes commissions paid to distributors.[250] It would also behoove Indian investors if SEBI were to require funds to provide the specific percentage of the scheme's net assets that go towards the payment of commissions to fund distributors instead of lumping that information in the category of marketing and selling expenses. This would enable investors to see how much of their investment is going into the pocket of distributors.

7. Increased Data Access

AMFI's website[251] is a helpful starting place for any mutual fund investor. However, SEBI needs to take the lead not just in requiring what information has to be offered by the industry, but also in how that information is presented to the public. The United States Securities and Exchange Commission established its EDGAR system as a central repository for all the information that a prospective investor might need.[252] SEBI should establish a similar type of database in order to make it easy for a new investor to obtain all the information and download the forms that he or she needs in one short

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248. June 30 Chojer Letter, *supra* note 183, para. 4(b), (d).
249. *Id.* para. 2.
250. *Id.*
251. AMFI Association of Mutual Funds in India, http://www.amfiindia.com/ (last visited Jan. 4, 2010).
252. *See* U.S. Securities and Exchange Commission, Search the Next-Generation EDGAR System, http://edgar.sec.gov/edgar/searchedgar/webusers.htm (last visited Jan. 4, 2010) (providing investors access to information on public companies).

Internet session. SEBI has recently taken a positive step in this direction by requiring that soft copies of every fund's SAI and SID be provided to SEBI for posting on SEBI's website.[253] However, SEBI should also require that Annual Reports and all other required forms and disclosures also be included on its website. Establishment of such a centralized repository would make it much easier for the investor to compare one fund versus another without the possibility of getting lost searching for such information on the Internet.

Investors are currently only entitled to receive an Annual Report or an abridged summary of the Annual Report, at the company's discretion.[254] However, if investors receive an abridged summary from the fund, they have to journey to the head office of the fund and pay a fee in order to see the fund's full Annual Report.[255] Investors should at least have easy, free access to all of the required disclosures for each of their investments. Forcing them to travel to Mumbai and pay money to save the AMC printing costs is ludicrous, particularly when the AMC already receives fees from the fund schemes for marketing and selling expenses. The AMC should at least be required to send every unitholder an Annual Report, as the abridged summary does not even provide a full fund portfolio breakdown.[256] It was an important step to require the fund to post unaudited half-yearly financial results on its website,[257] with one commentator noting that "[w]ith the requirement of compulsory display of financial results on the website SEBI has ensured that critical information is quickly made available to the investors and the public at large."[258] After all, SEBI has a mission to "call[] for information from . . . mutual funds."[259] In line with that mission, it should be organizing and publicizing the information it calls for. In addition, it is a bad idea to rely on the industry to decide how to comply with disclosure requirements. For instance, SEBI was forced to come up with a standard format for abridged annual reports in 2008 because of a

253. Letter from Ruchi Chojer, Deputy Gen. Manager, Inv. Mgmt. Dep't, Sec. & Exch. Bd. of India, to All Mut. Funds, Asset Mgmt. Companies (AMCs) & Assoc. of Mut. Funds in India (AMFI) para. 1 (Sept. 29, 2009).

254. *See* Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, para. 56(1)–(2), Gazette of India, pt. II, § 3(ii) (requiring an "Annual Report of [the] mutual fund or an abridged summary thereof" be mailed to all unitholders).

255. *See id.* para. 56(3) (requiring that where unitholders receive an abridged summary, the full Annual Report must be made available at the mutual fund's head office for a nominal fee).

256. *Id.* para. 56(2) & n.95.

257. Letter from P.K. Nagpal, Gen. Manager, Mut. Funds Dep't, Sec. & Exch. Bd. of India, to All Mut. Funds Registered with Sec. & Exch. Bd. of India and Unit Trust of India (Apr. 20, 2001), *available at* http://www.mutualfundsindia.com/sebi/april20.html.

258. GUPTA, *supra* note 29, at 81.

259. The Securities and Exchange Board of India Act, No. 15 of 1992, India Code (1993), para. 11(2)(i), *available at* http://indiacode.nic.in.

"lack of uniformity in the contents" of previous reports prepared by the industry.[260]

8. Language Issues

Periodically, each fund and asset manager must either send a complete statement of the scheme portfolio as well as its unaudited financial results for that period to unitholders or publish such information in one English-language daily newspaper that circulates throughout the entire country, as well as a newspaper published in the language of the region where the main office of the fund is located.[261] This requirement serves to the detriment of shareholders who cannot read (or speak) English, of which there are likely a substantial number in India. In addition, as distribution networks reach out to even more cities and to the rural countryside through the post office,[262] an increasing number of investors will be in need of the information that funds are required to provide to their investors. If an investor in a rural province cannot read or speak English and the home office of the fund in which he would like to invest is not in his region, then it would seem that he is out of luck. This regulation has even more bite considering that Mumbai houses a large majority of the major Indian mutual fund industry players. This works to the detriment of shareholders outside the greater Mumbai area because every fund can comply with the requirement that it publish certain information by doing so in the Mumbai area. SEBI should institute a requirement that a fund must file copies of all required disclosures in all of the major languages spoken in India as well as for any city in which the fund's distributors have a presence. If the city is important enough for the fund to have a sales presence in, then it is certainly important enough for the investors who live in or around that city to have access to information about their investments in a language that they comprehend.

9. Large Shareholders

Indian corporations have a substantial presence in the Indian mutual fund market place, holding just over 50% of Indian mutual fund shares as of March 2007.[263] However, Indian mutual fund investors likely have no idea whether their fellow shareholders are all individuals of modest means or are all large corporations. As one commentator notes: "[U]nit-holders have almost no clue about the

260. July 24 Chojer Letter, *supra* note 154 para. A(2).

261. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, paras. 59, 59A, Gazette of India, pt. II, § 3(ii).

262. *Supra* Part II.D.

263. Kamiyama, *supra* note 25, at 58.

concentration of unit-holdings. All they know is that any fund has to have at least 20 unit-holders. Lack of information makes them vulnerable to large outflows by a handful of corporate investors."[264] Another commentator favors "identifying large unit holders in order to see if the mutual fund's tax-exempt status is being misutilized by the 'not so small' corporate investor" because such a "situation also exposes the real small investor to an inferior unit performance as the corporate investments are volatile in nature and sudden pullouts may lead to unplanned sales and lesser values being realized than expected."[265]

Listed public companies in India are required to disclose exact details of promoter holdings, the aggregate stake of institutional investors (corporate investors not qualifying as institutional investors) and retail investors as well as the names of all non-promoter shareholders holding over 1% of a company's equity securities.[266] In addition, the mutual fund Code of Conduct promulgated under SEBI's 1996 mutual fund regulations specifically instruct that fund trustees and the AMC "should avoid . . . excessive holding of units in a scheme among a few investors."[267] In 2003, SEBI imposed a requirement that no single shareholder should have a stake of more than 25% in a single scheme[268] and that any single blockholding of more than 25% would have to be included in the required half-yearly disclosure.[269] That was a positive step, but a single blockholder can significantly harm small unitholders with less than a 25% stake, and SEBI should require disclosure of all shareholders that meet a lower threshold like 5 or 10% of a fund scheme's units. This is necessary in order to ensure that the average retail investor is not faced with a situation in which he is notified in the paper that his fund's corporate majority shareholder just exited, creating chaos for the remaining minority individual unitholders.

VI. CONCLUSION

India's mutual fund industry has come a long way since 1963. AUM has exploded to $139.6 billion as of December 2007,[270] and the country's regulatory framework has, for the most part, evolved with

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264. Gajra, *supra* note 11.

265. Amitabh Gupta, *Mutual Funds: Agenda for Transparency and Disclosures*, ICFAI J. CORP. GOVERNANCE, Oct. 2004, 35, 37 (India).

266. Gajra, *supra* note 11.

267. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, sched. 5, para. 3, Gazette of India, pt. II, § 3(ii).

268. Gupta, *supra* note 265, at 38.

269. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, sched. 12 n.3, Gazette of India, pt. II, § 3(ii).

270. SHAH ET AL., *supra* note 181, at 183.

the times. Disclosure protections for India's mutual fund investors have grown from where they were even five years ago,[271] but they still have further to go. Research has shown that the better a country's regulation of mutual funds, particularly in the case of disclosure, the larger its fund industry.[272] To that end, enhancing disclosure requirements might serve both industry players and investors in the long term.

There are nine major areas in which SEBI needs to reform India's mutual fund disclosure regime. The most important of the suggestions advanced by this Note are requiring specific disclosures and independent verification of the AMC's returns; increased fee transparency; and enhanced data access and increased risk disclosures. The last item has taken on supreme importance in a time of unprecedented market turmoil for the Indian capital markets. Further breaking out the money that each investor is losing in fund payments to distributors would provide a powerful statement to investors as to what percentage of their money is actually being invested by the AMC. Expanding SEBI's website to make it a central repository for Indian mutual fund related information like the SEC's EDGAR system would ensure timely access for all Indian mutual fund investors to any information about their funds that they might need from one centralized location. Finally, and perhaps most importantly, the AMC is the real force behind every mutual fund scheme. A scheme is only as good as its AMC, and investors deserve to know more about the track record of each Indian AMC.

Assuaging the fears of India's beginning investors is perhaps the most important reason for the improved disclosure called for in this note. India is notable for the dramatic surge in its economic growth since the early 1990s, which has brought increased wealth for many Indians and a huge increase in the number of mutual fund investors in the country. However, the current worldwide recession has hurt the Indian mutual fund industry: between the end of 2007 and mid-2008, Indian mutual fund assets had shrunk by more than 5% after growing more than four-fold over the previous five years.[273] Fund inflows have also fallen.[274] In another worrying sign for the Indian mutual fund industry, Indian investors are very skittish compared to those in other, more mature markets.[275]

271. *See* Krishnan, *supra* note 65 ("But the regulatory framework, disclosure norms and service standards have all changed beyond recognition, making mutual funds one of the most investor-friendly avenues available today.").

272. Khorana et al., *supra* note 190, at 148.

273. Kumar & Hodgson, *supra* note 62.

274. *See id.* ("More ominously for future growth, equity fund inflows fell to their lowest in June [2008] . . . and new stock funds have collected just Rs1,830 crore so far in fiscal 2009, compared with Rs6,335 crore in the year-earlier period.").

275. *See* Mohanan, *supra* note 63, at 288.

Considering that many Indian investors are first-timers means that with the better, more comprehensive information that an improved disclosure regime would provide, such investors might be less likely to panic in today's challenging market conditions. One commentator has noted that the industry has not seen too many "panic withdrawals so far, but the number of new investors has slowed. Mutual fund companies are rushing to counsel nervous investors against selling and telling them to learn to live with risk."[276] However, that could quickly change, which could doom an already crowded industry that has seen a profitability squeeze[277] at a time when it could ill afford such a possible loss of investor base. If India is to succeed in permanently retaining the skittish investors that may be scared off by tumultuous reductions in fund flows and negative performance of the Indian mutual funds over the last several years, then it needs to ensure that its investor protections are world class. It is in the best interests of the industry to strengthen existing disclosure standards in order to keep the customers they currently have as well as to enhance their ability to attract new investors. Indian investors might also be more likely to gravitate towards funds with better disclosures that would give them a better grasp on the investment and its risks.

*Stephen P. Smith**

> In India the investor profile is very short term and turnover of units by investors is very high compared to the UK and the USA. The average length of time an investor stays in a securities scheme, other than a money market/liquid scheme, is one-fifth of the time that he would in the UK and two-fifths of the time that he would in the USA.

Id.

276. Lakshmi, *supra* note 3.

277. *See* Kumar & Hodgson, *supra* note 62 ("India's fund industry has also found operating margins squeezed by spiraling real estate and staff costs.").

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