KEEPING THE FAITH
July 14, 2021

SUMMARY OF DISCUSSIONS

Background

Mutual Funds (MF) have traditionally been the entry level vehicle for first-time investors in the securities market. It has been believed, not without reason, that the expertise of Fund managers will deliver better returns to the investors, than any direct investment options that they might resort to. While the ecosystem has lived with occasional under-performance, and scheme-level meltdowns, confidence in the MF industry had remained unshaken. However, recent developments in one of the larger MF, and the reported inability of the Trustees to act quickly and effectively, have had the effect of seriously eroding investor confidence in the ability of MF to safeguard investors' interests. For the industry, introspection is the need of the hour. This would necessitate brainstorming among representatives of the Trustee companies, the AMCs and perhaps the Sponsors to re-establish faith in the system.

DISCUSSIONS

MUTUAL FUNDS INDUSTRY

- **All is well?** - MF industry does not have a series of systemic issues that should make investors worry. However, when some untoward incident occurs, it makes persons interested in the industry wonder whether all is well with it, and whether there are some things that need to be fixed.
- **MFs have inherent risks -** There are some risks that MFs have, and these cannot be avoided, especially since markets in India are not developed. Also, there is a limit beyond which MF industry cannot be monitored.
- **Regulator's role** - SEBI has done a lot of work in the area of regulation of the MF industry. There are a number of existing regulations. There is a continuous conversation between the Regulator and the industry. However, micro-regulation is not the solution to every problem.
- **Risk management practices** - The recent event in the industry has raised questions on the existing risk management practices, especially those related to liquidity. From time to time, SEBI has stepped in to ensure that risk management practices are adequate. In last couple of years, a number of corrective actions have been undertaken by SEBI to enforce tighter risk management principles. Further, the Mutual Fund Advisory Committee has been discussing matters relating to the further tightening of risk management related norms, including the final guidelines relating to liquidity risk management. It has also been considering implementing some good international practices in India. There are also plans of codifying the risk management guidelines, since the earlier guidelines were issued in 2002, subsequent to which changes have been made only through circulars.
- **Other norms also have been tightened -** Disclosures have been increased, with the objective of achieving clarity and transparency. The role of the Trustees, as custodians of the AMC, has also been a matter of focus.

MIS-SELLING

- **Positioning of MFs in the minds of investors** – Some instruments of the MF industry are considered to be relatively safer by the retail investors. This belief is also reiterated on the basis of the risk-o-meter. However, this may not always be the case. Mis-selling by marketing teams of MFs has resulted in creating this wrong impression. Risks associated with investment in MFs are not adequately recognised by investors. This causes expectation-reality mismatch. The only way to solve this is to manage the expectations at the point of time at which the product is sold.

- **Pressure from investors when things go wrong** – When things go wrong, there is a lot of pressure on SEBI from investors who lose money, requesting SEBI to conduct forensic investigations. However, in the event of a failure, a distinction needs to be drawn between negligence on the part of the Fund manager, and the state of the market, as the cause of failure. There could be issues of judgement, which are genuine mistakes. If products are sold with the clear understanding that the amount of investment could reduce, the hue and cry will not happen. There is a need for investors to understand that in MF, they would sometimes make, and sometimes lose, money. The upside alone cannot belong to the investors, while they expect the Government to pitch in, in the event of a downside.
- **Need for right marketing** - There is a need to sell MF products, after communicating to the buyers the risks involved, and setting the expectations right. The offer letter should mention whether the risks taken are higher than the market risks. Some MFs have already understood the need for right communication. MF is perhaps the only industry that focuses on risks, even in its advertisements.
- **Fund manager** - A Fund manager's job is not easy. There is a race to perform, as well as to outperform competition. But it is a very meaningless race, since investors usually invest on the basis of the name/ reputation of the AMC and the Fund house, and not only on the basis of the ranking of Funds. In such a situation, integrity and ethics become very significant.

TRUSTEE BOARD

- **3-tier structure** - AMCs, at present, have a three-tier structure. Trustees are the choice of the AMCs. But in theory, Trustees appoint the AMC. They enter into an agreement with the AMC, and are expected to tell the latter what to do. In practice, Trustee's oversight becomes practically non-existent.
- **Role of Trustees** – SEBI expects the Trustees to play a bigger role in safeguarding the interests of investors. However, there is a limit beyond which Trustees may not be able to ensure this. Trustees are part-timers. The Trustee Board is one step removed from the working of the MF. The AMC Directors/ Board comprises Executive Director(s) and Fund manager(s) who are involved in the day-to-day management. Trustee Boards do not have any such person, and so rely only on the agenda that comes to them. They may read some extra reports, and ask some questions, but it is difficult for them to deal with/ anticipate matters that are not brought to them. Is there therefore a need to lower the expectations from Trustees, having regard to ground realities? Unreasonable expectations often lead to more regulations, which may become counterproductive.
- **Quality of Trustees/ Directors** - It is important to focus on the quality of persons who are appointed on the Trustee Boards. To populate the Board with Trustees, who understand what the company does, is not easy, since there are not enough persons with the relevant background. They will be able to contribute to discussions only if they clearly understand what is expected of the AMCs.
- **Need for more Independent Trustees** - The current Trustee Boards have only a minimal number of representatives from the Sponsors. Notwithstanding this, there is a need to bring in more independent persons as Trustees. There could be a perception issue if even one Sponsor representative is present on the Trustee Board.
- **Compliance heavy agenda** - A good amount of time of the Trustee Board is spent on compliance related issues. This is consistent with their oversight role. However, some Trustee Boards are not happy with only procedural matters coming to them. Also, many compliances do not need application of mind of the Trustees, and can be completed administratively. There is a need to re-think some of these processes that are currently being prescribed/ followed.

- **Officer for Trustees** – As a response to the increased workload of, and expectations from, Trustees, SEBI has prescribed that each Trustee Board should have an officer to help the Trustees. This measure does not seem to travel far enough.
- **Executives on the Board** - Having Executive Director(s) on the AMC Board helps since persons who are directly involved with the functioning of the AMC interact with the Trustees.
- **Asking the tough questions** - Trustee Board members should know that they are custodians of the Fund. There should be a culture to not frown on Trustees who ask the tougher questions. The management/ Sponsor has to be willing to listen to the Trustees. One possible way of promoting the culture of asking tough questions is by availing the advice of a panel of auditors, who will give correct opinions and valuations, so that the AMC's proposals are not mechanically endorsed.
- **Processes at the Board-level** - Fund managers will take risks. Trustee Boards should ensure that there is a process driven fund management system, so that they are sure that the Fund manager is doing her/his job well. Fund management should not be the preserve of any individual, and there should be a team of professionals, with diversified responsibilities.
- **Compensation to Trustees** – Compensation paid to Trustees is very low. Getting good quality Trustees, with little compensation, and having the relevant background/ experience, is very difficult. It has been suggested time and again that SEBI should create a fund, to which the AMCs contribute, and from which the sitting fees to the Trustees could be paid. This could help in creating the right relationship between the Trustees and the AMCs. This suggestion has not found favour.
- **Professional Trustee Company -** Several years ago, a report by Cadogan Financial had suggested that India should consider having a system of professional Trustee companies, rather than appointing Trustees, who are selected by the AMCs/ Sponsors. In Malaysia, where this concept is used, the professional Trustee company takes the responsibility of supervision of the entire functions of the AMC, including Fund valuation, Fund auditing and Fund accounting. The Fund belongs to the Trustees, on behalf of the investors, and the AMC is only a manager. In this arrangement, the role of the Trustees is clear. Except for the management of the Fund by the AMC, all the responsibilities are with the professional Trustee company. However, in such a setup, the Sponsors' role is limited. In India, this idea has not found acceptance.

AMFI

- **Expansion of role of AMFI** – AMFI has been doing good work as an industry body of the MF industry. It could consider being bifurcated, and having two roles, a regulatory role, and a role as a representative body. If this is done, it could function as a first level Regulator, rather than depending on the Trustees for this role. It could also promote self-regulation. However, for AMFI to have a bigger role, it would have to invest in hiring professionals, who can help it perform this expanded role.

LAW AND REGULATIONS

- **Need for regulation** - There is a need for some degree of regulations. But these should be limited, for them to be productive. Micro-regulation will be counterproductive.
- **Statute for MF industry** - MF industry is 30 years old, and is governed by the Indian Trusts Act and Indian Company Law. It is probably time for MF industry to get its own statute, because each time something goes wrong, different sets of persons apply their minds and tweak the existing provisions of regulations. These tweaks/ reactions range from kneejerk changes to permanent solutions. But there is not one law by which MF industry can be comprehensively regulated. The Supreme Court too has raised some questions on SEBI's regulations relating to the MF industry. The statute could also help give clarity to issues such as

the role of Trustees. The flipside however of having a statute is that it would be time consuming and difficult to make even a small change therein.

INVESTOR EDUCATION

- **Need for investor education** – MFs have a large retail investor participation, and these persons have to be educated, so that their expectations are realistic. The principle of *caveat emptor* (purchaser beware) applies to MFs. The industry has been advertising that investors should be vigilant, especially since the potential for mischief is very large. Information asymmetry is large, resulting in mis-selling.
- **Entire amount is not invested** - Investor education should also focus on informing investors what percentage of their funds will be invested, since some amount of their money will be spent towards expenses too.
- **Risks in investment** - Investors should be informed about liquidity and credit risks, since the Indian market is not mature. This could result in losses. Investor should be aware that if returns are high, there will also be some additional risks involved.

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