MUTUAL FUNDS IN INDIA:

AN OVERVIEW

Nishith Desai Associates

Legal & Tax Counseling Worldwide

MUMBAI ● SILICON VALLEY ● BANGALORE

www.nishithdesai.com
nda@nishithdesai.com

MUTUAL FUNDS IN INDIA: AN OVERVIEW

93-B MITTAL COURT, NARIMAN POINT,
MUMBAI 400 021. INDIA.
TEL.: 91 (22) 2282 0609
FAX: 91 (22) 2287 5792

220 CALIFORNIA AVENUE, SUITE 201,
PALO ALTO, CA 94306. USA.
TEL.: 1 (650) 325 7100
FAX: 1 (650) 325 7300

DBS CENTER – SUTIE 217,
26, CUNNINGHAM ROAD,
BANGALORE 560052. INDIA.
TEL.: 91 (80) 2267272 / 2202440

Nishith Desai Associates (NDA) is a research based, multi-skilled law firm based in Mumbai, Silicon Valley and Bangalore. NDA specializes in globalization of Indian corporates, information technology, international financial and tax laws, corporate and securities laws, mergers & acquisitions, media and entertainment laws and telecom laws. NDA was awarded “Indian Law Firm of the Year 2000” and “Asian Law firm of the Year (Pro-bono)-2001” by the International Financial Law Review, a Euromoney Publication. NDA has also been ranked as having a leading practice in Private Equity, Media and Entertainment and IT and telecommunications law for 2001-02 by the Global Counsel 3000.

CONTENTS

SECTION 1

SECTION 1

A. EMERGENCE OF THE MUTUAL FUND INDUSTRY IN INDIA

The origin of the Indian mutual fund industry can be traced back to 1964 when the Indian government, with a view to augment small savings within the country and to channelise these savings to the capital markets, set up the Unit Trust of India ("**UTI**"). The UTI was set-up under a specific statute, the Unit Trust of India Act, 1963. The Unit Trust of India launched its first open-ended equity scheme called Unit 64 in the year 1964, which turned out to be one of the most popular mutual fund schemes in the country. In 1987, the government permitted other public sector banks and insurance companies to promote mutual fund schemes. Pursuant to this relaxation, six public sector banks and two insurance companies *viz.* Life Insurance Corporation of India and General Insurance Corporation of India launched mutual fund schemes in the country. Subsequently, in 1993, the Securities and Exchange Board of India ("**SEBI**") introduced The Securities and Exchange Board of India (Mutual Funds) Regulations, 1993, which paved way for the entry of private sector players in the mutual fund industry.

In the period between 1963 and 1988, when the UTI was the sole player in the industry, the assets under management grew to about Rs. 67 billion[1]. In the second phase between 1988-1994, when public sector banks and insurance companies were allowed to launch mutual fund schemes, the total assets in the mutual fund industry grew to about Rs. 610 billion with the total number of schemes increasing to 167 by the end of 1994. The third phase of the mutual fund industry, which commenced in 1994, witnessed exponential growth of the industry, with the advent of private players therein. Kothari Pioneer Mutual fund was the first fund to be established by the private sector in association with a foreign fund. As on September 30, 2002, the total assets under management stood at Rs. 1069 billion and the total number of schemes stood at 384.

During the last three and a half decades, UTI has been a dominant player in the mutual fund industry. The total assets under the management of the UTI as on September 30, 2002 were to the tune of Rs. 442 billion, which amount to almost 41% of the total assets under management in the domestic mutual fund industry. UTI has witnessed some erosion of assets pursuant to the last years crisis arising on account of its Unit 64 scheme, the scheme with largest amount of assets under management. This was the first scheme launched by the UTI with a significant equity exposure and the returns of which was not linked to the market. This resulted in a payment crisis when the stock markets crashed during the last two years which resulted in some degree of loss of investors' confidence in UTI leading to erosion of its assets under management. This period also gave opportunity to the private players to demonstrate better returns thereby capturing a significant market share. As at the end of September 30 2002, there are in all 22 private sector funds (excluding UTI and funds sponsored by banks and other government institutions) operating in India with total assets

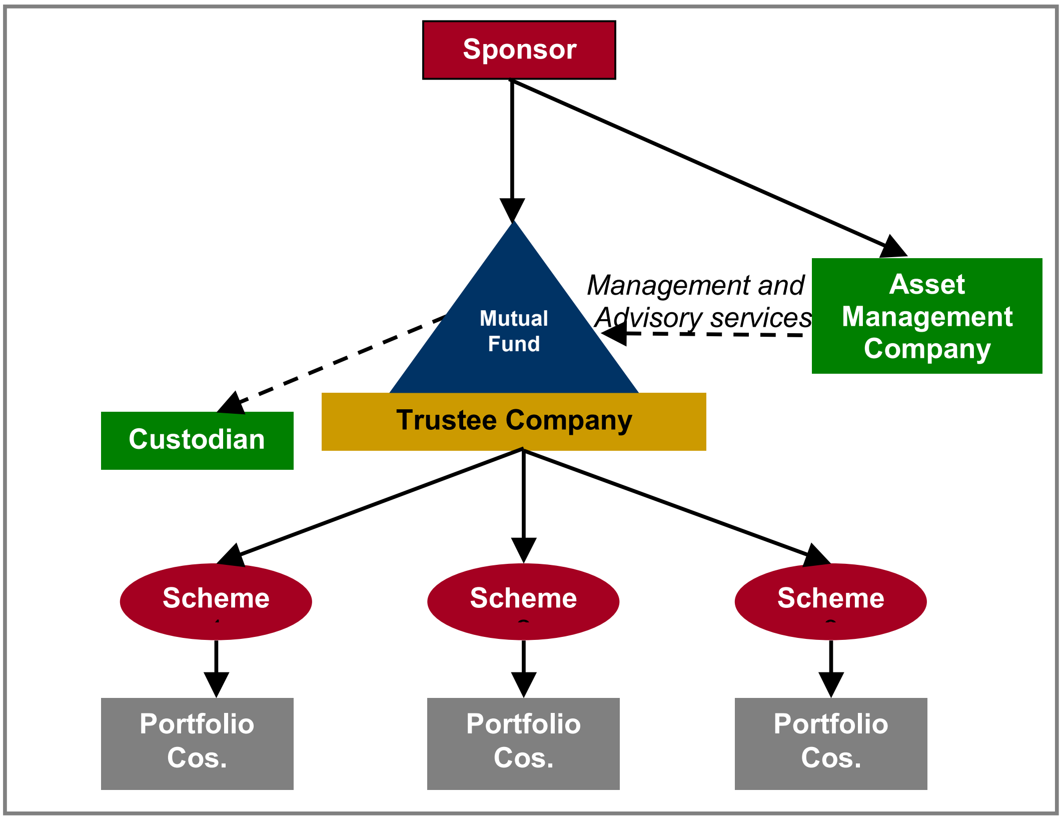
[1] Rupees One billion = approx USD 20.9 million as of date.

under management of Rs. 529 billion[2]. A list of mutual funds currently operating in India is attached hereto as ***Annexure 1***.

B. STRUCTURE OF A MUTUAL FUND

A mutual fund is set up in the form of a trust, which has sponsor, trustees, asset management company ("**AMC**") and a custodian. The trust is established by a sponsor or more than one sponsor who is like a promoter of a company. The trustees of the mutual fund hold its property for the benefit of the unit-holders. The AMC, approved by SEBI, manages the funds by making investments in various types of securities. The custodian, who is registered with SEBI, holds the securities of various schemes of the fund in its custody. The trustees are vested with the general power of superintendence and direction over AMC. They monitor the performance and compliance of SEBI Regulations by the mutual fund.

A typical mutual fund structure in India can be graphically represented as follows:



C. REGULATORY REGIME

A mutual fund is 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. The regulation of mutual funds operating in

2 Source: www.amfiindia.com

India falls under the purview of the authority of the Securities and Exchange Board of India ("**SEBI**"). Any person proposing to set up a mutual fund in India is required, under the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 ("**Mutual Fund Regulations**"), to be registered with the SEBI.

(a) Mutual Fund

The Mutual Fund Regulations lay down several criteria that need to be fulfilled in order to be granted registration as a mutual fund. Every mutual fund must be registered with SEBI and must be constituted in the form of a trust in accordance with the provisions of the Indian Trusts Act, 1882. The instrument of trust must be in the form of a deed between the sponsor and the trustees of the mutual fund duly registered under the provisions of the Indian Registration Act, 1908.

(b) Sponsor

The sponsor is required, under the provisions of the Mutual Fund Regulations, to have a sound track record[3], a reputation of fairness and integrity in all his business transactions Additionally, the sponsor should contribute at least 40% to the net worth of the AMC. However, if any person holds 40% or more of the net worth of an AMC shall be deemed to be a sponsor and will be required to fulfil the eligibility criteria specified in the Mutual Fund Regulations. The sponsor or any of its directors or the principal officer employed by the mutual fund should not be guilty of fraud, not be convicted of an offence involving moral turpitude or should have not been found guilty of any economic offence.

(c) Trustees

The mutual fund is required to have an independent Board of Trustees, *i.e*. two thirds of the trustees should be independent persons who are not associated with the sponsors in any manner whatsoever. An AMC or any of its officers or employees are not eligible to act as a trustee of any mutual fund. In case a company is appointed as a trustee, then its directors can act as trustees of any other trust provided that the object of such other trust is not in conflict with the object of the mutual fund. Additionally, no person who is appointed as a trustee of a mutual fund can be appointed as a trustee of any other mutual fund unless he is an independent trustee and prior approval of the mutual fund of which he is a trustee has been obtained for such an appointment.

The trustees are responsible for - *inter alia* - ensuring that the AMC has all its systems in place, all key personnel, auditors, registrars *etc*. have been appointed prior to the launch of any scheme. It is also the responsibility of the trustees to ensure that the AMC does not act

[3] Regulation 7 (a) Explanation, Securities and Exchange Board of India (Mutual Funds) Regulations, 1996: "*For the purposes of this clause* ***"sound track record"*** *shall mean the sponsor should:*
(i) be carrying on business in financial services for a period of not less than five years; and
(ii) the networth is positive in all the immediately preceding five years; and
(iii) the networth in the immediately preceding year is more than the capital contribution of the sponsor in the asset management company; and
(iv) the sponsor has profits after providing for depreciation, interest and tax in three out of the immediately preceding five years, including the fifth year."

in a manner that is favorable to its associates such that it has a detrimental impact on the unit holders, or that the management of one scheme by the AMC does not compromise the management of another scheme. The trustees are also required to ensure that an AMC has been diligent in empanelling and monitoring any securities transactions with brokers, so as to avoid any undue concentration of business with any broker. The Mutual Fund Regulations further mandates that the trustees should prevent any conflicts of interest between the AMC and the unit holders in terms of deployment of net worth.

The trustees are also responsible for ensuring that there is no change carried out in the fundamental attributes of any scheme or the trust or fees and expenses payable or any other change that would modify the scheme and affect the interest of unit holders, unless each unit holder is provided with written communication thereof. In addition, the unit holders must be given the option to exit at the prevailing Net Asset Value ("**NAV**") without any exit load. They are obliged to perform a quarterly review of all transactions carried out between the mutual funds, AMC and its associates.

As far as professional indemnity cover for the trustees or the AMC is concerned, industry practice in India reveals that the insurance policy is taken out by an Indian insurance company (as is required by the Insurance Act, 1938) while the risk is subsequently ceded to an overseas re-insurer who underwrites the primary policy issued by the Indian insurance company.

(d) Asset Management Company

The sponsor or the trustees are required to appoint an AMC to manage the assets of the mutual fund. Under the Mutual Fund Regulations, the applicant must satisfy certain eligibility criteria in order to qualify to register with SEBI as an AMC:

- the sponsor must have at least 40% stake in the AMC;

- the directors of the AMC should be persons having adequate professional experience in finance and financial services related field and not found guilty of moral turpitude or convicted of any economic offence or violation of any securities laws;

- the AMC should have and must at all times maintain, a minimum net worth of Rs. 100 million;

- the board of directors of such AMC has at least 50% directors, who are not associate of, or associated in any manner with, the sponsor or any of its subsidiaries or the trustees;

- the Chairman of the AMC is not a trustee of any mutual fund.

In addition to the above eligibility criteria and other on going compliance requirements laid down in the Mutual Fund Regulations, the AMC is required to observe the following restrictions in its normal course of business:

- any director of the AMC cannot hold office of a director in another AMC unless such person is an independent director and the approval of the board of the AMC of which such person is a director, has been obtained;

- the AMC shall not act as a trustee of any mutual fund;

- the AMC cannot undertake any other business activities except activities in the nature of portfolio management services, management and advisory services to offshore funds, pension funds, provident funds, venture capital funds, management of insurance funds, financial consultancy and exchange of research on commercial basis if any of such activities are not in conflict with the activities of the mutual fund;. However, the AMC may, itself or through its subsidiaries, undertake such activities if it satisfies the Board that the key personnel of the asset management company, the systems, back office, bank and securities accounts are segregated activity wise and there exist systems to prohibit access to inside information of various activities.

- the AMC shall not invest in any of its schemes unless full disclosure of its intention to invest has been made in the offer. However, an AMC shall not be entitled to charge any fees on its investment in that scheme.

The AMC is required to take all reasonable steps and exercise due diligence to ensure that the investment of funds pertaining to any scheme are not contrary to the provisions of the Mutual Fund Regulations and the trust deed. An AMC cannot, through any broker associated with the sponsor, purchase or sell securities, which is an average of 5% or more of the aggregate purchases and sale of securities made by the mutual fund in all its schemes. However, the aggregate purchase and sale of securities excludes the sale and distribution of units issued by the mutual fund and the limit of 5% shall apply only for a block of any three months.

(e) Custodian

The mutual fund is required, under the Mutual Fund Regulations, to appoint a custodian to carry out the custodial services for the schemes of the fund. Only institutions with substantial organizational strength, service capability in terms of computerization, and other infrastructure facilities are approved to act as custodians. The custodian must be totally de-linked from the AMC and must be registered with SEBI. Under the Securities and Exchange Board of India (Custodian of Securities) Guidelines, 1996, any person proposing to carry on the business as a custodian of securities must register with the SEBI and is required to fulfil specified eligibility criteria. Additionally, a custodian in which the sponsor or its associates holds 50% or more of the voting rights of the share capital of the custodian or where 50% or more of the directors of the custodian represent the interest of the sponsor or its associates cannot act as custodian for a mutual fund constituted by the same sponsor or any of its associate or subsidiary company.

(f) Schemes

Under the Mutual Fund Regulations, a mutual fund is allowed to float different schemes. Each scheme has to be approved by the trustees and the offer document is required to be filed with the SEBI. The offer document should contain disclosures which are adequate enough to enable the investors to make informed investment decision, including the disclosure on maximum investments proposed to be made by the scheme in the listed securities of the group companies of the sponsor. If the SEBI does not comment on the contents of the offering documents within 21 days from the date of filing, the AMC would be free to issue the offer documents to public.

There are obligations on the AMC and the trustee to ensure that the statements made in the offer documents are true and correct. The AMC is also required to provide an option to the unit-holder to nominate a person in whom the units held by him shall vest in the event of his death. SEBI has also prescribed an Advertising Code that has to be observed while launching a new scheme.

Close-ended schemes[4] are required to be listed on a recognized stock exchange within six months from the closure of the subscription. However, this requirement is not mandatory if the scheme provides for periodic repurchase facility to all the unit-holders or monthly income or caters to special classes of persons, if the details of such repurchase facility are clearly disclosed in the offer document or if the scheme opens for repurchase within a period of six months from the closure of subscription. The units of close-ended scheme may be converted into open-ended scheme[5] if the offer document of such scheme discloses the option and the period of such conversion or if the unit-holders are provided with an option to redeem their units in full. A close-ended scheme is required to be fully redeemed at the end of the maturity period. However, a close-ended scheme may be allowed to be rolled over if the purpose, period and other terms of the roll over and all other material details of the scheme including the likely composition of assets immediately before the roll over, the net assets and NAV of the scheme, are disclosed to the unit-holders and a copy of the same has been filed with SEBI. Additionally, such a roll over would be permitted only in case of those unit-holders who have expressed their consent in writing and the unit-holders who do not opt for the roll over or have not given written consent shall be allowed to redeem their holdings in full at NAV based price.

The SEBI has restricted a mutual fund from giving guaranteed returns in a scheme unless such returns are fully guaranteed by the sponsor or the AMC or a statement indicating the name of the person who will guarantee the return is made in the offer document or the manner in which the guarantee to be met has been stated in the offer document.

---

[4] Regulation 2(f), Securities and Exchange Board of India (Mutual Funds) Regulations, 1996: "***close-ended scheme”*** *means any scheme of a mutual fund in which the period of maturity of the scheme is specified*.

[5] Regulation 2(s), Securities and Exchange Board of India (Mutual Funds) Regulations, 1996: “***open-ended scheme"*** *means a scheme of a mutual fund which offers units for sale without specifying any duration for redemption*.

(g) Investment Criteria

The Mutual Fund Regulations lay down certain investment criteria that the mutual funds need to observe. There are certain restrictions on the investments made by a mutual fund. These restrictions are listed down as ***Annexure 2*** to this paper.

The moneys collected under any scheme of a mutual fund shall be invested only in transferable securities in the money market or in the capital market or in privately placed debentures or securitised debts. However, in the case of securitised debts, such fund may invest in asset backed securities and mortgaged backed securities. Furthermore, the mutual fund having an aggregate of securities which are worth Rs.100 million (approximately USD 2.15 million) or more shall be required to settle their transactions through dematerialised securities.

In addition to the above, mutual funds are not permitted to borrow money from the market except to meet temporary liquidity needs of the mutual funds for the purpose of repurchase, redemption of units or payment of interest or dividend to the unit holders. Even such borrowing cannot exceed 20% of the net asset of a scheme and the duration of such a borrowing cannot exceed a period of six months. Similarly, a mutual fund is not permitted to advance any loans for any purpose. A mutual fund is permitted to lend securities in accordance with the Stock Lending Scheme of SEBI. The funds of a scheme are prohibited from being used in option trading or in short selling or carry forward transactions. However, SEBI has permitted mutual funds to enter into derivative transactions on a recognized stock exchange for the purpose of hedging and portfolio balancing and such investments in derivative instruments have to be made in accordance with SEBI Guidelines[6] issued in this regard.

(h) Limitation of Fees and Expenses

The Mutual Fund Regulations lay down certain restrictions on the fees that can be charged by the AMC and also caps the expenses that can be loaded on to the Fund.

The AMC can charge the mutual fund with investment and advisory fees subject to the following restrictions:

- (i) One and a quarter of one per cent of the weekly average net assets outstanding in each accounting year for the scheme concerned, as long as the net assets do not exceed Rs. 1 billion, and
- (ii) One per cent of the excess amount over Rs. 1 billion, where net assets so calculated exceed Rs. 1 billion.

For schemes launched on a no load basis, the AMC can collect an additional management fee not exceeding 1% of the weekly average net assets outstanding in each financial year. In addition to the aforesaid fees, the AMC may charge the mutual fund with the initial expenses of launching the schemes and recurring expenses such as marketing and selling

[6] *Guidelines for Participation by Mutual Funds in Trading in Derivative Products; February 1, 2001*

expenses including agents' commission, if any, brokerage and transaction cost, fees and expenses of trustees, audit fees, custodian fees *etc*.

The Mutual Fund Regulations also lay down a cap on the initial expense and the ongoing expense that can be borne by a scheme. In respect of a scheme, initial expenses, they cannot exceed 6% of the initial resources raised under that scheme and any excess over the 6% initial issue expense shall be borne by the AMC. Ongoing expenses (excluding issue or redemption expenses) including the investment management and advisory fee cannot exceed the following limits:

i)	on the first Rs.100 crores of the average weekly net assets	-	2.5%
ii)	on the next Rs.300 crores of the average weekly net assets	-	2.25%
iii)	on the next Rs.300 crores of the average weekly net assets	-	2.0%
iv)	on the balance on the assets	-	1.75%

In addition to the above provisions, the Mutual Fund Regulations lay down several compliance / filing requirements pertaining to reporting to the SEBI, guidelines for calculation of Net Asset Value, disclosure requirements, accounting norms, *etc*.

D. TAXATION OF MUTUAL FUNDS AND INVESTORS

The taxation of the mutual fund and the investors is according to the provisions of the Income Tax Act, 1961 ("**ITA**").

(a) Taxation of Mutual Fund

An Indian mutual fund registered with the SEBI, or schemes sponsored by specified public sector banks / financial institutions[7] and approved by the Central Government or authorized by the RBI are tax exempt as per the provisions of section 10(23D) of the ITA. The mutual fund will receive all income without any deduction of tax at source under the provisions of Section 196(iv), of the ITA.

(b) Taxation of Resident Unit holders

(i) Capital Gains

Under Section 2(42A) of the ITA, a unit of a mutual fund is treated as a long-term capital asset if the same is held for more than 12 months. Under Section 112 of the ITA, capital gains chargeable on transfer of long-term capital assets are subject to tax at the rate of 20%. The capital gains will be computed by deducting the following amounts from the sale consideration:

- Expenditure incurred wholly and exclusively in connection with such transfer, and

[7] As defined under section 10(23D) of the ITA.

- Cost as inflated by the cost-inflation index notified by the Central Government of India in case of resident unit-holders.

In case of an individual or Hindu undivided family ("**HUF**"), being a resident, where the total income as reduced by the long-term capital gains is below the maximum amount not chargeable to tax, the long-term capital gains shall be reduced to the extent of the shortfall and only the balance long-term capital gains will be subject to the flat rate of taxation. However, the maximum tax payable on long-term capital gains on units is restricted to 10% of capital gains of capital gains calculated without indexation of cost. In addition to the aforesaid tax, a surcharge of 5% of such tax liability is also payable.

The capital loss resulting from sale of units would be available for setting off against other capital gains made by the investor and would reduce the tax liability of the investor to that extent. However, losses on transfer of long-term capital assets would be allowed to be set-off only against gains from transfer of long-term capital assets and the balance long-term capital loss shall be carried forward separately to be set-off only against long-term capital gains.

(ii) Dividends

Under section 194K of the ITA, a mutual fund is required to deduct tax at source at the rate of 10.5% (including surcharge of 5%) on any income credited or paid on or after June 1, 2002 in excess of Rs. 1,000 during the financial year in case of resident unit-holders. However, if the unit-holder submits a declaration as prescribed under section 197A of the ITA, then no tax will be deducted from any income distributed by the mutual fund subject to the condition that income so distributed does not exceed the maximum income not chargeable to tax under the ITA.

In case of resident unit-holders, no tax is required to be deducted at source from capital gains arising at the time of repurchase or redemption of units.[8]

(c) Taxation of Non-resident Individual Unit holders

(i) Capital Gains

Any long-term capital gains received by a non-resident individual investor is subject to tax at the rate of 10.5% (including a surcharge of 5%), as per section 112 of the ITA. In respect of short-term capital gains, tax is required to be deducted at source at the rate of 31.5% (including of a surcharge of 5%).

(ii) Dividends

A mutual fund is required to deduct tax at source, as per section 196A of the ITA, at the rate of 21% (including surcharge of 5%) on any income credited or paid on or after June 1, 2002 in case of non-resident individual unit-holders. However, in case of non-resident unit-

[8] *Central Board of Direct Taxes, Circular No. 715 dated August 8, 1995.*

holders, if provisions of the Double Taxation Avoidance Agreement ("**DTAA**") are more beneficial, then the tax deducted would be at the rate provided in the DTAA.

(d) Taxation of Non-resident Unit holders being a company

(i) Capital gains

Any long-term capital gains received by a non-resident investor, being a company, is subject to tax at the rate of 10.5% (including a surcharge of 5%), as per section 112 of the ITA. In respect of short-term capital gains, tax is required to be deducted at source at the rate of 42% (including of a surcharge of 5%).

(iii) Dividends

A mutual fund is required to deduct tax at source, as per section 196A read with section 115A of the ITA, at the rate of 21% (including surcharge of 5%) on any income credited or paid on or after June 1, 2002 in case of non-resident unit-holders, being a company. However, in case of non-resident unit-holders, if provisions of the DTAA are more beneficial, then the tax deducted would be at the rate provided in the DTAA.

(e) Foreign Institutional Investors

(i) Capital gains

Any long-term capital gains received by a foreign institutional investor ("**FII**"), being a company, is subject to tax at the rate of 10.5% (including a surcharge of 5%), as per section 115AD of the ITA. In respect of short-term capital gains, tax is required to be deducted at source at the rate of 31.5% (including of a surcharge of 5%).

(ii) Dividends

A mutual fund is required to deduct tax at source at the rate of 21% (including a surcharge of 5%) on any dividends paid to an FII.

E. OVERSEAS INVESTMENT IN THE DOMESTIC MUTUAL FUND SECTOR

Depending on the objective, there are broadly two ways in which overseas investors can participate in the domestic mutual fund sector. If the objective is to set up mutual fund operations and raise funds from domestic investors, the first alternative can be used and if the objective is to invest in Indian capital markets, the second alternative may be used.

(a) Setting up your own AMC and mutual fund

In the recent years, there has been an increasing trend in India towards globalisation of the Mutual Fund industry. Several reputed international asset managers have forged tie-ups with leading Indian institutions and fund managers. Some of these international players have decided to venture into the Indian Mutual Fund market independently and have established their own operations in India. The Mutual Fund Regulations do not restrict entry of any foreign asset manager into India and several of the international players like Prudential of UK, Alliance, ANZ Grindlays, ING Baring, *etc*. have set up shop in India.

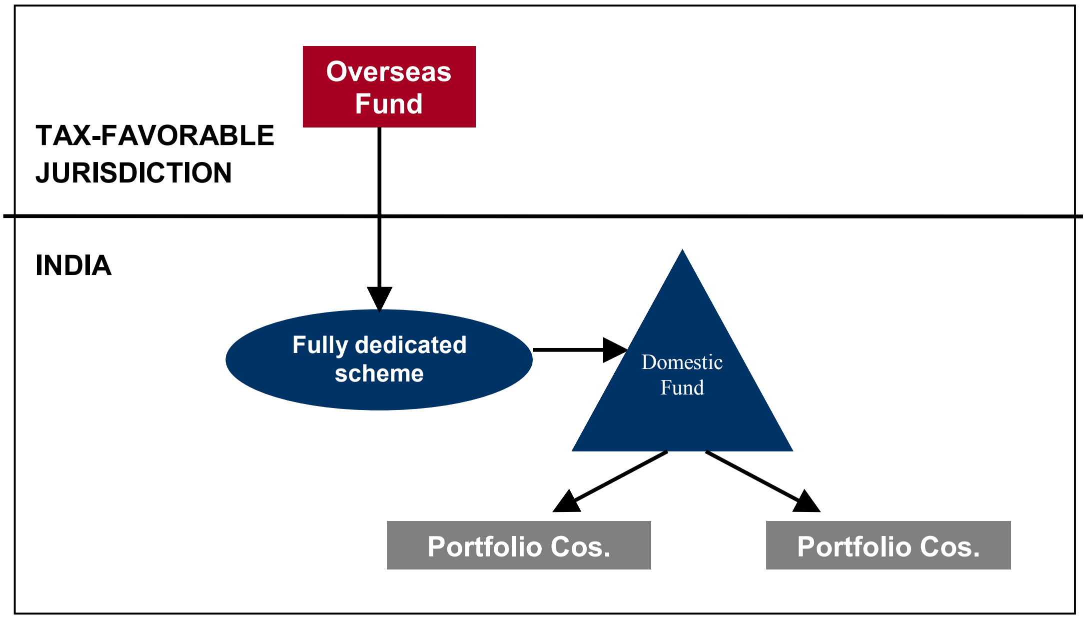
However, the important factor that one needs to consider while setting up operations in India is the foreign investment guidelines prescribed by the Foreign Investment Promotion Board ("**FIPB**"). Under the present guidelines issued by the FIPB for foreign investment into India, asset management activity is part of the definition of non-banking finance activity. Certain minimum capitalization norms have been laid down for foreign investment in such Non-Banking Finance Companies ("**NBFCs**"). These capitalization norms are as follows:

Foreign Holding as a percentage of Equity		Minimum capital
Up to 51% foreign equity	:	US$ 500,000
Between 51% and 75%	:	US$ 5 million
More than 75% foreign equity	:	US$ 50 million

In the light of the high capitalization requirements, several of the international players have elected to enter the market *via* a joint venture with a domestic partner, despite their desire to retain 100% control over their Indian investments. A number of interesting structures could be evolved to strike a balance between the retention of operative control over the AMC and prescribed capitalization requirements. Investment in this sector is under the automatic route whereby no prior approval of the FIPB would be required for setting up the AMC. However, there are some *post-facto* filing requirements with the Reserve Bank of India that need to be complied with.

(b) Investing *via* a Domestic Mutual Fund ("Offshore Fund Structure")

Offshore mutual funds that may not want to set up operations in India but are interested in participating in Indian capital markets can do so by investing through a scheme of an existing domestic mutual fund. A typical structure for this kind of investment can be graphically represented as under:



An investment fund ("**Overseas Fund**") is often set up in a tax favourable jurisdiction and will subsequently invest all the monies it raises from overseas investors into a scheme set up by an Indian mutual fund ("**Scheme**"). The Scheme is fully dedicated to the Overseas Fund, *i.e.* all the units of the Scheme are issued only to the Overseas Fund. The Scheme will then invest in the securities of Indian companies. The Scheme can be managed by the domestic AMC. Innovative management structures can be evolved if there is an overseas investment manager who wishes to participate in the management of assets of the Scheme. The Scheme and the Overseas Fund have to be registered with SEBI. Once they are registered with SEBI no further approvals for making any down-line investments are required.

SEBI approval to the Overseas Fund and the domestic scheme is largely based on the fulfilment of the following criteria:

1. The Overseas Fund is a broad-based fund
2. The approval of the RBI and the Ministry of Finance under Section 115AB of the Income-tax Act, 1961 has been obtained
3. The scheme should report its Net Asset Value on a monthly basis
4. The investment management agreement is put on records of the SEBI.

In this context, it is pertinent to note that the above restrictions placed on investment management and advisory services will not be applicable; neither are the minimum capitalization requirements mandatory in such cases.

The aforesaid structure has been very successfully used by domestic mutual funds that want to raise funds from overseas investors for investing in Indian securities. UTI and several other domestic mutual funds have floated offshore funds using the above structure. One of the benefits of establishing an Overseas Fund has been the tax advantage endowed upon the investor pursuant to the Indo-Mauritius Double Taxation Avoidance Agreement (“**Mauritius DTAA**”).

(c) Foreign Institutional Investment (“FII”) in the Indian mutual fund market

In September 1992, the Government of India issued guidelines which enable foreign institutional investors, including institutions such as pension funds, investment trusts, asset management companies, nominee companies and incorporated/institutional portfolio managers, to make portfolio investments in all securities of listed and unlisted companies in India including the units of a Mutual Fund. Under the guidelines, all FIIs must be registered with the Securities and Exchange Board of India and obtain a general permission from the Reserve Bank of India under the Foreign Exchange Management Act, 1999. However, since the Securities and Exchange Board of India provides a single window clearance, a single application must be made to the Securities and Exchange Board of India.

FIIs are required to comply with the provisions of the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995, (“**SEBI FII Regulations**”) or foreign institutional investor regulations. A registered foreign institutional investor may, subject to the ownership restrictions discussed below, freely buy and sell securities issued by any Indian company, realize capital gains on investments made through the initial amount invested in India, subscribe to or renounce rights offerings for shares, appoint a domestic custodian for custody of investments made and repatriate the capital, capital gains, dividends, income received by way of interest and any compensation received towards sale or renunciation of rights offerings of shares.

The Securities and Exchange Board of India and the Reserve Bank of India regulations restrict portfolio investments in Indian companies by foreign institutional investors, non-resident Indians and overseas corporate bodies, all of which we refer to as foreign portfolio investors. An FII may purchase equity shares of each company in which it has invested on his own account not exceeding 5% of the total issued capital of that company. In respect of a FII investing in equity shares of a company on behalf of his sub-accounts, the investment on behalf of each such sub-account shall not exceed 5% of the total issued capital of that company. However, in case of foreign corporates or individuals, each of such sub-account shall not invest more than 5% of the total issued capital of the company in which such investment is made.

(d) Investment Into The Indian Mutual Fund Market Via Mauritius

Of the many jurisdictions that are considered tax-favorable for inbound investments into the Indian economy, Mauritius is almost unequivocally the first choice and is India's largest investor. In contrast, investments made directly into the Indian market by nations like the United States have registered a deceleration.

India signed the DTAA with Mauritius on August 24, 1982. Pursuant to the Mauritius DTAA, capital gains earned by ordinary offshore companies organized in Mauritius on divestments made from Indian companies will not be taxed in India, subject to certain preconditions, *i.e*. if the Mauritius company does not have a permanent establishment in India. The India-

Mauritius tax treaty also does not contain a limitation of benefits provision (otherwise known as the anti-treaty shopping clause). Politically it is considered more stable than some other jurisdictions with which India has favorable tax treaties.

Apart from its reputation as a "clean" jurisdiction, Mauritius is also perceived to be a comparatively low-cost offshore alternative for investments directed into the South East Asian region. In addition to the DTAA it has entered into with India, Mauritius has signed approximately twenty comprehensive double tax treaties, excluding the number of treaties pending negotiation. This, combined with the fiscal incentives - some of which are mentioned hereinbelow - makes Mauritius a favored jurisdiction for international tax planning.

It is pertinent to note that all companies incorporated in Mauritius are treated as tax resident in Mauritius. It is necessary, however, to ensure that substantial management control vests in the resident Directors of the Mauritius company, so that the validity of its presence is unquestioned. This can be effected in various ways, such that the balance of control is achieved to the satisfaction of the overseas investor. In addition to the fact that Mauritius does not tax capital gains accruing to its residents, ordinary companies pay tax at the rate of 15% of their income excluding capital gains. However such companies are eligible for a deemed foreign tax credit to the extent of 90% of the Mauritius tax liability till the year 2003. There are no other "hidden costs", such as stamp duties or levies. No withholding taxes are levied on dividends, interests and royalties.

However, in the recent times the India-Mauritius DTAA has been under a storm. The lower tax authorities in India attempted to deny the India-Mauritius DTAA benefits to some Mauritius resident companies, challenging their residency in Mauritius. Since tax treaties are a part of international law and have to be honored by the treaty partners, India’s Ministry of Finance issued a circular[9] confirming the availability of the benefits under the India-Mauritius DTAA to residents of Mauritius who hold the requisite tax residency certificate issued by the Income-tax authorities in Mauritius. It concerned the clarification regarding taxation of income from dividends and capital gains under the Indo-Mauritius Double Tax Avoidance Convention (DTAC). The relevant part of the circular is reproduced as under:

"*…Doubts have been raised regarding the taxation of dividends in the hands of investors from Mauritius. It is hereby clarified that wherever a Certificate of Residence is issued by the Mauritian Authorities, such Certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the DTAC accordingly…Accordingly, FIIs etc., which are resident in Mauritius would not be taxable in India on income from capital gains arising in India on sale of shares as per paragraph 4 of Article 13*."

Certain non-profit organizations in India has filed the public interest litigations (“**PILs**”) with the Delhi High Court against the Indian Government challenging the Circular. The Delhi High Court allowed the PILs and struck down the Circular issued by the CBDT on the grounds that the CBDT has exceeded its powers in issuing the Circular.

[9] *Circular No. 789, April 13, 2000 243 ITR (St) 57*

The Indian Government and Global Business Institute[10] filed an appeal before the Supreme Court of India against the said Delhi High Court order. The appeal came up for hearing before the Supreme Court on November 18, 2002 and the Supreme Court, while admitting the appeals, stayed the operation of the Delhi High Court order till it passed further orders. As a result of this, the Circular is reinstated into force. Based on Indian judicial decisions and international law[11] we believe that there are strong chances that Global Business Institute and the Government of India would succeed in the appeal.

Further, India has also signed more favorable treaties with UAE and Cyprus during the past few years and is therefore unlikely to put Mauritius in a less favorable position as compared to those countries. Therefore, it is unlikely that the India-Mauritius tax treaty can be re-negotiated. However, it would be important to give careful consideration to structuring of investment through Mauritius in order to minimise the risk of denial of India-Mauritius DTAA benefits.

F. RECENT DEVELOPMENTS

(a) Investment in Foreign Debt

SEBI has permitted the Indian Mutual Funds to make investments in foreign debt securities[12]. As per the circular issued by SEBI, Mutual Funds have been allowed to invest in foreign debt securities with highest credit rating (such as A-1/AAA by Standard and Poor, P-1/AAA by Moody's, F1/AAA by Fitch IBCA, *etc.*) in the countries with fully convertible currencies provided the guidelines laid down in the Circular are complied with. Similarly, the Indian Mutual Funds have also been permitted to make investments in non-Indian government securities where the countries are AAA rated. However, such investment is permitted subject to an overall cap of 10% of the net assets of a Mutual Fund, subject to the maximum of USD 50 million, per Mutual Fund for making investments in the Foreign Debt Securities and American Depository Receipts/Global Depository Receipts issued by Indian companies ("**ADRs/GDRs**").

This has opened up newer opportunities for domestic mutual funds for investing in foreign securities. This also enables mutual funds to hedge their country risk by spreading their investments amongst different countries. Several funds have announced schemes for such overseas investments.

(b) Investment by resident in Foreign Securities

The Reserve Bank of India, as a part of its ongoing liberalisation and with a view to usher in full convertibility of Rupee, has recently permitted Indian residents, including mutual funds, subject to an overall cap of USD 1 billion. Such investment will have to be made in foreign companies whose shares are listed on an overseas exchange and which has atleast 10% holding in an Indian company which is also listed on the Indian stock exchange. While these conditions may sound restrictive, it is only a matter of time when the RBI will look at further

[10] *A not for profit corporation incorporated under the Mauritius corporate laws.*
[11] On the principle of *pacta sunt servanda,* parties to an international treaty must honour their obligations in good faith.
[12] *Circular no. MFC/CIR/17/419/02 dated March 30, 2002*

relaxations. This has opened up an opportunity for Indian investors to invest in the overseas market and this also throws up an opportunity for mutual funds to tap into these investments since individual investors would be more comfortable to invest through a mutual fund vis-à-vis a direct exposure to foreign securities.

(c) Compulsory Certification of Sales/Marketing Personnel

SEBI together with the Association of Mutual Funds of India has made it mandatory for the sales and marketing personnel of mutual funds to obtain a certification. This requires such personnel to appear for a test which is currently conducted by the AMFI. The move is to educate the sales personnel on the basics of investment and on the current regulations so as to ensure that no false representations are made to the investors by the sales personnel and is a move towards bringing in more accountability to the asset management company.

(d) Mutual Fund Schemes for Real Estate

AMFI has recently submitted to SEBI, draft guidelines for allowing mutual funds to invest in real estate. The move is in response to a growing need of the real estate sector and also the fact that this sector has provided to be an attractive investment opportunity for investors. Real Estate Investment Trusts (REITS) are a popular investment vehicles in the development markets of the US and the UK and have contributed significantly to the development of those economy. A need was felt for implement such REITs structure in India and in response to that SEBI constituted a committee to examine the current regulations governing mutual funds and to recommend a set of guidelines for setting up schemes under the current framework for investing in real estate. The report has been submitted by the committee to the SEBI which has been put-up for public comments. It is expected that shortly, the SEBI would notify these new set of regulations.

(e) Splitting up of UTI

An ordinance was recently passed by the President of India which repealed the Unit Trust of India Act, 1963 thereby splitting UTI into two funds viz. UTI I and UTI II. The ordinance was issued in wake of the severe payment crisis that UTI had faced on account of its assured return schemes which resulted in an adverse impact to the Indian capital markets. UTI being the first mutual fund set-up in India has always been a symbol of trust and currently is the largest mutual fund in India. Also, since it was constituted under a special enactment, it was not strictly governed by the SEBI regulations. A need was felt to bring UTI within the SEBI purview and also to ensures that the units are made NAV linked. UTI I now consists of all assured return scheme (including US 64) whereas UTI II now consists of all other schemes which are NAV linked. UTI I has a government guarantee and will be managed by an AMC formed by The Life Insurance Corporation of India, the Bank of Baroda and The Punjab National Bank. Over a period of time, the asset management function of UTI II will be privatised.

G. CONCLUSION

The Indian mutual fund industry is beginning to blossom and with the recent relaxations it is evident that the industry will rise to the international standard. India as a country holds great potential and the rise in income and savings levels signify the tremendous growth opportunity that lies ahead. The very presence of most significant international player in India demonstrates that they cannot afford to ignore the Indian market if they want to maintain their positions internationally. Also, Indian market has provided to be a good investment destination which has attracted foreign players to invest in Indian securities. Relaxation in exchange controls and consultative approach to formation of regulatory framework has given several international mutual fund players a comfort in the Indian economy which is driving their desire to set-up operations in India. Indian mutual fund industry can look forward to exciting times ahead and the current consolidation phase will result in only the serious players a long term commitment to India exist.

ANNEXURE 1
ASSETS UNDER MANAGEMENT AS ON SEPTEMBER 30, 2002

Name	AUM (Rs. Crores)
A) Unit Trust Of India	**44255**
B) Bank sponsored	**4529**
a. BOB Asset Management Co. Ltd.	121
b. Canbank Investment Management Services Ltd.	874
d. PNB Asset Management Co. Ltd.	108
e. SBI Funds Management Ltd.	3426
C) Institutions	**5196**
a. GIC Asset Management Co. Ltd.	270
b. IDBI Principal Asset Management Co. Ltd.	1543
c. IL & FS Asset Management Co. Ltd.	748
d. Jeevan Bima Sahayog Asset Management Co. Ltd.	2635
D) Private Sector	
D 1. Indian	**6733**
a. Benchmark Asset Management Co. Pvt. Ltd.	6
b. Cholamandalam Asset Management Co. Ltd.	706
c. Escorts Asset Management Ltd.	90
d. J.M. Capital Management Ltd.	1704
e. Kotak Mahindra Asset Management Co. Ltd.	2525
f. Reliance Capital Asset Management Ltd.	1702
D 2. Joint Ventures – Predominantly Indian	**15335**
a. Birla Sun Life Asset Management Pvt. Ltd.	4885
b. Credit Capital Asset Management Co. Ltd.	91
c. DSP Merrill Lynch Investment Managers Ltd.	2235
d. First India Asset Management Private Ltd.	81
e. HDFC Asset Management Co. Ltd.	6245
f. Sundaram Asset Management Company	909
f. Tata TD Waterhouse Asset Management Private Ltd.	889
D3. Joint Ventures – Predominantly Foreign	**30881**
a. Alliance Capital Asset Management (India) Pvt. Ltd.	3646
b. Dundee Investment Management & Research (Pvt.) Ltd.	27
c. ING Investment Management (India) Pvt. Ltd.	565
d. Morgan Stanley Dean Witter Investment Management Pvt. Ltd.	702
e. Prudential ICICI Management Co. Ltd.	8926
f. Standard Chartered Asset Mgmt Co. Pvt. Ltd.	4177
g. Sun F & C Asset Management (India) Pvt. Ltd.	452
h. Templeton Asset Management (India) Pvt. Ltd.	8193
i. Zurich India Asset Management Corp. Ltd.	4193
TOTAL (D1+D2+D3)	**52949**
TOTAL (A+B+C+D)	**106929**

ANNEXURE 2

1. A mutual fund scheme shall not invest more than 15% of its NAV in debt instruments issued by a single issuer which are rated not below investment grade by a credit rating agency authorised to carry out such activity under the Act. Such investment limit may be extended to 20% of the NAV of the scheme with the prior approval of the Board of Trustees and the Board of asset management company. However, such limit shall not be applicable for investments in government securities and money market instruments. Further, the investment within such limit can be made in mortgaged backed securitised debt which are rated not below investment grade by a credit rating agency registered with the Board.

2. A mutual fund scheme shall not invest more than 10% of its NAV in unrated debt instruments issued by a single issuer and the total investment in such instruments shall not exceed 25% of the NAV of the scheme. All such investments shall be made with the prior approval of the Board of Trustees and the Board of asset management company.

3. No mutual fund under all its schemes should own more than ten per cent of any company's paid up capital carrying voting rights.

4. Transfers of investments from one scheme to another scheme in the same mutual fund shall be allowed only if:

    a. such transfers are done at the prevailing market price for quoted instruments on spot basis.
    b. the securities so transferred shall be in conformity with the investment objective of the scheme to which such transfer has been made.

5. A scheme may invest in another scheme under the same asset management company or any other mutual fund without charging any fees, provided that aggregate inter-scheme investment made by all schemes under the same management or in schemes under the management of any other asset management company shall not exceed 5% of the net asset value of the mutual fund.

6. The initial issue expenses in respect of any scheme may not exceed six per cent of the funds raised under that scheme.

7. Every mutual fund shall buy and sell securities on the basis of deliveries and shall in all cases of purchases, take delivery of relative securities and in all cases of sale, deliver the securities and shall in no case put itself in a position whereby it has to make short sale or carry forward transaction or engage in badla finance. However, mutual funds shall enter into derivatives transactions in a recognised stock exchange for the purpose of hedging and portfolio balancing, in accordance with the guidelines issued by the Board.

8. Every mutual fund shall, get the securities purchased or transferred in the name of the mutual fund on account of the concerned scheme, wherever investments are intended to be of long-term nature.

9. Pending deployment of funds of a scheme in securities in terms of investment objectives of the scheme a mutual fund can invest the funds of the scheme in short term deposits of scheduled commercial banks.

10. No mutual fund scheme shall make any investment in:

    a. any unlisted security of an associate or group company of the sponsor; or
    b. any security issued by way of private placement by an associate or group company of the sponsor; or
    c. the listed securities of group companies of the sponsor which is in excess of 25% of the net assets.

11. No mutual fund scheme shall invest more than 10 per cent of its NAV in the equity shares or equity related instruments of any company. However, the limit of 10 per cent shall not be applicable for investments 95*[in case of] index fund or sector or industry specific scheme.

12. A mutual fund scheme shall not invest more than 5% of its NAV in the unlisted equity shares or equity related instruments in case of open ended scheme and 10% of its NAV in case of close ended scheme.