

# Mutual Fund Distributors



**NiSM** NATIONAL INSTITUTE OF  
SECURITIES MARKETS  
An Educational Initiative of SEBI

**Workbook for**  
**NISM-Series-V-A: Mutual Fund Distributors**  
**Certification Examination**

**NiSM**  
**National Institute of Securities Markets**  
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This workbook has been developed to assist candidates in preparing for the National Institute of Securities Markets (NISM) Certification Examination for Mutual Fund Distributors.

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NISM supports candidates by providing lucid and focused workbooks that assist them in understanding the subject and preparing for NISM Examinations. The book covers all important topics to enhance the quality of sales, distribution and related support services in the mutual fund industry. It covers topics related to the basics of mutual funds, their role and structure, different kinds of mutual fund schemes and their features, accounting, valuation and taxation aspects underlying mutual funds and their distribution. The book also discusses the concept of scheme evaluation, services to investors and prospective investors. It will be immensely useful to all those who want to have a better understanding of Indian mutual fund industry.

**S.K. Mohanty**  
**Director**

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The School for Certification of Intermediaries (SCI) at NISM is engaged in developing and administering Certification Examinations and CPE Programs for professionals employed in various segments of the Indian securities markets. These Certifications and CPE Programs are being developed and administered by NISM as mandated under Securities and Exchange Board of India (Certification of Associated Persons in the Securities Markets) Regulations, 2007.

The skills, expertise and ethics of professionals in the securities markets are crucial in providing effective intermediation to investors and in increasing the investor confidence in market systems and processes. The School for Certification of Intermediaries (SCI) seeks to ensure that market intermediaries meet defined minimum common benchmark of required functional knowledge through Certification Examinations and Continuing Professional Education Programmes on Mutual Funds, Equities, Derivatives Securities Operations, Compliance, Research Analysis, Investment Advice and many more.

Certification creates quality market professionals and catalyzes greater investor participation in the markets. Certification also provides structured career paths to students and job aspirants in the securities markets.

## **About the Certification Examination for Mutual Fund Distributors**

The examination seeks to create a common minimum knowledge benchmark for all persons involved in selling and distributing mutual funds including:

- Individual Mutual Fund Distributors
- Employees of organizations engaged in sales and distribution of Mutual Funds
- Employees of Asset Management Companies especially persons engaged in sales and distribution of Mutual Funds

The certification aims to enhance the quality of sales, distribution and related support services in the mutual fund industry.

## **Examination Objectives**

On successful completion of the examination, the candidate should:

- Know the basics of mutual funds, their role and structure, different kinds of mutual fund schemes and their features.
- Understand how mutual funds are distributed in the market-place, how schemes are to be evaluated, and how suitable products and services can be recommended to investors and prospective investors in the market.

- Get oriented to the legalities, accounting, valuation and taxation aspects underlying mutual funds and their distribution.

### **Assessment Structure**

The examination consists of 100 questions of 1 mark each and should be completed in 2 hours. The passing score for the examination is 50 percent. There shall be no negative marking.

### **How to register and take the examination**

To find out more and register for the examination please visit [www.nism.ac.in](http://www.nism.ac.in)

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## CHAPTER 1: INVESTMENT LANDSCAPE

### Learning Objectives:

After studying this chapter, you should understand about:

- Investors and their financial goals
- Saving or investment
- Different asset classes
- Investment risks
- Risk measures and management strategies
- Behavioral biases in investment decision making
- Risk profiling
- Understanding asset allocation
- Do-it-yourself v/s taking professional help

### 1.1 Investors and their Financial Goals

“Please suggest some good investments.” “Which mutual fund schemes should one buy this year?” “Which is the best mutual fund scheme?” “Which is the best investment?” “Should I invest in stocks or real estate?” “What is your view of the stock market?” “Are my investments proper? Or should I make some changes?”

One hears these and many similar questions, very regularly. There is an issue with these questions. These are about the investments and not the investor. The investor’s needs are not even discussed, and probably not even considered important.

As leadership guru, and bestselling author Simon Sinek says, “Start with Why”. The discussion of investments must start with “why” – the purpose of investment. “Why is one investing?”

#### 1.1.1 Why Investments?

Let us take a look at some examples:

Shalini, an eight-year-old girl, lives in a mid-size town in North India with her parents. She is highly inspired by watching the recent success of India’s space programs, in which some women scientists played a huge role. She wants to become a space scientist. Her parents, Mrs. And Mr. Gupta want to support her pursue her dream.

Rabindra, 45 years old, is working as an engineer in a large multinational firm. His wife is a homemaker. Since the company does not provide any pension plan, he is worried about how they would be able to live a comfortable life once he retires from the job.

Surinder Singh has recently moved to a large city from his hometown, as he got a promotion and a transfer in the company where he works. While his job is very good, he is facing trouble in settling down with a house. He is tired of going house-hunting every now and then, and is thinking of buying his own house in the near future.

Mrs. D'Souza has recently retired from her job. She received a large sum as retirement benefits. She intends to invest the same in order to receive regular income to live a comfortable life.

### 1.1.2 Financial Goals

The above are some examples of common situations we see regularly in our own life, or the lives of people around us. Though, there is no explicit mention of money in these examples, we intuitively know that money would be involved in each of these situations, whether Shalini has to be educated well, or Surinder Singh has to buy a house, or Mrs. D'Souza or Rabindra have to fund their lives in retirement. In the investment world, the requirements of these four are known as financial objectives. When we assign amounts and timelines to these objectives, we convert these into **financial goals**.

There are numerous examples of such financial goals. Among the most common are funding a child's education, cost of the marriage of one's son or daughter, funding the lifestyle in retirement, buying a vehicle, buying or renovating one's house, taking a big vacation. At the same time, there could be some not-so-common ones like starting one's own business, or taking a sabbatical from work and fund one's higher education.

Goal setting is a very important exercise, while planning for investments. As seen above, all the financial goals are about the need of money that cannot be fulfilled through the inflow at that time. While the expenses for the goal may be high or low, the income (from salary, professional fees, etc.) may be less than the amount required to fund the goal. This is where money needs to be withdrawn from the investments – in other words, this is why one needs to invest the money.

The first step in goal setting is to identify these events in life. Some of these are desirable and can be planned, whereas some others, which may be undesirable, may spring up as surprises. Those events with potential negative outcome would be undesirable. Some of the examples of the same are death of a family member, hospitalization, accident, theft, fire, etc. One cannot plan to fund the expenses associated with such events through investments, though we can create an emergency fund using some savings and investment products. Apart from the emergency fund, one may buy insurance policies to cover the risks of such events.

After identifying the events, one needs to assign priorities—which of these are more important than the others. Retirement, or children’s education fall into the responsibilities category, whereas a grand vacation maybe a good-to-have goal. Having said that, it is only the individual and the family that can decide which is which. A financial advisor or a mutual fund distributor may only guide and help one take an appropriate decision. At the same time, the role of such an intermediary would be very important.

After that, one needs to assign a timeline as well as amount of funding required at the time of such events. Take for example, if someone is planning to buy a house, one needs to decide the type of house one wants, as well as the location. These inputs would help arrive at approximate cost. After that one needs to decide by when one would like to buy this. Both the timeline and amount are critical for one to be able to plan to achieve the goal.

Such an exercise allows one to classify the goals in terms of the timeline – are the goals in the near term, or far in the future?

### 1.1.3 Short term needs versus Long Term Goals

Take a relook at the examples in the beginning of the chapter. Shalini’s higher education is roughly ten years away, whereas Rabindra may work for another fifteen years. On the other hand, Surinder Singh may need to buy a house in the next couple of years. Mrs. D’Souza’s case is interesting, since she has a need for income from investments in the immediate term, but the same must also continue for a long and uncertain period, as the income is required for life. Rabindra would also enter a similar situation on retirement.

The retirement goal can be broken into two parts – accumulating a sum for retirement, and then taking income out of the corpus thus accumulated. Another look at the two approaches to classifying the goals indicates that the goals can be placed in the following matrix:

	<b>Critically important (responsibilities or needs)</b>	<b>Dreams</b>	<b>Good-to-have</b>
<b>Immediate term</b>			
<b>Near term</b>			
<b>Medium term</b>			
<b>Long term</b>			

This looks very similar to the urgent v/s important matrix that Stephen Covey discussed in his bestseller “The Seven Habits of Highly Effective People”. The matrix is referred in the context of time management, and it classifies various tasks one undertakes during the day, as well as over a period. Let us take a look at the matrix:

<b>The Time Management Matrix</b>		
	Urgent	Not Urgent
Important	I	II
Not Important	III	IV

*(Source: The Seven Habits of Highly Effective People, by Stephen R Covey)*

In the book, Covey says that as long as you keep focusing on the Quadrant I, it keeps going bigger and bigger and then starts to dominate you. This quadrant, referred by Covey is the “urgent and important”. When that happens, the ‘important but not-so-urgent’ tasks are not planned for in time until they also enter the quadrant 1, by becoming urgent. The same principle applies to financial goals, too. A large number of people struggle with their finances, since they do not plan for the important and not urgent events in life.

Wisdom suggests that if one plans well for those important and not urgent tasks (and goals), life changes for the better. In order to achieve this, it is important to first classify the financial goals – those events in life in terms of timeline and importance in one’s life.

#### **1.1.4 Financial Goals, Time Horizon for their achievement and Inflation**

The next step would be to assign amount to the financial goals. In the process of planning, this is an important question: How much would it cost? Shalini, the eight-year-old, wants to be a space scientist, for which she needs a good quality education. How much would such education cost? Well, this question must be answered in terms of amount needed when Shalini reaches college. And that is roughly a decade from now. In such a case, the costs are quite likely to move up. Such a rise in the cost of the goals is called inflation. It applies to many other areas of personal finance. This is known as inflation with respect to the goal value.

Inflation adjustment for the goal values is critical, without which the entire planning can go haywire. The cost of education has been going up at a very fast pace over the last few decades. Similar is the case of the cost of healthcare, which can have a big impact on the expenses during the retirement years.

#### **Case Study:**

In case of Shalini’s higher education. Assume that the cost of her higher education is Rs. 50 lacs (in today’s price), whereas Shalini would go to college 10 years later. If the inflation in college fees is expected to be 8 percent p.a., her parents need to provide for Rs. 1,07,94,625 in 10 years, approximately.<sup>1</sup> There are too many assumptions involved here—the course Shalini would pursue, the cost of the education, and the inflation. However, one needs to

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<sup>1</sup> Note: Inflation numbers are taken based on random assumptions, and only for illustration purposes.

start with some assumptions to start. Else, the parents may plan to accumulate Rs. 50 lacs, which would be grossly insufficient.

Inflation has a long-term impact, and hence while planning for funding all the long-term goals, one must consider inflation in the cost of the goal. On the other hand, the immediate term and near-term goals may not have a big impact due to changes in price.

As mentioned earlier, inflation is the rise in prices of various products, and services consumed. If the inflation is 6 percent p.a., the household expenses would be higher a year later in comparison to today's cost of living. If a family's monthly expenses are Rs. 30,000 currently, they would be spending Rs. 31,800 next year if the inflation is 6 percent. This does not look like much, but if the inflation stays at the same level, this family's monthly expenses would be roughly Rs. 53,725 after 10 years; and Rs. 96,214 after 20 years.

There is one thing common in all these financial goals: a mismatch of cashflows. Either the expenses are far higher than the income at that point of time, or there is no income at the time of funding these goals. Since these are future goals, an investor may have time to accumulate one's savings; and grow them through appropriate investment avenues.

## **1.2 Savings or Investments?**

Before taking a look at various investment options available for an investor, some important questions need to be tackled. Do the two words "saving" and "investment" mean the same thing? Or are they different words? If these are different things, which is better – saving or investing? Such a clarification is warranted since many individuals use the two terms interchangeably.

The word "saving" originates from the same root as "safe". The safety of money is of critical importance here. Whereas, when one invests money, the primary objective typically is to earn profits. The important point to note here is that there is a trade-off between risk and return.

The other difference is evident from the dictionary definition of "saving" – reduction in the amount of money used. This definition refers to reducing consumption so that some money is saved. It is this saved money that can be invested. In other words, saving and investing are not to be considered as two completely different things, but two steps of the same process – in order to invest money, one needs to save first. Thus, saving precedes investing.

### **1.2.1 Factors to evaluate investments**

The three most important factors to evaluate investments are safety, liquidity, and returns. In addition to these, there are few more parameters such as convenience, ticket size (or the minimum investment required), taxability of earnings, tax deduction, etc. These factors have been discussed below:

**Safety:** This begins with the safety of capital invested. However, one could stretch that to also include the degree of surety of income from investment. In order to understand the safety of an investment, it is important to understand the risks involved.

**Liquidity:** How easily can one liquidate the investment and convert it to cash? The degree of ease is different across different categories, and even within the categories, the same could be different across products. Sometimes, the nature of the product could be such that selling it is difficult, whereas sometimes there could be some operational features, e.g. a lock-in for a certain period, after which one may be able to liquidate the investment; or a penalty for early exit. While such a penalty does not hamper liquidity, it only lowers the investment returns. Another aspect that one may also want to look at is the divisibility. Is it possible to liquidate part of the investment or is it necessary to sell the whole thing?

**Returns:** As seen earlier in the definition of investments, the major purpose is to get some returns from investment. Such returns may be in the form of regular (or periodic) income, also known as current income; and capital appreciation, or capital gains.

The current income is receivable periodically, without having to sell the investment, whereas the capital gains can be realized only when one sells the investment.

The exit charges, or penalty would bring down the returns, as seen earlier. Hence, whenever there are any such charges for early withdrawals, the same must be considered as a trade-off between liquidity and returns.

**Convenience:** Any investment must be evaluated in terms of convenience with respect to investing, taking the money out—fully or partially, as well as the investor's ability to conveniently check the value of the investment, as well as to receive the income.

**Ticket size:** What is the minimum amount required for investment? There are some avenues where an investor can start investing amounts as small as Rs. 50 or Rs. 100, whereas some require more than Rs. 1 lakh, and sometimes more than Rs. 1 crore. This becomes an important factor while taking a decision about selection of investment options. At the same time, this must not be the only factor. Some investors (though a very small number) have started considering certain investments (requiring large amounts), only because they could afford the same, without checking whether they needed it, or if that was appropriate for their situation and need.

**Taxability of income:** What one retains after taxes is what matters, and hence, taxation of the earnings is another important factor that one must consider. While looking at the taxability of income, it is critical to evaluate various other factors, too, and not look at taxation in isolation. For example, some products may offer lower tax on investment returns, but the safety also may be low. At the same time, there could be some products that may offer low tax on investment returns, only if the investor stays invested for a certain term, or till the

maturity of the product. In other words, if the investor sells the investment before maturity (or a certain minimum period), the investment returns may be taxable.

**Tax deduction:** A related matter is the tax deduction that may be available in case of certain products. Such a deduction effectively increases the return on investment, since the same is calculated after factoring the net amount invested.

However, where a deduction is available, the product may have a lock-in period of certain years. Once again, this is a trade-off between liquidity and tax deduction.

The above discussion offers a good framework for evaluation of investment products. However, as mentioned earlier, no factor should be seen in isolation. One also must consider the investor's situation while evaluating the avenues.

### **1.3 Different Asset Classes**

Various investment avenues can be grouped in various categories, called asset classes. An asset class is a grouping of investments that exhibit similar characteristics. There are four broad asset categories or asset classes, and then there are various subcategories, within each of these. The four broad categories—Real estate, Commodities, Equity and Fixed income.

#### **1.3.1 Real Estate**

Real estate is considered as the most important and popular among all the asset classes. However, the popularity of this asset category is largely because of a reason not related to investment. For those who have bought their own houses, it is the largest expense in life. The word used here is "expense", and not "investment". This would be elaborated later, but it is pertinent to mention here that in majority of cases, individuals purchase real estate for self-occupation. This should not be considered as investment, since selling the same may have a negative impact on one's lifestyle.

Real estate could be further classified into various categories, viz., residential real estate, land, commercial real estate, etc.

As an asset category, real estate exhibits certain traits, some of which are listed as under:

- Location is the most important factor impacting the performance of investment in real estate
- Real estate is illiquid
- It is not a divisible asset
- One can invest in physical real estate, as well as in financial form
- Apart from capital appreciation, it can also generate current income in form of rents

- In case of real estate, the transaction costs, e.g. brokerage charges, registration charges, etc. are quite high. This would bring down the return on investment.
- The cost of maintenance of the property, as well as any taxes payable must be adjusted before calculating the return on investment, something that many individual investors do not. These expenses are also quite high, and cannot be ignored.

### **1.3.2 Commodities**

This is another asset category that people at large are familiar with in various ways. On a regular basis, people consume many commodities, e.g. agricultural commodities like spices; petroleum products such as petrol and diesel; or metals like gold and silver. However, it is not possible to invest in most of these, as many of these are either perishable and hence cannot be stored for long, or storage of the same could take a lot of space, creating different kind of difficulties.

Though, there are commodities derivatives available on many commodities, it may not be wise to call these “investments” for two reasons, (1) these are leveraged contracts, i.e. one can take large exposure with a small of money making it highly risky and (2) these are normally short term contracts, whereas the investors’ needs may be for longer periods.

On the other hand, there are at least two commodities that many investors are quite familiar with as investment avenues, viz., gold, and silver.

When someone invests in these commodities, the prices are almost in sync across the world. It is easy to understand the prices of gold and silver across countries by simply looking at the foreign exchange rate between the two countries’ currencies, and making adjustments for various costs and restrictions imposed by any of the countries. In this manner, these two are globally accepted assets.

Both these commodities have been used as investments or storage of value for long. In fact, the history of currency would be incomplete without mention of these two. Gold has also been considered by many as a safe haven asset. In case of failure of an economy, or a currency, gold is considered to be the final shelter. However, the opposite camp also comes with very strong arguments. Many currencies across the world were pegged to the gold reserves available with the central bank of the country for long. However, this so-called gold standard has been done away with few decades ago. And still, most of the central banks hold gold in their reserves.

An investor in these commodities would have to count only on capital appreciation, since these do not generate any current income.

Gold and silver come in varying degrees of purity. Each one can be bought at different prices from the market. However, for a large majority of investors it is almost impossible to make out the level of purity. If we opt for purity certificate, the cost goes up and without one, the risk of getting lower quality metal is high.

### **1.3.3 Fixed Income**

When someone borrows money, one has to return the principal borrowed to the lender in the future. There could also be some interest payable on the amount borrowed. There are various forms of borrowing, some of which are through marketable instruments like bonds and debentures<sup>2</sup>.

There are many issuers of such papers, e.g. Companies, Union Government, State Governments, Municipal Corporations, banks, financial institutions, public sector enterprises, etc.

Many bonds pay regular interest; thus the investors can expect current income. At the same time, if someone has invested at the time of issuance of the bond and hold the same till maturity, in almost all cases, there would be no capital gains. On the other hand, a transaction through secondary market – whether at the time of buying or at the time of selling, or both – may result into capital gains or losses.

Bonds are generally considered to be safer than equity. However, these are not totally free from risks. These risks will be discussed in detail later in the chapter.

Bonds can be classified into subcategories on the basis of issuer type i.e. issued by the government or corporates or on the basis of the maturity date: short term bonds (ideal for liquidity needs), medium term bonds, and long term bonds (income generation needs).

### **1.3.4 Equity**

This is the owner's capital in a business. Someone who buys shares in a company becomes a part-owner in the business. In that sense, this is risk capital, since the owner's earnings from the business are linked to the fortunes, and hence the risks, of the business. When one buys the shares of a company through secondary market, the share price could be high or low in comparison to the fair price.

Historically, equity investing has generated returns in excess of inflation, which means the purchasing power of one's money has increased over the years. It has also delivered higher returns than other investment avenues, most of the times, if one considers long investment

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<sup>2</sup> We would use the two words bonds and debentures interchangeably in this discussion.

periods. Since the base year of 1979, Sensex has grown from a level of 100 to around 36,000 i.e. December 2019. This is an appreciation of 16 percent p.a., compounded annually.<sup>3</sup>

Apart from long term capital appreciation, equity share owners may also receive dividends from the company. Such dividends are shared out of the profit that the company has generated from its business operations. If the company does really well, the dividends tend to grow over the years.

To sum up, equity share prices generally fluctuate a lot, often without regard to the business fundamentals. However, over long periods of time, the share prices follow the fortunes of the firm. If the profits of the company continue to grow over the years, the share price follows.

### **There are similarities and differences between the various asset categories.**

Investments in equity and bonds can be done only in financial form, whereas one can buy the other two assets, viz., real estate and commodities either in financial or in physical form. It is this physical form that gives a feeling of safety to many. Anything that is tangible is perceived to be safer than something intangible.

Real estate and commodities differ from equity and bonds in another way, too. These could be bought as investment or for consumption purposes. For example, one may invest in a residential property and give it on rent to generate income. This is investment. At the same time, one may also buy a flat to live in—for residential purpose. Such a self-occupied house may not be an investment. A similar logic may be applied to gold and silver by checking whether one has invested in the metal or bought the same for personal use.

When someone invests in equity shares, part of the profits made by the company may be shared with the investor. With a careful analysis of various equity shares, it is possible to receive a periodic income (though without any guarantee about how much would one receive, and whether one receives anything at all). Similarly, a real estate could be given on rent to generate intermittent cash flow. Bonds pay interest income. It is the commodities where such intermittent cash flow is not generated.

Investor in equity, real estate and commodities is an owner of the asset, whereas an investor in bonds has lent money to someone. In such a case, the lender's receipts—be it interest payments or return of principal amount invested – are agreed at the time of the issue of such instruments. In all the other three cases, the investor's cashflows (or receipts) are unknown. To that extent, the future returns from these assets, which may also be called ownership assets, would be highly uncertain in comparison to the lending assets like bonds or fixed deposits.

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<sup>3</sup> Sensex is BSE's benchmark index representing shares of 30 large sized companies. It is also considered to be one of the bellwether indices, a barometer of what is happening in the stock market in India.

While the above discussion was about the characteristics of various asset classes, and certain differences across the asset categories, the same must be seen from another perspective, too. While one may buy equity shares listed in India in Indian Rupees, one can also invest in shares of various companies listed outside India. This provides exposure to another currency. For example, an investor buying the shares of a company listed on the London Stock Exchange is exposed to the fortunes of the company, as well as the change in exchange rate between British Pound and Indian Rupee.

Similarly, one could also invest in bonds denominated in various currencies other than Indian Rupee, and one could also buy real estate abroad.

These are called International assets. However, one must understand the basic nature of the asset class as discussed earlier, and then try to assess the impact of currency fluctuation on these investments.

Different investment avenues can be categorised into different asset category as can be seen from the illustration in Table 1.1:

**Table 1.1 Investment avenues classified under different asset categories**

<b>Equity</b>	<b>Fixed Income</b>
<ul style="list-style-type: none"> <li>• Bluechip Companies</li> <li>• Mid-sized companies</li> <li>• Small-sized companies</li> <li>• Unlisted Companies</li> <li>• Foreign Stocks</li> <li>• Equity Mutual Funds</li> <li>• Exchange Traded Funds</li> <li>• Index Funds</li> </ul>	<ul style="list-style-type: none"> <li>• Fixed deposit with a bank</li> <li>• Recurring deposit with a bank</li> <li>• Endowment Policies</li> <li>• Money back Policies</li> <li>• Public Provident Fund</li> <li>• Sukanya Samruddhi Yojana (SSY)</li> <li>• Senior Citizens' Savings Scheme (SCSS)</li> <li>• Post office Monthly Income Scheme</li> <li>• Recurring deposit with a post office</li> <li>• Company fixed deposit</li> <li>• Debentures/bonds</li> <li>• Debt Mutual Funds</li> </ul>
<b>Real Estate/Infrastructure</b>	<b>Commodities</b>
Physical Asset <ul style="list-style-type: none"> <li>• Residential/ Commercial</li> </ul> Financial Asset <ul style="list-style-type: none"> <li>• Real Estate Mutual Funds (REMF)</li> <li>• Real Estate Investment Trusts (ReIT)</li> <li>• Infrastructure Investment Trust (InvIT)</li> </ul>	<ul style="list-style-type: none"> <li>• Gold</li> <li>• Silver</li> <li>• Gold Funds</li> <li>• Commodity ETFs</li> </ul>
<b>Hybrid asset classes</b>	<b>Others</b>
<ul style="list-style-type: none"> <li>• Hybrid Mutual funds or Multi Asset Fund</li> </ul>	<ul style="list-style-type: none"> <li>• Rare coins</li> <li>• Art</li> <li>• Rare stamps</li> </ul>

## 1.4 Investment Risks

To obtain a better understanding of the investment avenues, it is essential to understand the different types of risks involved.

### 1.4.1 Inflation Risk

Inflation, or price inflation is the general rise in the prices of various commodities, products, and services that we consume. Inflation erodes the purchasing power of the money. The following table explains what inflation can do to the purchasing power of our money.

<b>How much money would you need to buy the goods you can buy with Rs. 10,000 today</b>	<b>If inflation is assumed at 8% p.a.<sup>4</sup></b>
After 5 years	Rs. 14,693
After 10 years	Rs. 21,589
After 20 years	Rs. 46,610
After 30 years	Rs. 1,00,627

The above table shows how fast the purchasing power of the money goes down. This risk really hits hard over long periods. If this is not properly accounted for in the investment plan, one may fall short of target when the need arises.

One may also look at the impact of inflation in another way. If one could buy 100 units of something with Rs. 10,000 today, assuming inflation of 8 percent p.a., one would be able to buy only 68 units of the same thing after 5 years, and only 46 units after 10 years. This clearly shows the loss of purchasing power.

In this context, it is pertinent to take a look at whether the investments are able to protect purchasing power or not. In order to protect purchasing power, the investment return should be at least as much as inflation. If the same is higher than inflation, the purchasing power increases, whereas if one earns lower returns than inflation, the purchasing power drops.

Incidentally, when one seeks total safety of invested capital, along with anytime liquidity, the investment returns are usually lower than inflation. Take for example, if you earn an interest rate of 7 percent p.a. on your fixed deposit when the inflation is at 8 percent p.a., it is obvious that the investment grows at a slower pace than the rise in prices. The returns on investment without factoring inflation is known as “nominal rate”. However, when this number is adjusted for inflation, one gets “real rate of return”. If the investment returns are higher than inflation, the investor is earning positive real rate, and vice versa.

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<sup>4</sup> The numbers are arrived at by using the future value equation, i.e.  $A = P * (1 + r)^n$ , where A is the future value (the values in the right side column); P is the present value (Rs. 10,000 in the example); r is the rate of inflation (8% p.a. in the example); and n is the number of years (the periods in the first column in this table).

### **1.4.2 Liquidity Risk**

Investments in fixed income asset are usually considered less risky than equity. Even within that, government securities are considered the safest. In order to avail the full benefits of the investments, or to earn the promised returns, there is a condition attached. The investment must be held till maturity. In case if one needs liquidity, there could be some charges or such an option may not be available at all.

Here is an example. Assume that an investor has invested one's money in a safe investment option, a bank deposit for a goal that is due five years from now. For such a goal, one chose to invest in a five year fixed deposit. As is clear, the term of the deposit is five years, and the promised returns would accrue to the investor only if the money is kept in the deposit for the entire period. In case, for some reason the investor needs the money before maturity, there could be some deduction in the interest, which reduces the investment return. Some other products like PPF (Public Provident Fund) may offer no liquidity for a certain period, and even after that there may be only partial liquidity.

This risk is also very closely associated with real estate, where liquidity is very low, and often it takes weeks or months to sell the investment.

Some investment options offer instant access to funds, but the value of the investment may be subject to fluctuations. Equity shares, listed on stock exchanges are an example of this. While it is easy to sell shares to get cash in case of a large number of listed shares, the equity prices go up and down periodically. Such investments are not appropriate for funding short term liquidity needs.

### **1.4.3 Credit Risk**

When someone lends money to a borrower, the borrower commits to repay the principal as well as pay the interest as per the agreed schedule. The same applies in case of a debenture or a bond or a fixed deposit. In case of these instruments, the issuer of the instruments is the borrower, whereas the investor is the lender. The issuer agrees to pay the interest and repay the principal as per an agreed schedule. There are three possibilities in such arrangements: (1) the issuer honors all commitments in time, (2) the issuer pays the dues, but with some delay, and (3) the issuer does not pay principal and the interest at all. While the first is the desirable situation, the latter two are not. Credit risk is all about the possibility that the second or the third situation may arise.

Any delay or a default in the repayment of principal or payment of interest may arise due to a problem with one or both of the two reasons: (1) the ability of the borrower, or (2) the intention of the borrower. While the ability of the borrower, if the same happens to be a

company, is a function of the business stability and profitability of the company. Stable companies, which may be market leaders in their respective segment, may pose a lower risk, in comparison to a new company, or a small-sized company in the same industry. Some industries may also exhibit higher stability in comparison to some other.

A lender tries to assess both before lending the money, or expects enough compensation in case the ability appears to be low. In case of debentures or bonds, the investor would expect higher interest from bonds with low safety.

In this context, the bonds issued by the government of their own country would be considered to be the safest for investors. Such bonds normally offer the lowest interest rates for the citizens of the country, due to the high (highest) safety of capital. All the other bonds/debentures available in the country would offer a higher rate of interest.

#### **1.4.4 Market Risk and Price Risk**

When securities are traded in an open market, people can buy or sell the same based on their opinions. It does not matter whether these opinions are based on facts, or otherwise. Since the opinions may change very fast, the prices may fluctuate more in comparison to the change in facts related to the security. Such fluctuations are also referred to as volatility.

There are two types of risks to a security—market risk and price risk.

Let us understand this through an example. When there is a possibility of a country getting into a warlike situation, there is a widespread fear that this may impact the economy, and the companies within it. Due to such a fear, it is quite possible that the prices of all stocks (or at least a large number of stocks) in the market may witness a fall. This is a market wide fall. On the other hand, when the sales of a company's products fall, due to technological changes, or arrival of a better product, the company's share price falls. During such times, there could be many other companies, whose share prices may rise. This is an example of a company specific risk. As is evident from the discussion, the stability of the company's business and the profitability of the firm play a major role with respect to company specific risk factors. Between the general, market wide factors and firm-specific factors, there could be some industry-specific factors, which would impact all the firms within the same industry. For example, if the Government policy changes with respect to a particular industry, all the firms may get impacted. Similarly, if a new and better technology becomes available, all the firms within the same industry that use the old technology may get impacted. This happened when mobile phones started becoming popular, the pager industry totally vanished in less than a couple of decades.

The risk specific to the security can be reduced through diversification across unrelated securities, but the one that is market-wide cannot be reduced through diversification.

### **1.4.5 Interest Rate Risk**

Interest rate risk is the risk that an investment's value will change as a result of a change in interest rates. This risk affects the value of bonds/debt instruments more directly than stocks. Any reduction in interest rates will increase the value of the instrument and vice versa.

While most investors are familiar with the concept of debentures, they normally buy and hold these bonds till maturity. On maturity of the bond, they get the maturity amount, since it is part of the bond agreement (assuming the company does not default on the commitment).

On the other hand, if an investor sells the bond in the secondary market, one would have to do the transaction at the current market price. This price depends on many factors, but chief among these is the change in the interest rates in the economy. The relationship between interest rates and bond prices is inverse.

When the interest rates in the economy increases, the prices of existing bonds decreases, since they continue to offer the old interest rates. Assume that a bond was issued at Rs. 1000 for one year, and it offered interest rate of 8 percent. Immediately after the bond was issued, the interest rates in the economy increased, and new bonds are now offering 8.5 percent interest. In such a case, the earlier bond becomes less attractive. If the investor who invested in that bond wants to sell, it can only be done at a discount. The reverse is also true. If in the above example, had the interest rate moved down, the price of the bond would have moved up. The interest rate risk varies for bonds with different maturities. Those with longer maturity would witness higher price fluctuations in comparison to those with shorter maturities. Such movements in bond prices on account of changes in interest are referred as "interest rate risk". This is a market-wide factor affecting the prices of all bonds.

### **1.5 Risk Measures and Management Strategies**

Many of the risks cannot be eliminated, and the investor must take some of those, in order to earn decent returns on one's investment portfolio. However, one needs to manage the risks that one is taking. One may consider the following strategies for management of the investment risks:

- Avoid

One may totally avoid certain investment products, if one does not want to take the respective risk. However, this may also mean giving up the opportunity to benefit out of the said investment. Many experts recommend that one should avoid the investment avenues that one does not understand.

- Take a position to benefit from some event / development

An investor can also take an investment position in anticipation of some development in the market. Let us take an example here: a bond investor expects the interest rates to go down. In such a case, one may sell the short maturity bonds and invest in long maturity bonds. If the interest rates move down, the investor's judgment would be rewarded handsomely. At the same time, if the judgment is wrong, there could be losses, too. This is an example of managing the interest rate risk.

Similarly, some investors manage their investment portfolios using such strategies across multiple asset categories.

In order to take and dynamically change such positions, the investor must have superior knowledge than a large number of investors in the market. This is difficult and hence risky. Due to the amount of skill required, and the risks involved, such strategies are not recommended for a large number of investors.

- Diversify

While the previous strategy is possible when one has superior knowledge, not everyone would possess the same. Those who do not know everything about everything, a prudent approach would be to diversify across various investment options. This spreads the risk of loss and thus the probability of losing everything can be significantly reduced through diversification.

Before managing the risks, the risks have to be measured. Measurement of credit risk is undertaken through credit rating and credit spreads. Risks related to volatility in prices, primarily the fluctuations that happen in investment returns is measured through variance, standard deviation, beta, modified duration which will be discussed in Chapter 10.

## **1.6 Behavioral Biases in Investment Decision Making**

Before discussing asset allocation, it is important to take a detour and discuss about behavioral biases in investment decision making. This is also one of the risks the investors must understand. However, this risk is not related to the investments, but to the role of emotions in decision making, or in other words the irrational behavior of investors towards management of money.

Investors are driven by emotions and biases. The most dominant emotions are fear, greed and hope. Some important biases are discussed below:

### **Availability Heuristic**

Most people rely on examples or experiences that come to mind immediately while analyzing any data, information, or options to choose from. In the investing world, this means that enough research is not undertaken for evaluating investment options. This leads to missing out on critical information, especially pertaining to various investment risks.

### **Confirmation Bias**

Investors also suffer from confirmation bias. This is the tendency to look for additional information that confirms to their already held beliefs or views. It also means interpreting new information to confirm the views. In other words, investors decide first and then look for data to support their views. The downside is very similar to the previous one – investors tend to miss out on many risks.

### **Familiarity Bias**

An individual tends to prefer the familiar over the novel, as the popular proverb goes, “A known devil is better than an unknown angel.” This leads an investor to concentrate the investments in what is familiar, which at times prevents one from exploring better opportunities, as well as from a meaningful diversification.

### **Herd Mentality**

“Man is a social animal” – Human beings love to be part of a group. While this behavior has helped our ancestors survive in hostile situations and against powerful animals, this often works against investors interests in the financial markets. There are numerous examples, where simply being against the herd has been the most profitable strategy.

### **Loss Aversion**

Loss aversion explains people's tendency to prefer avoiding losses to acquiring equivalent gains: it is better not to lose Rs. 5,000 than to gain Rs. 5,000. Such a behavior often leads people to stay away from profitable opportunities, due to perception of high risks, even when the risk could be very low. This was first identified by Psychologists Daniel Kahneman and Amos Tversky. Kahneman went on to win Nobel Prize in Economics, later on.

### **Overconfidence**

This bias refers to a person's overconfidence in one's abilities or judgment. This leads one to believe that one is far better than others at something, whereas the reality may be quite different. Under the spell of such a bias, one tends to lower the guards and take on risks without proper assessment.

## Recency bias

The impact of recent events on decision making can be very strong. This applies equally to positive and negative experiences. Investors tend to extrapolate the event into the future and expect a repeat. A bear market or a financial crisis lead people to prefer safe assets. Similarly, a bull market makes people allocate more than what is advised for risky assets. The recent experience overrides analysis in decision making.

These are only some of the biases. This not an exhaustive list. The negative effect of these biases is that the investor does not gather enough information to be able to identify more opportunities, or to evaluate various risks related to investment avenues. It is only prudent for an investor to do as detailed analysis as is possible, without taking such short cuts.

### 1.7 Risk Profiling

The risk profilers try to ascertain the risk appetite of the investor so that one does not sell mutual fund schemes that carry higher risk than what the investor can handle. In order to ascertain the risk appetite, the following must be evaluated:

- The need to take risks
- The ability to take risks, and
- The willingness to take risks

Out of the above, the need to take risk arises when the investor needs higher returns to reach one's goals. The ability to take risk refers to the financial ability, and the investment horizon, whereas the willingness is linked to the psychological capacity to handle risk. The distributor has to evaluate these three, and strike a balance between these, whenever there is a conflict.

There are various approaches to creating the risk profile of the investor. The distributor is free to choose from these options. Alternately, one can also design one's own method or tools for the same, based on the brief discussion mentioned above.

### 1.8 Understanding Asset Allocation

The basic meaning of asset allocation is to allocate an investor's money across asset categories in order to achieve some objective. In reality, most investors' portfolio would have the money allocated across various asset categories. However, in many such cases, the same may be done without any process or rationale behind it.

Asset Allocation is a process of allocating money across various asset categories in line with a stated objective. The underlined words are very important. First, it is a "process", which always involves several steps, and those steps should not be ignored or skipped. Second, the whole idea behind asset allocation is to achieve some objective. Whichever approach one selects, one must go through the steps of the process in order to achieve the objective.

There are two popular approaches to asset allocation<sup>5</sup>.

### ***Strategic asset allocation***

**Strategic Asset Allocation** is allocation aligned to the financial goals of the individual. It considers the returns required from the portfolio to achieve the goals, given the time horizon available for the corpus to be created and the risk profile of the individual.

In other words, it is an approach to maintain a target allocation across various asset categories. Such a target asset allocation across the asset categories is decided based on the analysis of the needs and risk appetite of the investor. Such an analysis would help a mutual fund distributor to arrive at allocation between various asset categories in percentage terms. This percentage target is also called the “strategic asset allocation”.

### ***Tactical asset allocation***

As opposed to the strategic asset allocation, one may choose to dynamically change the allocation between the asset categories. The purpose of such an approach may be to take advantage of the opportunities presented by various markets at different points of time, but the primary reason for doing so is to improve the risk-adjusted return of the portfolio. In other words, the attempt is to either reduce the portfolio risk without compromising the returns, or to enhance portfolio returns without increasing the risk. Tactical asset allocation is also referred as dynamic asset allocation. Tactical asset allocation is typically suitable for seasoned investors operating with large investible surplus.

### ***Rebalancing***

An investor may select any of the asset allocation approach, however there may be a need to make modifications in the asset allocations.

Let us first start with the strategic allocation. In that case, the asset allocation is likely to change periodically, since the different assets may not move together in the same direction and may not move equally, even when the direction is the same. In such a case, it is quite possible that the current asset allocation may be different from the target allocation. What should one do in such a scenario?

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<sup>5</sup> Note: In order to keep the discussion simple, and to understand the concept of asset allocation well, we will use a two-asset portfolio, consisting equity and debt, as example in the discussion under this topic.

Well, many practitioners advocate that the portfolio should be rebalanced to restore the target asset allocation. Their argument is that the asset allocation was decided by an analysis of the needs and risk appetite of the investor. We need to reduce the allocation to the risky asset if that has gone up. On the other hand, if the allocation has gone down in the asset that has the potential to generate higher returns, we need to correct that as well.

Such a rebalancing offers a huge benefit – it makes the investor buy low and sell high. Let us understand this through an example:

Assume that the target asset allocation for an investor is 50:50 between asset categories A and B. A year later, asset category A went up by 20 percent, whereas asset B went down by 5 percent. In such a case, the allocation has obviously deviated from the target. If we started investment of Rs. 1,000 each in both the cases, the value in both the cases would stand at Rs. 1,200 in asset A and Rs. 950 in asset B, with the total portfolio value at Rs. 2,150. The current allocation stands at 55.81 percent in asset A and 44.19 percent in asset B. This needs to be restored to 50:50. That means selling some part of investment in asset A (worth Rs. 125) and buying some in asset B.

As we can see here the asset A, which has gone up, is sold; and asset B, which has gone down, is bought. This happens automatically, without the investor having to take a view on the direction of the markets.

The rebalancing approach can work very well over the years, when the various asset categories go through many market cycles of ups and downs.

On the other hand, one may also need to do a rebalancing of the asset allocation, when the investor's situation changes and thus the needs or the risk appetite might have changed.

Rebalancing is required in case of strategic asset allocation as well as tactical asset allocation.

### **1.9 Do-it-yourself versus Taking Professional Help**

As discussed earlier, investors need to invest money from time to time. These investments can be made in various financial instruments ranging from Government sponsored schemes to bank fixed deposits to company debentures to shares of companies or real estate properties of even precious metals like gold or silver.

One option is to manage the investments oneself. That would involve finding the right investments and carrying out the related research and administration work. The other option is to outsource the entire job to a professional or a company engaged in such a business.

Mutual fund is that second option – it is managed by a team of professionals, known as the asset management company. This is what really needs to be understood. By choosing to invest through mutual funds, one is not investing in alternative investment options, but only

changing the way of investing money. The entire job of investing is outsourced to a professional firm.

So, the next logical question is: “which of the two choices is better – investing oneself or taking professional help to manage my investments?”

This question should be broken down into three components:

1. Can one do the job oneself?
2. Does one want to do it?
3. Can one afford to outsource?

### **Can one do the job oneself?**

This is the question about ability. In order to do a good job, there are a few requirements, viz., ability to do the job and the availability of time required for the same. There are tasks where one may not have the skills and knowledge, e.g. a history teacher may not be able to help her daughter to study Mathematics in the higher classes. At the same time, one may not have enough time required for the job.

In either case, one is unable to do manage money oneself and should consider outsourcing it.

### **Does one want to do it?**

Even when one has the required skills and knowledge to manage one’s money, it is very likely that one may not enjoy money management—either the research and analysis or administration or accounting. At the same time, one may want to spend time on one’s main profession or on certain other activities, e.g. spending time with family and friends, pursuing hobbies, etc. That also means that one needs help in managing investments.

### **Can one afford to outsource?**

There is some cost associated with mutual funds, since the agencies involved need to be paid their professional fees. While we will cover the costs associated with managing mutual funds in a later chapter, it is important to mention here that SEBI (the securities markets regulator) has issued guidelines on the maximum amount that can be charged to the fund.

Most people make the mistake of comparing these fees with zero cost of managing one’s own money oneself. By this comparison, the cost of mutual fund always looks higher between the two options.

What is missed out in this comparison is the hidden costs of doing the investment management job on one’s own. This hidden cost comes in the form of one’s time and the potential mistakes that an individual investor is likely to make.

First, let us look at the cost of one's time. Let us assume that a person generates the same investment returns as what a fund manager would have generated before the costs. Let us also assume that the cost of fund management is 2 percent p.a. This means if one is able to generate 12 percent p.a. by investing oneself, the mutual fund scheme would return 10 percent p.a. net of the fund management charges. On a portfolio of Rs. 10 lakhs, this amounts to a saving of roughly Rs. 20,000 for the year. Is it worth spending the amount of time one is required to spend for this saving? Please consider the amount of research one has to put as well as the administration and accounting work. Someone may start thinking that this means investors with smaller portfolios should invest through mutual funds, but the bigger ones should not. This is where the concept of value of time should be looked at. The value of time may be higher in case of people with more wealth.

The second hidden cost comes in the form of the mistakes one is likely to make given the emotional attachment with one's own finances.

For most investors, mutual fund would turn out to be a better option than to build the portfolio oneself. The next chapter discusses what mutual funds are and their role in an investor's portfolio.

## **Chapter 1: Sample Questions**

- 1. Which among the following investment avenues does not offer income on a regular basis?**
  - a. Real estate
  - b. Physical Gold
  - c. Stocks
  - d. Debentures
  
- 2. Which amongst the following asset categories can also be purchased for consumption purposes apart from investment?**
  - a. Real estate
  - b. Stocks
  - c. Bonds
  - d. Debentures
  
- 3. The purchasing power of currency changes on account of which of the following?**
  - a. Asset allocation
  - b. Compound interest
  - c. Inflation
  - d. Diversification
  
- 4. What is real rate of return?**
  - a. Return that the investor gets after payment of all expenses
  - b. Return that the investor gets after taxes
  - c. Return that the investor gets after adjusting the risks
  - d. Return that the investor gets after adjusting inflation
  
- 5. When interest rate in the economy increases, the price of existing bonds \_\_\_\_.**
  - a. Increases
  - b. Fluctuate
  - c. Decreases

## CHAPTER 2: CONCEPT AND ROLE OF A MUTUAL FUND

### Learning Objectives:

After studying this chapter, you should know about:

- Concept and Role of mutual funds
- Classification of mutual funds
- Growth of mutual fund industry in India

### 2.1 Concept of a Mutual fund

A mutual fund is a professionally managed investment vehicle. Practically, one does not invest in mutual fund, but invests through mutual funds. However, we hear of “investing in mutual funds” or “investing in mutual fund schemes”. While that is fine for the purpose of discussions, technically it is not correct. As a mutual fund distributor, it is critical to understand the difference between the two concepts.

When someone says that one has invested in a mutual fund scheme, often, the scheme is perceived to be competing with the traditional instruments of investment, viz. equity shares, debentures, bonds, etc. The reality is that one invests in these instruments through a mutual fund scheme. In other words, through investment in a mutual fund, an investor can get access to equities, bonds, money market instruments and/or other securities, that may otherwise be unavailable to them and avail of the professional fund management services offered by an asset management company.

Thus, an investor does not get a different product, but gets a different way of investing. The difference lies in the professional way of investing, portfolio diversification, and a regulated vehicle.

Mutual fund is a vehicle (in the form of a “trust”) to mobilize money from investors, to invest in different markets and securities, in line with stated investment objectives. In other words, through investment in a mutual fund, an investor can get access to equities, bonds, money market instruments and/or other securities, that may otherwise be unavailable to them and avail of the professional fund management services offered by an asset management company.

### **2.1.1 Role of Mutual Funds**

The primary role of mutual funds is to help investors in earning an income or building their wealth, by investing in the opportunities available in securities markets. It is possible for mutual funds to structure a scheme for different kinds of investment objectives.

Mutual funds offer different kinds of schemes to cater to the need of diverse investors. In the industry, the words 'fund' and 'scheme' are used inter-changeably. Various categories of schemes are called "funds". In order to ensure consistency with what is experienced in the market, this workbook goes by the industry practice. However, wherever a difference is required to be drawn, the scheme offering entity is referred to as "mutual fund" or "the fund".

The money that is raised from investors, ultimately benefits governments, companies and other entities, directly or indirectly, for funding of various projects or paying for various expenses. The projects that are facilitated through such financing, offer employment to people; the income they earn helps them buy goods and services offered by other companies, thus supporting projects of these goods and services companies. Thus, overall economic development is promoted.

As a large investor, the mutual funds can keep a check on the operations of the investee company, and their corporate governance and ethical standards.

The mutual fund industry itself, offers livelihood to a large number of employees of mutual funds, distributors, registrars and various other service providers.

Higher employment, income and output in the economy boosts the revenue collection of the government through taxes and other means. When these are spent prudently, it promotes further economic development and nation building.

Mutual funds can also act as a market stabilizer, in countering large inflows or outflows from foreign investors. Mutual funds are therefore viewed as a key participant in the capital market of any economy.

### **2.1.2 Investment Objectives of Mutual Funds**

Mutual funds seek to mobilize money from all possible investors. Various investors have different investment preferences and needs. In order to accommodate these preferences, mutual funds mobilize different pools of money. Each such pool of money is called a mutual fund scheme.

Every scheme has a pre-announced investment objective. Investors invest in a mutual fund scheme whose investment objective reflects their own needs and preference.

The primary objective of various schemes stems from the basic needs of an investor, viz., safety, liquidity, and returns. Let us look at some examples of investment objectives (Table 2.1), as taken from the scheme information documents of certain mutual fund schemes.

**Table 2.1: Examples of Investment Objectives**

Investment Objectives	Type of mutual fund scheme
The scheme intends to provide reasonable income along with high liquidity by investing in overnight securities having maturity of one business day.	Overnight fund
To generate capital appreciation/income from a portfolio, predominantly invested in equity and equity related instruments	Equity fund
The primary objective of the scheme is to generate long term capital appreciation by investing predominantly in equity and equity related securities of companies across the market capitalization spectrum. The fund also invests in debt and money market instruments with a view to generate regular income.	Hybrid fund
The primary objective of the scheme is to generate a steady stream of income through investment in fixed income securities.	Long Duration fund

As can be seen from the above examples, the investment objectives are a combination of safety, liquidity, and returns (be it regular income or long-term capital appreciation).

It is in line with these objectives that the scheme would decide the investment universe i.e. the types of securities to invest in. As discussed in the previous chapter, different asset classes serve different purposes. Exactly in the same way, the schemes that seek liquidity invest in money market securities, and those seeking capital appreciation invest in equity.

Mutual fund schemes are often classified in terms of the investment objectives, and often in terms of the investment universe, i.e. where they invest. As can be seen from the discussion above, there is a very close relation between the two types of classifications.

The money mobilized from investors is invested by the mutual fund scheme in a portfolio of securities as per the stated investment objective. Profits or losses, as the case might be, belong to the investors or unitholders. No other entity involved in the mutual fund in any capacity participates in the scheme's profits or losses. They are all paid a fee or commission for the contributions they make to launching and operating the schemes.

### **2.1.3 Investment Policy of Mutual Funds**

Each mutual fund scheme starts with an investment objective. Since mutual funds are investment vehicles that invest in different asset categories, the mutual fund scheme returns would depend on the returns generated from these underlying investments. Hence, once the investment objective is finalised, the mutual fund scheme's investment policy is arrived at. This is to achieve the investment objective. The investment policy includes the scheme's asset allocation and investment style.

A mutual fund scheme with an objective of providing liquidity would invest in money market instruments or in debt papers of very short-term maturity. At the same time, a mutual fund scheme that aims to generate capital appreciation over long periods, would invest in equity shares. This would reflect in the scheme's asset allocation, which would be disclosed in the Scheme Information Document (SID). However, even within the same asset category, the fund manager may adopt different styles, e.g. growth style or value style; or different levels of portfolio concentration, e.g. focused fund or diversified fund.

The scheme's investment policy would disclose two aspects—asset allocation and investment style.

### **2.1.4 Important Concepts in Mutual Funds**

#### **Units**

The investment that an investor makes in a scheme is translated into a certain number of 'Units' in the scheme. Thus, an investor in a scheme is issued units of the scheme.

#### **Face Value**

Typically, every unit has a face value of Rs. 10. The face value is relevant from an accounting perspective.

#### **Unit Capital**

The number of units issued by a scheme multiplied by its face value (Rs. 10) is the capital of the scheme—its Unit Capital.

#### **Recurring Expenses**

The fees or commissions paid to various mutual fund constituents come out of the expenses charged to the mutual fund scheme. These are known as recurring expenses. These expenses are charged as a percentage to the scheme's assets under management (AUM). The scheme expenses are deducted while calculating the NAV. This means that higher the expenses, lower the NAV, and hence lower the investor returns. Given this, SEBI has imposed strict limits on

how much expenses could be charged to the scheme. For running the scheme of mutual funds, operating expenses are also incurred.

### **Net Asset Value**

The true worth of a unit of the mutual fund scheme is otherwise called Net Asset Value (NAV) of the scheme. When the investment activity is profitable, the true worth of a unit increases. When there are losses, the true worth of a unit decreases. The NAV is also the net realizable value per unit in case the scheme is to be liquidated—how much money could be generated if all the holdings of the scheme are sold and converted into cash.

### **Assets Under Management**

The sum of all investments made by investors' in the mutual fund scheme is the entire mutual fund scheme's size, which is also known as the scheme's Assets Under Management (AUM). This can also be obtained by multiplying the current NAV with the total units outstanding. The relative size of mutual fund companies/asset management companies is assessed by their assets under management (AUM). When a scheme is first launched, assets under management is the amount mobilized from investors. Thereafter, if the scheme has a positive profitability metric, its AUM goes up; a negative profitability metric will pull it down.

Further, if the scheme is open to receiving money from investors even post-NFO, then such contributions from investors boost the AUM. Conversely, if the scheme pays any money to the investors, either as dividend or as consideration for buying back the units of investors, the AUM falls.

The AUM thus captures the impact of the profitability metric and the flow of unit-holder money to or from the scheme.

### **Mark to Market**

The process of valuing each security in the investment portfolio of the scheme at its current market value is called Mark to Market (MTM). The mark-to-market valuation is done on a daily basis for calculation of daily NAV of a mutual fund scheme. This results in daily fluctuations in the NAVs of all schemes.

## **2.1.5 Advantages of Mutual Funds for Investors**

### **Professional Management**

Mutual funds offer investors the opportunity to earn an income or build their wealth through professional management of their investible funds. There are several aspects to such professional management viz. investing in line with the investment objective, investing based on adequate research, and ensuring that prudent investment processes are followed.

Investing in the securities markets will require the investor to open and manage multiple accounts and relationships such as broking account, demat account and others. Mutual fund investment simplifies the process of investing and holding securities.

The fund management function is not restricted to research and selection of securities to construct a portfolio of investments, but also to take care of various administrative tasks like collection of corporate benefits (for example: interest payments, dividends, rights issues, buybacks, etc.), or follow up on the same.

The calculation and publishing of NAV on a daily basis means that the accounting of the entire portfolio is done on a daily basis. The investor managing one's portfolio independently would need to take too much efforts to take care of this part.

All these benefits come at a very low cost and is available even for the smallest investments. Further, the expenses charged for professional management of funds are quite reasonable.

### **Affordable Portfolio Diversification**

Investing in the units of a scheme provide investors the exposure to a range of securities held in the investment portfolio of the scheme in proportion to their holding in the scheme. Thus, an investor can get proportionate ownership in a diversified investment portfolio even for a small investment of Rs. 500 in a mutual fund scheme.

With diversification, an investor ensures that "all the eggs are not in the same basket". Consequently, the investor is less likely to lose money on all the investments at the same time. Thus, diversification helps reduce the risk in investment. In order to achieve the same level of diversification as a mutual fund scheme, investors will need to set apart several lakhs of rupees. Instead, they can achieve the diversification through an investment of less than thousand rupees in a mutual fund scheme.

### **Economies of Scale**

Pooling of large sum of money from many investors makes it possible for the mutual fund to engage professional managers for managing investments. Individual investors with small amounts to invest cannot, by themselves, afford to engage such professional management.

Large investment corpus leads to various other economies of scale. For instance, costs related to investment research and office space gets spread across investors. Further, the higher transaction volume makes it possible to negotiate better terms with brokers, bankers and other service providers.

Mutual funds give the flexibility to an investor to organize their investments according to their convenience. Direct investments may require a much higher investment amount than what many investors may be able to invest. For example, an effectively diversified equity portfolio may require a large outlay. Mutual funds offer the same benefits at a much lower investment

value since it pools small investments by multiple investors to create a large fund. Similarly, the dividend and growth options of mutual funds allow investors to structure the returns from the fund in the way that suits their requirements.

Thus, investing through a mutual fund offers a distinct economic advantage to an investor as compared to direct investing in terms of cost saving.

### **Transparency**

An investor is well served if relevant information is available on time. Availability of such information is critical for taking informed investment decision. The structure of the mutual funds and the regulations by SEBI have ensured that investors get such transparency about their investments. There are three essential places from where the investor can get enough information for taking informed decisions, viz., scheme related documents (SID, SAI, and KIM), portfolio disclosures, and the NAV of the scheme. Incidentally, even a prospective investor can access all this information.

### **Liquidity**

At times, investors in financial markets are stuck with a security for which they can't find a buyer—worse, at times they can't find the company they invested in. Such investments, whose value the investor cannot easily realize in the market, are technically called illiquid investments and may result in losses for the investor.

Investors in a mutual fund scheme can recover the market value of their investments, from the mutual fund itself. Depending on the structure of the mutual fund scheme, this would be possible, either at any time, or during specific intervals, or only on closure of the scheme. Schemes, where the money can be recovered from the mutual fund only on closure of the scheme, are compulsorily listed on a stock exchange. In such schemes, the investor can sell the units through the stock exchange platform to recover the prevailing value of the investment.

If a 'material' development takes place related to investments in a mutual fund scheme, then such information is made available on time. This helps an investor to take an appropriate action, including taking out the money from a mutual fund scheme. This combination of transparency and liquidity enhances the safety.

### **Tax Deferral**

Mutual funds are not liable to pay tax on the income they earn. If the same income were to be earned by the investor directly, then tax may have to be paid in the same financial year.

Mutual funds offer options, whereby the investor can let the money grow in the scheme for several years. By selecting such options, it is possible for the investor to defer the tax liability.

This helps investors to legally build their wealth faster than would have been the case, if they were to pay tax on the income each year.

### **Tax benefits**

Specific schemes of mutual funds (Equity Linked Savings Schemes) give investors the benefit of deduction of the amount subscribed (upto Rs. 150,000 in a financial year), from their income that is liable to tax. This reduces their taxable income, and therefore the tax liability.

### **Convenient Options**

The options offered under a scheme allow investors to structure their investments in line with their liquidity preference and tax position.

There are also transaction conveniences like the ability to withdraw only part of the money from the investment account, ability to invest additional amount to the account, setting up systematic transactions, etc.

### **Investment Comfort**

Once an investment is made with a mutual fund, they make it convenient for the investor to make further purchases with very little documentation. This simplifies subsequent investment activity.

### **Regulatory Comfort**

The regulator, Securities and Exchange Board of India (SEBI), has mandated strict checks and balances in the structure of mutual funds and their activities. Mutual fund investors benefit from such protection.

### **Systematic Approach to Investments**

Mutual funds also offer facilities that help investors invest amounts regularly through a Systematic Investment Plan (SIP); or withdraw amounts regularly through a Systematic Withdrawal Plan (SWP); or move money between different kinds of schemes through a Systematic Transfer Plan (STP). Such systematic approaches promote investment discipline, which is useful in long-term wealth creation and protection.

## **2.1.6 Limitations of Mutual Fund**

### **Lack of Portfolio Customization**

Some brokerages offer Portfolio Management Services to large investors. In a PMS, the investor has better control over what securities are bought and sold on his behalf. The investor can get a customized portfolio in case of PMS.

On the other hand, a unit-holder in a mutual fund is just one of several thousand investors in a scheme. Once a unit-holder has bought into the scheme, investment management is left to the fund manager (within the broad parameters of the investment objective). Thus, the unit-holder cannot influence what securities or investments the scheme would invest into.

### **Choice Overload**

There are multiple mutual fund schemes offered by several mutual fund houses and multiple options within those schemes which makes it difficult for investors to choose between them. Greater dissemination of industry information through various media and availability of professional advisors or mutual fund distributors in the market helps investors handle this overload.

In order to overcome this choice overload, SEBI has introduced the categorisation of mutual funds to ensure uniformity in characteristics of similar type of schemes launched by different mutual funds. This would help investors to evaluate the different options available before making informed decision to invest.

### **No Control Over Costs**

All the investor's money is pooled together in a scheme. Costs incurred for managing the scheme are shared by all the Unit-holders in proportion to their holding of units in the scheme. Therefore, an individual investor has no control over the costs in a scheme.

SEBI has however imposed certain limits on the expenses that can be charged to any scheme. These limits, which vary with the size of assets and the nature of the scheme, are discussed later. However, at the same time, it should be noted that the market forces also push the cost down, and there are many schemes that operate at expenses much lower than the limits allowed by the regulator. This aspect turns out to be advantageous for investors.

### **No Guaranteed Returns**

The structure of mutual funds is such that—it is a pass-through vehicle and passes on the risk and return to the fund's investors. That itself protects the interests of the investors. A mutual fund is not a guaranteed return product. It is just another way of managing money—except that instead of an investor—it is a professional fund management team that takes care of the funds invested. The performance of these investments impacts the returns generated by the

mutual fund scheme. The deciding factors are: the movement of the specific market in which the money is invested, the performance of individual securities held and the skills of the investment management team. Out of these, the fund manager can work towards improving one's skills, but the other factors are out of his control.

## **2.2 Classification of Mutual Funds**

Mutual funds can be classified in multiple ways. Funds can be classified based on the investment objective, as discussed earlier. We have different types of mutual fund schemes- growth funds, income funds, and liquid funds. The names of the categories suggest the investment objectives of the schemes. The other ways in which the mutual funds can be classified have been discussed below.

### **2.2.1 By the structure of the fund**

Mutual fund schemes are structured differently. Some schemes are open for purchase and repurchase on a perpetual basis. Once the scheme is launched, the scheme remains open for transactions, and hence the name of this category of schemes is open-ended funds. On the other hand, some schemes have a fixed maturity date. This means that these schemes are structured to operate for a fixed period till the maturity date and cease to exist thereafter. Since the closure of the scheme is pre-decided, such schemes are known as close-ended schemes. Apart from these two, there are a couple of other variants, which would be discussed later.

***Open-ended funds*** allow the investors to enter or exit at any time, after the NFO.<sup>6</sup> Investors can buy additional units in the scheme any time after the scheme opens for on-going transactions. Prospective investors can also buy units. At any time, the existing investors can redeem their investments, that is, they can sell the units back to the scheme to get their money back.

Although some unit-holders may exit from the scheme, wholly or partly, the scheme continues operations with the remaining investors. The scheme does not have any kind of time frame in which it is to be closed. The on-going entry and exit of investors implies that the unit capital in an open-ended fund would keep changing on a regular basis.

When an investor invests money in the scheme, new units would be created and thus the unit balance would increase. On the other hand, when someone exits the scheme (fully or partly), the units sold back to the scheme would be cancelled, due to which the unit balance of the scheme would go down.

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<sup>6</sup> NFO stands for New Fund Offer, or the launch of a mutual fund scheme. This is when the scheme is offered to public for the first time.

**Close-ended funds** have a fixed maturity. Investors can buy units of a close-ended scheme, from the fund, only during its NFO. The investors cannot transact with the fund after the NFO is over. At the end of the maturity period, the scheme is wound up, units are cancelled and the money is returned to the investors. The fund makes arrangements for providing liquidity, post-NFO through listing of the units on a stock exchange. Such listing is compulsory for close-ended schemes to provide liquidity to the investors. Therefore, after the NFO, investors who want to buy units will have to find a seller for those units in the stock exchange. Similarly, investors who want to sell units will have to find a buyer for those units in the stock exchange. Since post-NFO sale and purchase of units happen to or from counter-party in the stock exchange—and not to or from the scheme—the unit capital of the scheme remains stable or fixed.

Post-NFO, the sale and purchase transactions happen on the stock exchange between two different investors, and the fund is not involved in the transaction. Depending on the demand-supply situation for the units of the scheme on the stock exchange, the transaction price could be higher or lower than the prevailing NAV. Therefore, the transaction price is likely to be different from the NAV. Experience suggests that most of the time, the units trade at a discount to the NAV. This can be understood logically. The buyer has money, and hence many options to choose from, whereas the seller has the units of the close-ended fund. This puts the buyer in a better bargaining position.

**Interval funds** combine features of both open-ended and close-ended schemes. They are largely close-ended but become open-ended at pre-specified intervals. For instance, an interval scheme might become open-ended between January 1 to 15, and July 1 to 15, each year. The benefit for investors is that, unlike in a purely close-ended scheme, they are not completely dependent on the stock exchange to be able to buy or sell units of the interval fund. However, to provide liquidity to the investors between these intervals, the units must be compulsorily listed on stock exchanges to allow investors an exit route.

The periods when an interval scheme becomes open-ended, are called ‘transaction periods’; the period between the close of a transaction period, and the opening of the next transaction period is called ‘interval period’. Minimum duration of transaction period is 2 days, and maximum duration of interval period is 15 days. No redemption/repurchase of units is allowed except during the specified transaction period (during which both subscription and redemption may be made to and from the scheme).

While the units of close-ended and interval funds are listed on the stock exchanges, the liquidity in these units may be poor. At the same time, even when the trade happens, the actual price may be at a discount to the NAV. This happens because of the demand-supply situation for the units of the schemes, as discussed earlier.

The Exchange Traded Funds (ETFs), are an innovation that addresses this liquidity issue. The market price also tracks the NAV very closely.

### **2.2.2 By the management of the portfolio**

**Actively managed funds** are funds where the fund manager has the flexibility to choose the investment portfolio, within the broad parameters of the investment objective of the scheme. Since this increases the role of the fund manager, the expenses for running the fund turn out to be higher. Investors expect actively managed funds to perform better than the market.

**Passive funds** invest on the basis of a specified index; whose performance it seeks to track. Thus, a passive fund tracking the S&P BSE Sensex would buy only the shares that are part of the composition of the S&P BSE Sensex. The proportion of each share in the scheme's portfolio would also be the same as the weightage assigned to the share in the S&P BSE Sensex. Thus, the performance of these funds tends to mirror the concerned index. They are not designed to perform better than the market. Such schemes are also called index schemes. Since the portfolio is determined by the index itself, the fund manager has no role in deciding on investments. Therefore, these schemes have low running costs.

### **2.2.3 By the investment universe**

This type of classification looks at the investment universe where the scheme may invest money. There are equity funds, fixed income funds, money market funds, gold funds, international funds, etc. Here, the category names indicate where the money could be invested.

This classification may get further specific depending on narrowing the investment universe. For example, within equity funds, we have large-cap funds, mid-cap funds, etc. Similarly, within debt funds, we have Government Securities funds, and corporate debt funds.

### **2.2.4 Mutual fund scheme categorization and SEBI regulation**

With a view to bring-in standardization in classification of mutual funds and to ensure the schemes are clearly distinct from one another, SEBI issued a circular on Categorization and Rationalization of Mutual Fund Schemes in 2017.

The objective was to bring uniformity in the characteristics of similar type of schemes launched by different mutual fund houses so that the investor can objectively evaluate the schemes chosen for investment. Accordingly, there are five broad categories of mutual fund schemes. Within each category, there are many sub-categories.<sup>7</sup>

#### **A. Equity Schemes (10 sub-categories)**

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<sup>7</sup> SEBI Circular No. SEBI/HO/IMD/DF3/CIR/P/2017/114 dated October 6, 2017 and SEBI/HO/IMD/DF3/CIR/P/2017/126 dated December 4, 2017

[https://www.sebi.gov.in/legal/circulars/oct-2017/categorization-and-rationalization-of-mutual-fund-schemes\\_36199.html](https://www.sebi.gov.in/legal/circulars/oct-2017/categorization-and-rationalization-of-mutual-fund-schemes_36199.html) and [https://www.sebi.gov.in/legal/circulars/dec-2017/categorization-and-rationalization-of-mutual-fund-schemes\\_36804.html](https://www.sebi.gov.in/legal/circulars/dec-2017/categorization-and-rationalization-of-mutual-fund-schemes_36804.html)

- B. Debt Schemes (16 sub-categories)
- C. Hybrid Schemes (6 sub-categories)
- D. Solution Oriented Schemes (2 sub-categories)
- E. Other Schemes (2 sub-categories)

## A. Equity schemes

**1. Multi Cap Fund:** An open-ended equity scheme investing across large cap, mid cap, small cap stocks. (See Box 2.1)<sup>8</sup> The minimum investment in equity and equity related instruments shall be 65 percent of total assets.

Vide SEBI Circular dated September 11, 2020, multi-cap funds shall be defined as those with minimum investment in equity & equity related instruments --75% of total assets in the following manner\*:

- Minimum investment in equity & equity related instruments of large cap companies - 25% of total assets
- Minimum investment in equity & equity related instruments of mid cap companies - 25% of total assets
- Minimum investment in equity & equity related instruments of small cap companies - 25% of total assets

*\*All the existing Multi Cap Funds shall ensure compliance with the above provisions within one month from the date of publishing the next list of stocks by AMFI, i.e. January 2021.*

For this purpose, SEBI also defined the various market capitalization categories as under:

### **Box 2.1: Definition of Large-cap, Mid-cap and Small-cap**

Large cap, mid cap and small cap companies are defined as follows:

1. Large Cap: 1<sup>st</sup>-100<sup>th</sup> company in terms of full market capitalization
2. Mid Cap: 101<sup>st</sup>-250<sup>th</sup> company in terms of full market capitalization
3. Small Cap: 251<sup>st</sup> company onwards in terms of full market capitalization

The same definition applies in case of other scheme categories, too, as applicable.

<sup>8</sup> [https://www.sebi.gov.in/legal/circulars/sep-2020/circular-on-asset-allocation-of-multi-cap-funds\\_47542.html](https://www.sebi.gov.in/legal/circulars/sep-2020/circular-on-asset-allocation-of-multi-cap-funds_47542.html) (dated September 11, 2020). All the existing Multi Cap Funds shall ensure compliance with the above provisions within one month from the date of publishing the next list of stocks by AMFI, i.e. January 2021.

**2. Large Cap Fund:** An open-ended equity scheme predominantly investing in large cap stocks. The minimum investment in equity and equity related instruments of large cap companies shall be 80 percent of total assets.

**3. Large and Mid-Cap Fund:** An open-ended equity scheme investing in both large cap and mid cap stocks. The minimum investment in equity and equity related instruments of large cap companies shall be 35 percent of total assets. The minimum investment in equity and equity related instruments of mid cap stocks shall be 35 percent of total assets.

**4. Mid Cap Fund:** An open-ended equity scheme predominantly investing in mid cap stocks. The minimum investment in equity and equity related instruments of mid cap companies shall be 65 percent of total assets.

**5. Small cap Fund:** An open-ended equity scheme predominantly investing in small cap stocks. Minimum investment in equity and equity related instruments of small cap companies shall be 65 percent of total assets.

**6. Dividend Yield Fund:** An open-ended equity scheme predominantly investing in dividend yielding stocks. Scheme should predominantly invest in dividend yielding stocks. The minimum investment in equity shall be 65 percent of total assets.

**7. Value Fund or Contra Fund:** A value fund is an open-ended equity scheme following a value investment strategy. Minimum investment in equity & equity related instruments shall be 65 percent of total assets. A contra fund is an open-ended equity scheme following contrarian investment strategy. Mutual Funds will be permitted to offer either Value fund or Contra fund.

**8. Focused Fund:** An open-ended equity scheme investing in maximum 30 stocks (the scheme needs to mention where it intends to focus, viz., multi cap, large cap, mid cap, small cap). Minimum investment in equity & equity related instruments shall be 65 percent of total assets.

**9. Sectoral/Thematic:** An open-ended equity scheme investing in a specific sector such as bank, power is a sectoral fund. While an open-ended equity scheme investing in line with an investment theme. For example, an infrastructure thematic fund might invest in shares of companies that are into infrastructure, construction, cement, steel, telecom, power etc. The minimum investment in equity and equity related instruments of a particular sector/ theme shall be 80 percent of total assets.

**10. Equity Linked Savings Scheme:** An open-ended equity linked saving scheme with a statutory lock-in of 3 years and tax benefit. The minimum investment in equity and equity related instruments shall be 80 percent of total assets (in accordance with Equity Linked Saving Scheme, 2005 notified by the Ministry of Finance).

## **B. Debt schemes**

**1. Overnight Fund:** An open-ended debt scheme investing in overnight securities. The investment is in overnight securities having maturity of 1 day.

**2. Liquid Fund:** An open-ended liquid scheme whose investment is into debt and money market securities with maturity of upto 91 days only.

**3. Ultra-Short Duration Fund:** An open ended ultra-short-term debt scheme investing in debt and money market instruments with Macaulay duration between 3 months and 6 months.

**4. Low Duration Fund:** An open ended low duration debt scheme investing in debt and money market instruments with Macaulay duration between 6 months and 12 months.

**5. Money Market Fund:** An open-ended debt scheme investing in money market instruments having maturity upto 1 year.

**6. Short Duration Fund:** An open ended short-term debt scheme investing in debt and money market instruments with Macaulay duration between 1 year and 3 years.

**7. Medium Duration Fund:** An open ended medium-term debt scheme investing in debt and money market instruments with Macaulay duration of the portfolio being between 3 years to 4 years. Portfolio Macaulay duration under anticipated adverse situation is 1 year to 4 years.

**8. Medium to Long Duration Fund:** An open ended medium-term debt scheme investing in debt and money market instruments with Macaulay duration between 4 years and 7 years. Portfolio Macaulay duration under anticipated adverse situation is 1 year to 7 years.

**9. Long Duration Fund:** An open-ended debt scheme investing in debt and money market instruments with Macaulay duration greater than 7 years.

**10. Dynamic Bond:** An open ended dynamic debt scheme investing across duration.

**11. Corporate Bond Fund:** An open-ended debt scheme predominantly investing in AA+ and above rated corporate bonds. The minimum investment in corporate bonds shall be 80 percent of total assets (only in AA+ and above rated corporate bonds).

**12. Credit Risk Fund:** An open-ended debt scheme investing in below highest rated corporate bonds. The minimum investment in corporate bonds shall be 65 percent of total assets (only in AA (excludes AA+ rated corporate bonds) and below rated corporate bonds).<sup>9</sup>

**13. Banking and PSU Fund:** An open-ended debt scheme predominantly investing in debt instruments of banks, Public Sector Undertakings, Public Financial Institutions and Municipal Bonds. The minimum investment in such instruments should be 80 percent of total assets.

**14. Gilt Fund:** An open-ended debt scheme investing in government securities across maturity. The minimum investment in G-secs is defined to be 80 percent of total assets (across maturity).

**15. Gilt Fund with 10-year constant duration:** An open-ended debt scheme investing in government securities having a constant maturity of 10 years. Minimum investment in G-secs is 80 percent of total assets such that the Macaulay duration of the portfolio is equal to 10 years.

**16. Floater Fund:** An open-ended debt scheme predominantly investing in floating rate instruments (including fixed rate instruments converted to floating rate exposures using swaps/derivatives). Minimum investment in floating rate instruments (including fixed rate instruments converted to floating rate exposures using swaps/derivatives) shall be 65 percent of total assets.

### Hybrid Schemes

**1. Conservative Hybrid Fund:** An open-ended hybrid scheme investing predominantly in debt instruments. Investment in debt instruments shall be between 75 percent and 90 percent of total assets while investment in equity and equity instruments shall be between 10 percent and 25 percent of total assets.

**2. Balanced Hybrid or Aggressive Hybrid Fund:**

**Balanced Hybrid Fund:** An open-ended balanced scheme investing in equity and debt instruments. The investment in equity and equity related instruments shall be between 40 percent and 60 percent of total assets while investment in debt instruments shall be between 40 percent and 60 percent. No arbitrage is permitted in this scheme.

**Aggressive Hybrid Fund:** An open-ended hybrid scheme investing predominantly in equity and equity related instruments. Investment in equity and equity related instruments shall

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<sup>9</sup> Vide SEBI Circular (SEBI/HO/IMD/DF3/CIR/P/2017/114 October 6, 2017) words/phrases that highlight/emphasize only return aspect of the scheme shall not be used in the name of the scheme (for instance credit opportunities fund, high yield fund, credit advantage etc.)

be between 65 percent and 80 percent of total assets while investment in debt instruments shall be between 20 percent and 35 percent of total assets.

*Mutual funds in India are permitted to offer either Aggressive Hybrid Fund or Balanced Fund.*

- 3. Dynamic Asset Allocation or Balanced Advantage:** It is an open-ended dynamic asset allocation fund with investment in equity/debt that is managed dynamically.
- 4. Multi Asset Allocation:** An open-ended scheme investing in at least three asset classes with a minimum allocation of at least 10 percent each in all three asset classes. Foreign securities are not treated as a separate asset class in this kind of scheme.
- 5. Arbitrage Fund:** An open-ended scheme investing in arbitrage opportunities. The minimum investment in equity and equity related instruments shall be 65 percent of total assets.
- 6. Equity Savings:** An open-ended scheme investing in equity, arbitrage and debt. The minimum investment in equity and equity related instruments shall be 65 percent of total assets and minimum investment in debt shall be 10 percent of total assets. The minimum hedged and unhedged investment needs to be stated in the SID. Asset Allocation under defensive considerations may also be stated in the SID.

#### **Solution Oriented Schemes**

- 1. Retirement Fund:** An open-ended retirement solution-oriented scheme having a lock-in of 5 years or till retirement age (whichever is earlier). Scheme having a lock-in for at least 5 years or till retirement age whichever is earlier.
- 2. Children's Fund:** An open-ended fund for investment for children having a lock-in for at least 5 years or till the child attains age of majority (whichever is earlier). Scheme having a lock-in for at least 5 years or till the child attains age of majority whichever is earlier.

#### **Other Schemes**

- 1. Index Funds/Exchange Traded Fund:** An open-ended scheme replicating/tracking a specific index. This minimum investment in securities of a particular index (which is being replicated/ tracked) shall be 95 percent of total assets.
- 2. Fund of Funds (Overseas/Domestic):** An open-ended fund of fund scheme investing in an underlying fund. The minimum investment in the underlying fund shall be 95 percent of total assets.

**There can be only one scheme per category, except in the following cases:**

1. Index funds and ETFs replicating or tracking different indices,
2. Fund of Funds having different underlying schemes, and
3. Sector funds or thematic funds investing in different sectors or themes

Apart from the above, let us also take a look at certain other categories:

**Fixed Maturity Plans** are a kind of close-ended debt fund where the duration of the investment portfolio is closely aligned to the maturity of the scheme. AMC's tend to structure the scheme around pre-identified investments. Further, being close-ended schemes, they do not accept money post-NFO. Therefore, the fund manager has little ongoing role in deciding on the investment options. Such a portfolio construction gives more clarity to investors on the likely returns if they stay invested in the scheme until its maturity (though there can be no guarantee or assurance of such returns). This helps them compare the risk and returns of the scheme with alternative investments.

**Capital Protection Funds** are closed-end hybrids funds. In these types of funds, the exposure to equity is typically taken through the equity derivatives market. The portfolio is structured such that a portion of the principal amount is invested in debt instruments so that it grows to the principal amount over the term of the fund. For example, Rs.90 may be invested for 3 years to grow into Rs.100 at maturity. This provides the protection to the capital invested. The remaining portion of the original amount is invested in equity derivatives to earn higher returns.

**Infrastructure Debt Funds** are investment vehicles which can be sponsored by commercial banks and NBFCs in India in which domestic/offshore institutional investors, specially insurance and pension funds can invest through units and bonds issued by the IDFs. Infrastructure Debt Funds (IDFs), can be set up either as a Trust or as a Company. A trust based IDF would normally be a Mutual Fund (MF), regulated by SEBI, while a company based IDF would normally be a NBFC regulated by the Reserve Bank.

According to SEBI Mutual Fund Regulations, IDF means a close ended mutual fund scheme that invests primarily (minimum 90 percent of scheme assets) in the debt securities or securitized debt instrument of infrastructure companies or infrastructure capital companies or infrastructure projects or special purpose vehicles which are created for the purpose of facilitating or promoting investment in infrastructure, and other permissible assets in accordance with Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 or bank loans in respect of completed and revenue generating projects of infrastructure companies or projects or special purpose vehicles. IDF-MFs can be sponsored by banks and NBFCs. Only banks and Infrastructure Finance companies can sponsor IDF-NBFCs.

**Real Estate Mutual Fund** scheme invests directly or indirectly in real estate assets or other permissible assets in accordance with the SEBI (Mutual Funds) Regulations, 1996. SEBI's regulations require that at least 35 percent of the portfolio should be held in physical assets. Not less than 75 percent of the net assets of the scheme shall be in real estate assets, mortgage-backed securities (but not directly in mortgages), equity shares or debentures of companies engaged in dealing in real estate assets or in undertaking real estate development projects. Assets held by the fund will be valued every 90 days by two valuers accredited by a credit rating agency. The lower of the two values will be taken to calculate the NAV. These funds are closed-end funds and have to be listed on a stock exchange. Other real estate and infrastructure investment instruments allowed by SEBI are Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs). However, these two are not mutual fund schemes. (See Box 2.2)

**Box 2.2: Real Estate Investment Trusts and Infrastructure Investment Trusts**

**Real Estate Investment Trusts (REIT)** are trusts registered with SEBI that invest in commercial real estate assets. The REIT will raise funds through an initial offer and subsequently through follow-on offers, rights issue and institutional placements. The value of the assets owned or proposed to be owned by a REIT coming out with an initial offer will not be less than Rs. 500 crore and the minimum offer size will not be less than Rs.250 crore. The minimum subscription amount in an initial offer shall be Rs. 50,000/-. The units are listed on the stock exchange.

**Infrastructure Investment Trusts (InvIT)** are trusts registered with SEBI that invest in the infrastructure sector. The InvIT will raise funds from the public through an initial offer of units. The offer shall be for not less than Rs. 250 crores and the value of the proposed assets of the InvIT shall not be less than Rs. 500 crores. The minimum subscription size will be Rs.1 lakh. The units are listed on a stock exchange.

### 2.3 Growth of the mutual fund industry in India

Mutual funds have started acquiring their fair share in the portfolios of the investors, as well as in the minds of the people. India witnessed a surge in the mutual fund assets under management (AUM) from Rs. 6,14,546 crores in March 2010 to Rs. 22,26,203 crores in March 2020. The 10-year growth stands at 13.74 percent p.a. compounded annually.<sup>10</sup> Even, the number of folios has also seen a big rise. From a little over 4.80 crore folios in March 2010,

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<sup>10</sup> Source: SEBI

the number has crossed 8.97 crores in March 2020, a healthy growth of 6.45 percent p.a. compounded annually.

The share of mutual funds in the overall financial investments in India has risen from 10 percent in March 2016 to 12 percent in March 2017 and to 14 percent in March 2018. Compared to this, there has been a drop in the share of bank deposits from 71 percent to 69 percent and then to 65 percent during the same period. At the same time, the growth of Indian mutual fund industry has been stupendous in comparison to the world. The Indian mutual fund industry's share has gone up from 0.33 percent in 2008 to 0.60 percent in 2018.<sup>11</sup>

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<sup>11</sup> Source: *Digital Evolution – Can technology be the propelling factor for the industry?*; a report published by CRISIL for AMFI in August 2018)

## Chapter 2: Sample Questions

1. \_\_\_\_\_ indicates how much money can be generated per unit of mutual fund in case the scheme is liquidated.
  - a. Asset Under Management
  - b. Net Asset Value
  - c. Market price
  - d. Exit load
  
2. Each mutual fund scheme must have a stated investment objective. State whether True or False.
  - a. True
  - b. False
  
3. Which of the following is an advantage of mutual funds?
  - a. Customized portfolio
  - b. Convenience to buy stocks and bonds directly from the mutual fund
  - c. Economies of scale
  
4. The transparency levels in mutual funds are very low. State whether True or False.
  - a. True
  - b. False
  
5. Which amongst the following categories of mutual funds have a fixed maturity date?
  - a. Open-ended funds
  - b. Exchange Traded Funds
  - c. Close-ended funds
  - d. Interval funds

## CHAPTER 3: LEGAL STRUCTURE OF MUTUAL FUNDS IN INDIA

### Learning Objectives:

#### After studying this chapter, you should know about:

- Legal Structure of mutual funds
- Key Constituents of a Mutual Fund
- Organization Structure of Asset Management Company
- Role and support functions of service providers of mutual funds

### 3.1 Structure of Mutual Funds in India

SEBI (Mutual Fund) Regulations, 1996 as amended till date define “mutual fund” as “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 or real estate assets.” The firm must set up a separate Asset Management Company (AMC) to run mutual fund business.

Key features of a mutual fund that flows from the definition above are:

- It is established as a trust
- It raises money through sale of units to the public or a section of the public
- The units are sold under one or more schemes
- The schemes invest in securities (including money market instruments) or gold or gold-related instruments or real estate assets.

SEBI has stipulated the legal structure under which mutual funds in India need to be constituted. The structure, which has inherent checks and balances to protect the interests of the investors, can be briefly described as follows:

- Mutual funds are constituted as Trusts. Therefore, they are governed by the Indian Trusts Act, 1882
- The mutual fund trust is created by one or more Sponsors, who are the main persons behind the mutual fund business.

- Every trust has beneficiaries. The beneficiaries, in the case of a mutual fund trust, are the investors who invest in various schemes of the mutual fund.
- The operations of the mutual fund trust are governed by a Trust Deed, which is executed between the sponsors and the trustees. SEBI has laid down various clauses that need to be part of the Trust Deed.
- The Trust acts through its trustees. Therefore, the role of protecting the interests of the beneficiaries (investors) is that of the Trustees. The first trustees are named in the Trust Deed, which also prescribes the procedure for change in Trustees.
- To perform the trusteeship role, either individuals may be appointed as trustees or a Trustee company may be appointed. When individuals are appointed as trustees, they are jointly referred to as 'Board of Trustees'. A trustee company functions through its Board of Directors.
- Day to day management of the schemes is handled by an Asset Management Company (AMC). The AMC is appointed by the sponsor or the Trustees.
- The trustees execute an investment management agreement with the AMC, setting out its responsibilities.
- Although the AMC manages the schemes, custody of the assets of the scheme (securities, gold, gold-related instruments & real estate assets) is with a Custodian, who is appointed by the Trustees.
- Investors invest in various schemes of the mutual fund. The record of investors and their unit-holding may be maintained by the AMC itself, or it can appoint a Registrar & Transfer Agent (RTA).

## **3.2 Key Constituents of a Mutual Fund**

### **3.2.1 Sponsors**

The application to SEBI for registration of a mutual fund is made by the sponsor(s). Thereafter, the sponsor invests in the capital of the AMC.

Since sponsors are the main people behind the mutual fund operation, eligibility criteria has been specified as follows:

- The sponsor should have a sound track record and reputation of fairness and integrity in all business transactions. The requirements are:

- Sponsor should be carrying on business in financial services for not less than 5 years.
  - Sponsor should have positive net worth (share capital plus reserves minus accumulated losses) in all the immediately preceding 5 years.
  - Net worth in the immediately preceding year should be more than the amount that the sponsor contributes to the capital of the AMC.
  - The sponsor should have earned profits, after providing for depreciation and interest and tax, in three of the previous five years, including the fifth (latest) year.
- The sponsor should be a fit and proper person for this kind of operation.
  - The sponsor needs to contribute a minimum 40 percent of the net worth of the AMC. Further, anyone who holds 40 percent or more of the net worth of share-holding in the AMC is considered to be a sponsor and should therefore fulfil the eligibility criteria mentioned above.
  - Sponsors have to contribute a minimum of Rs.50,00,000 or 1 percent of the corpus raised in the NFO, whichever is lower, as initial contribution to the corpus of the mutual fund. (See Box 3.1).<sup>12</sup> This provision does not apply to close-ended schemes.

Association of Mutual Funds in India's (AMFI) website lists the names of all the Asset Management Companies, which are members of AMFI, in terms of the category of the sponsor, viz., Banks, Institutions, Private sector, etc. Within banks there are predominantly Indian joint ventures, and others; and similarly, within the private sector, there are Indian, foreign, and predominantly Indian joint ventures.

**Box 3.1: Investment by the sponsor or asset management company in the scheme**

In terms of Regulation 28 (4) of SEBI (Mutual Funds) (Amendment) Regulations, 2020, the Sponsor or the Asset Management Company is required to invest not less than **1 percent** of the amount which would be raised in the New Fund Offer or **Rs. 50 lakh** whichever is less in such option of the scheme as may be specified by SEBI. In this regard, it has been decided that the above referred investment shall be made in growth option of the scheme. For such schemes where growth option is not available the investment shall be made in the dividend reinvestment option of the scheme.

Further, for such schemes where growth option as well as dividend reinvestment option are not available the investment shall be made in the dividend option of the scheme. This has come into effect from June 12, 2020.

<sup>12</sup> [https://www.sebi.gov.in/legal/circulars/jun-2020/investment-by-the-sponsor-or-asset-management-company-in-the-scheme\\_46848.html](https://www.sebi.gov.in/legal/circulars/jun-2020/investment-by-the-sponsor-or-asset-management-company-in-the-scheme_46848.html) (dated: June 12, 2020). This has come into effect from June 12, 2020.

### 3.2.2 Board of Trustees

The trustees have a critical role in ensuring that the mutual fund complies with all the regulations and protects the interests of the unit-holders.

The SEBI Regulations stipulate that:

- Every trustee must be a person of ability, integrity and standing.
- A person who is guilty of moral turpitude cannot be appointed as a trustee.
- A person convicted of any economic offence or violation of any securities law cannot be appointed as trustee.
- No AMC and no director (including independent director), officer, employee of an AMC shall be eligible to be appointed as a trustee of a mutual fund.
- No person who is appointed as a trustee of a mutual fund shall be eligible to be appointed as trustee of any other mutual fund.

Prior approval of SEBI needs to be taken, before a person is appointed as Trustee.

The sponsor will have to appoint at least 4 trustees. If a trustee company has been appointed, then that company would need to have at least 4 directors on the Board. Further, at least two-thirds of the trustees on the Board of the trustee company would need to be *independent trustees* i.e. not associated with the sponsor in any way.

SEBI expects Trustees to perform a key role in ensuring legal compliances and protecting the interest of investors. Accordingly, various General Due Diligence and Special Due Diligence responsibilities have been assigned to them. The rights and responsibilities include the following:

- The trustees shall enter into an Investment Management Agreement with the AMC that will define the functioning of the AMC in making and managing the mutual fund's investments.
- The trustees have the right to seek any information they require from the AMC to facilitate meeting their responsibilities as trustees.
- The trustees shall ensure before the launch of any scheme that all the key personnel and associates such as fund managers, compliance officer, R&T agent, auditors and others have been appointed and all systems are in place.
- The trustees shall periodically review the service contracts entered into for custody arrangements, transfer agency and others and ensure they are in the interest of the unitholders and that all service providers are registered with SEBI.

- The trustees shall ensure that all transactions entered into by the AMC are in compliance with the regulations and the scheme's objectives and intent.
- The trustees shall ensure that the interests of the unitholders are not compromised in any of the AMC's dealings with brokers, other associates and even unitholders of other schemes.
- If the trustees believe that the conduct of the business of the mutual fund is contrary to the provisions of the regulations, then they must take corrective action and inform SEBI of the same.
- The trustees shall not permit a change in the fundamental attributes of the scheme, the trust or fees and expenses or any other change that will affect the interests of the unit holders unless a written communication is sent to each unitholder, a notice is given in the newspaper with national circulation and the unitholders are given the option to exit at NAV without paying an exit load.
- The trustees have to file details of their securities dealings on a quarterly basis with the mutual fund.
- On a quarterly basis the trustees shall review the transactions of the mutual fund with the AMC and its associates. They shall also review the net worth of the AMC on a quarterly basis and ensure that any shortfall is made up.
- The trustees shall periodically review the investor complaints received and their redressal by the AMC.
- The trustees shall ensure that the trust property is properly protected, held and administered.
- The trustees shall obtain and consider the reports of the auditors and compliance officers in their periodic meetings and take action as required.
- The trustees shall file half-yearly reports to SEBI.

The strict provisions go a long way in promoting the independence of the role of trusteeship in a mutual fund.

The trustees of mutual funds can now seek administrative assistance to monitor various activities of asset management companies.<sup>13</sup>

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<sup>13</sup> Candidates are advised to read: [https://www.sebi.gov.in/legal/circulars/aug-2020/resources-for-trustees-of-mutual-funds\\_47291.html](https://www.sebi.gov.in/legal/circulars/aug-2020/resources-for-trustees-of-mutual-funds_47291.html) and [https://www.sebi.gov.in/legal/circulars/sep-2020/circular-on-resources-for-trustees-of-mutual-funds\\_47630.html](https://www.sebi.gov.in/legal/circulars/sep-2020/circular-on-resources-for-trustees-of-mutual-funds_47630.html). SEBI, vide circular no. SEBI/HO/IMD/DF4/CIR/P/2020/0000000151 dated August 10, 2020, has issued guidelines on resources for Trustees of Mutual Funds. Upon consideration of the subsequent representation received from AMFI, it has been decided that compliance of the aforesaid Circular shall be applicable from January 01, 2021.

### 3.2.3 Mutual Fund Trust

A mutual fund is constituted in the form of a trust and the instrument of trust is in the form of a deed, duly registered under the provisions of the Indian Registration Act, 1908 (16 of 1908), executed by the sponsor in favour of the trustees named in such an instrument.

### 3.2.4 Asset Management Company

Day to day operations of mutual fund is handled by the AMC. The sponsor or, the trustees if so authorized by the trust deed, shall appoint the AMC with the approval of SEBI.

As per SEBI regulations:

- The directors of the asset management company need to be persons having adequate professional experience in finance and financial services related field.
- The directors as well as key personnel of the AMC should not have been found guilty of moral turpitude or convicted of any economic offence or violation of any securities laws.
- Key personnel of the AMC should not have worked for any asset management company or mutual fund or any intermediary during the period when its registration was suspended or cancelled at any time by SEBI.

Prior approval of the trustees is required, before a person is appointed as director on the board of the AMC.

Further, at least 50 percent of the directors should be *independent* directors i.e. not associate of or associated with the sponsor or any of its subsidiaries or the trustees.

The AMC needs to have a minimum net worth of Rs. 50 crore.

A change in the controlling interest of the AMC can be made only with the prior approval of the trustees and SEBI. A written communication about the change in the controlling interest of the AMC is sent to each unitholder and an advertisement is given in one English daily newspaper having nationwide circulation and in a newspaper published in the language of the region where the Head Office of the mutual fund is situated. The unitholders are given the option to exit at NAV without paying an exit load.

The AMC is responsible for conducting the activities of the mutual fund. It therefore arranges for the requisite offices and infrastructure, engages employees, provides for the requisite software, handles advertising and sales promotion, and interacts with regulators and various service providers.

The AMC has to take all reasonable steps and exercise due diligence to ensure that the investment of funds pertaining to any scheme is not contrary to the provisions of the SEBI regulations and the trust deed. Further, it has to exercise due diligence and care in all its investment decisions.

The appointment of an AMC can be terminated by a majority of the trustees, or by 75 percent of the Unit-holders. However, any change in the AMC is subject to prior approval of SEBI and the Unit-holders.

### **3.2.5 Custodian**

The custodian has custody of the assets of the fund. As part of this role, the custodian needs to accept and give delivery of securities for the purchase and sale transactions of the various schemes of the fund. Thus, the custodian settles all the transactions on behalf of the mutual fund schemes.

All custodians need to register with SEBI under the SEBI (Custodian) Regulations 1996. The Custodian is appointed by the trustees. A custodial agreement is entered into between the trustees and the custodian.

The SEBI regulations provide that if the sponsor or its associates control 50 percent or more of the shares of a custodian, or if 50 percent or more of the directors of a custodian represent the interest of the sponsor or its associates, then, unless certain specific conditions are fulfilled, that custodian cannot be appointed for the mutual fund operation of the sponsor or its associate or subsidiary company.

An independent custodian ensures that the securities are indeed held in the scheme for the benefit of investors—an important control aspect.

The custodian also tracks corporate actions such as dividends, bonus and rights in companies where the fund has invested.

## **3.3 Organization Structure of Asset Management Company**

It is important to understand various functions of an Asset Management Company (AMC) through the details of various departments within the firm (Chart 3.1).

**Chart 3.1: Organisation Structure of Asset Management Company**

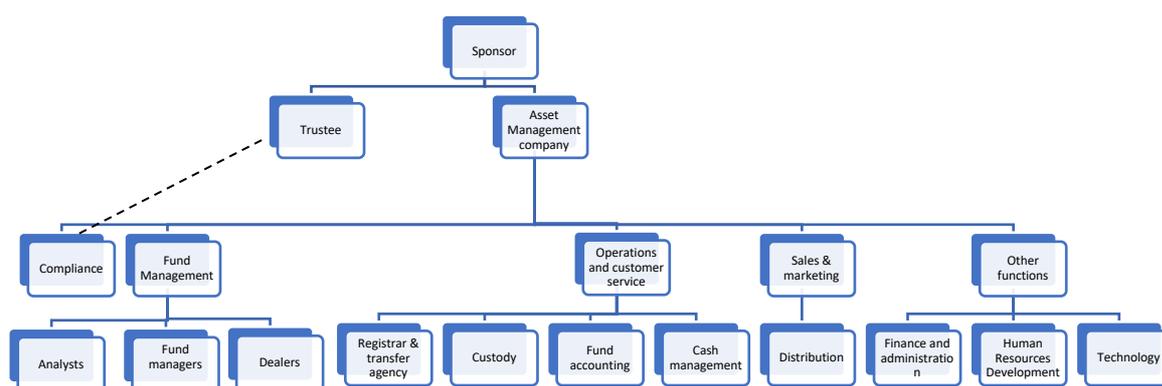


Chart 3.1 is used for explanation of various functions within an AMC. Individual AMCs may have some differences in the structure.

### 3.3.1 Compliance Function

Compliance Officer needs to ensure all the legal compliances. In the scheme documents of new issues, the Compliance Officer signs a due-diligence certificate to the effect that all regulations have been complied with, and that all the intermediaries mentioned in the scheme related documents have the requisite statutory registrations and approvals. To ensure independence, the Compliance Officer reports directly to the head of the AMC. The Compliance Officer works closely with the Trustees on various compliance and regulatory issues. It is the responsibility of the compliance officer to report any issue of non-compliance directly and immediately to the trustees.

### 3.3.2 Fund management

Fund management is the most critical function in an Asset Management Company. It is at the core of the value proposition offered by the firm. The main function of this team is to invest the investors' money in line with the stated objective of the scheme, and to manage the same effectively.

Normally, the team can be broken into three sub-teams, viz., the analysts, the fund managers, and the dealers.

The analysts analyse various opportunities, be it individual securities, or sectors, or the state of the markets, or the economy. Some of them may analyse the stock markets, whereas some may analyse debt markets. Within debt markets, some may evaluate credit opportunities, whereas some may analyse the interest rate movements. Their job is to identify investment opportunities.

The fund managers evaluate the opportunities presented to them by the analysts, the brokers, and other research firms. They may also identify opportunities by themselves. Performance of the scheme is the fund manager's responsibility.

The third sub-team is that of the dealers, whose responsibility is to place orders with securities brokers based on the instructions of the fund managers.

### **3.3.3 Operations and customer services team**

When a customer visits a branch office of an AMC, s/he is attended to by the customer services team. Such a team is also called the front office team. Apart from this front office team, there is also a team in the back office to help investors by resolving various queries. Both these together are part of the Customer Services Team. Many AMCs have adopted information technology solutions and have set up call centres and chat bots to answer customer queries and to resolve service issues.

The Registrar and Transfer Agency (RTA), which is a big part of this unit, maintains investor records as well as allots or redeems units, processes purchase/redemption/switch requests, dividends, etc. It also generates the account statement that an investor receives.

There is a Custody Team within this group that interacts with the custodian for the purpose of settlement of various transactions that the fund management team initiates.

Fund accounting team maintains books of accounts of each individual mutual fund scheme and calculates NAV on a daily basis.

Cash management team works as an interface between the banks and the fund management team—they ensure that money received in the bank when investors purchase units are passed on to the fund managers for further investment in securities and the investors get the redemption proceeds when they submit the redemption request.

### **3.3.4 Sales and Marketing Team**

This team reaches out to the investors through mass media, marketing campaigns and through distribution channel. Their major responsibilities include branding, advertising,

management of various events, and distribution of mutual fund products through various distribution channels. Mostly, it is this team that would interact with the mutual fund distributors, and take care of relationship management and engagement. This team also helps in the growth of the distribution network through various interactions and training programs.

### **3.3.5 Other functions**

These functions are largely support functions to run the AMC operations smoothly. These include Finance/Accounts, Administration, Human Resources (HR) and Development, Information Technology. They perform various tasks that ensure smooth functioning of the AMC, as well as improve customer experiences.

- The **Accounts team** handles the finances of the AMC. This unit is different from the fund accounting team.
- There is an **Administration Department** that takes care of various facilities, offices, and other infrastructure. In many AMCs, the administration reports to the finance function.
- The **HR department** is responsible for attracting, nurturing and retaining talent within the firm. They take care of learning and development requirements of the personnel.
- The **Information Technology department**, also referred as the Technology team, takes care of the IT infrastructure required by various functions and departments. This may also include the AMC website, as well as many facilities offered to investors and distributors with the help of technology.

## **3.4 Role and Support function of Service Providers**

### **3.4.1 Fund Accountant**

The fund accountant performs the role of calculating the NAV, by collecting information about the assets and liabilities of each scheme. The AMC can either handle this activity in-house or engage a service provider. There is no need for a registration with SEBI to perform this function.

### **3.4.2 Registrars and Transfer Agents**

The Registrars and Transfer Agents (RTAs) maintain investor records. Their offices in various centres serve as Investor Service Centres (ISCs), which perform a useful role in handling the documentation of investors. The functions of the RTA include processing of purchase and redemption transactions of the investor and dealing with the financial transactions of receiving funds for purchases and making payments for redemptions, updating the unit capital of the scheme to reflect these transactions, updating the information in the individual records of the investor, called folios, keeping the investor updated about the status of their investment account and information related to the investment.

The appointment of RTA is done by the AMC. It is not compulsory to appoint a RTA. The AMC can choose to handle this activity in-house. All RTAs need to register with SEBI.

### **3.4.3 Auditors**

Auditors are responsible for the audit of accounts.

Accounts of the mutual fund schemes need to be maintained independent of the accounts of the AMC. The auditor appointed to audit the mutual fund scheme accounts needs to be different from the auditor of the AMC.

While the scheme auditor is appointed by the Trustees, the AMC auditor is appointed by the AMC.

### **3.4.4 Distributors**

Distributors have a key role in selling suitable types of mutual fund schemes to their clients/investors. A distributor can be empanelled with more than one AMCs. Distributors can be individuals or institutions such as distribution companies, broking companies and banks.

Distributors need to pass the NISM certification Examination (NISM-Series- V-A: Mutual Fund Distributors (MFD) Certification Examination) and register with AMFI. Regulatory aspects of their role and, some of the distribution and channel management practices are covered later in Chapter 6 of the book.

Through a circular, SEBI has also allowed provisions for empanelment of a new cadre of mutual fund distributors, who are allowed to sell a certain limited set of schemes<sup>14</sup>. This new cadre of distributors can be empanelled if they clear NISM-Series- V-B: Mutual Fund Foundation Certification Examination and register with AMFI under the particular category of distributors.

### **3.4.5 Collecting Bankers/Payment Aggregators**

The investors' money goes into the bank account of the scheme they have invested in. These bank accounts are maintained with collection bankers who are appointed by the AMC.

Leading collection bankers make it convenient to invest in the schemes by accepting applications of investors in most of their branches. Payment instruments against applications handed over to branches of the AMC or the RTA need to be banked with the collecting bankers, so that the money is available for investment by the scheme. Thus, the banks enable collection and payment of funds for the schemes.

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<sup>14</sup> SEBI circular CIR/IMD/DF/21/2012 dated September 13, 2012.

Through this kind of a mix of constituents and specialized service providers, most mutual funds maintain high standards of service and safety for investors.

While banks play a big role in facilitating mutual fund transactions, a new category of players have made an entry – the payment aggregators. There are some payment gateway providers, digital wallets, and payment banks. All these players facilitate the transactions by allowing investors to buy mutual fund units.

#### **3.4.6 KYC Registration Agencies**

It is mandatory for all investors in the securities market, including the mutual fund investors, to be KYC (Know Your Customer) compliant under the provisions of the Prevention of Money Laundering Act. The KYC process (covered in detailed later in the book) involves establishing the identity and the address of the investor.

If the investor has to go through the KYC process with each mutual fund, then it would become a repetitive process. SEBI issued regulations for registration of central KYC Registry Agencies (KRAs) in 2011. This introduced a common KYC for investors investing in securities markets. KYC registration firms are registered with SEBI.

KRAs process various details and documents to establish the identity of the investor and assign a number through a letter. A copy of this letter can be submitted to any SEBI registered intermediary with whom the investor wants to transact. Since the KRAs deal with sensitive investor information, they are mandated to have enough checks and balances in place to ensure that confidentiality is maintained. The regulations mandate KRAs to have computerised connectivity to share data with one another.

#### **3.4.7 Valuation agencies**

SEBI has issued guidelines for the purpose of arriving at fair valuation of debt securities that are non-traded or thinly traded. According to these guidelines, there have to be at least two valuation agencies that provide valuation matrix. The AMCs have to make use of this matrix to arrive at fair valuation of these investments. AMFI has appointed CRISIL Ltd. and ICRA Ltd. for the purpose.

#### **3.4.8 Credit Rating Agencies**

Credit rating agencies rate debt securities issued by various issuers. Fund managers consider such ratings as a key input while taking investment decisions. In few mutual fund products, credit rating assumes greater importance. Certain categories of debt funds such as corporate bond funds, credit risk funds are defined on the basis of credit rating. Even capital protection-oriented schemes need to carry a credit rating assigned by the rating agency. Such schemes have restrictions pertaining to their investment universe, which is also a function of the credit rating assigned by these agencies.

In case of Fixed Maturity Plans (FMPs), the AMC is allowed to disclose the proposed rating profile of the scheme before the portfolio is constructed. It is then mandatory to invest in debt securities only within the proposed rating profile, or less risky papers (higher credit rating than proposed). Thus, credit rating agencies assume an important role in case of debt mutual funds.

#### **3.4.9 Depositories and the Depository Participants**

A depository is an institution, which holds the securities in dematerialised or electronic form on behalf of the investors. Initially depositories held only equity shares on behalf of the investors, later other securities including mutual funds were also dematerialised. Investors have the option of holding their mutual fund units in dematerialised form through a depository participant.

The depositories reach out to the investors through the depository participants. As an analogy, one can consider the depositories as the head office of a bank and the depository participants akin to the branches of the bank. Like a bank account holder does not transact directly with the head office of the bank, but only with the branch; an investor does not deal with the depository, but with the depository participant.

There are two depositories in India, viz., National Securities Depository Limited (NSDL), and Central Depository Services Limited (CDSL).

#### **3.4.10 Stock exchanges and the transaction platforms**

Investors can now transact in mutual fund units through the stock exchanges. The units of close-ended funds and ETFs are compulsorily listed on at least one stock exchange. At the same time, units of open-ended funds are also available through special segments on the stock exchanges. At the Bombay Stock Exchange (BSE), this segment is known as BSE-StarMF; while at the National Stock Exchange of India (NSE), it is called NSE Mutual Fund II Platform (NMF-II). Now, investors can also transact directly through stock exchanges.

MF Utilities India is another transaction platform for units of mutual funds. Investors can perform various transactions such as purchase, sale, switch, etc.

These platforms play a very important role in enhancing the reach of mutual funds. Further, the internet and mobile based applications have helped to reduce paperwork and reduce transaction related errors.

### **3.5 Role and Function of AMFI**

Association of Mutual Funds in India (AMFI) is the association of all the registered Asset Management Companies. The objectives of AMFI are:

- To define and maintain high professional and ethical standards in all areas of operation of mutual fund industry.
- To recommend and promote best business practices and code of conduct to be followed by members and others engaged in the activities of mutual fund and asset management including agencies connected or involved in the field of capital markets and financial services.
- To interact with SEBI and to represent to SEBI on all matters concerning the mutual fund industry.
- To represent to the Government, Reserve Bank of India and other bodies on all matters relating to the mutual fund Industry.
- To undertake nationwide investor awareness programme to promote proper understanding of the concept and working of mutual funds.
- To disseminate information on mutual fund industry and to undertake studies and research directly and/or in association with other bodies.
- To regulate conduct of distributors including disciplinary actions (cancellation of ARN) for violations of Code of Conduct.
- To protect the interest of investors/unit holders.

A major role of AMFI involves the registration of mutual fund distributors, by allotting them AMFI Registration Number (ARN), which is mandatory for becoming a mutual fund distributor. Periodically, AMFI also issues various circulars recommending best practices for the asset management companies, as well as the distributors.

An important point to note here is that AMFI is neither a regulatory body nor a Self-Regulatory Organisation (SRO).

### Chapter 3: Sample Questions

- 1. Mutual funds are constituted as 'Trusts' in India. Who are the beneficiaries of the trust?**
  - a. The employees of the Asset Management Company
  - b. The mutual fund distributors
  - c. Unitholders
  - d. Trustees of the mutual fund
  
- 2. Who handles the day-to-day management of the mutual fund?**
  - a. Asset Management Company
  - b. Registrar and Transfer Agency
  - c. Mutual Fund Trustees
  - d. Unitholders
  
- 3. Whose job is it to track the various corporate actions like bonus, dividend, or rights issues in companies where the mutual fund scheme has invested?**
  - a. Registrar and Transfer Agency
  - b. Custodian
  - c. Auditors of the Asset Management Company
  - d. Unitholders
  
- 4. Registrar and Transfer Agency function must be independent of the Asset Management Company, and it cannot be retained in-house. State whether this statement is True or False.**
  - a. True
  - b. False
  
- 5. With which agency are the mutual fund distributors registered?**
  - a. Securities and Exchange Board of India
  - b. Fund Accounting Team
  - c. Depositories
  - d. Association of Mutual Funds in India

## CHAPTER 4: LEGAL AND REGULATORY FRAMEWORK

### Learning Objectives:

After studying this chapter, you should know about:

- Role of regulators in India
- Role of SEBI in regulating mutual funds
- Due Diligence Process by AMCs for Distributors of Mutual Funds
- SEBI Advertisement Code for mutual funds
- Investor Grievance and Redress Standards
- AMFI Code of Ethics and AMFI Code of conduct for Intermediaries

### 4.1 Role of Regulators in India

At a broad level, the regulations in financial markets are driven by the need to safeguard the interests of the consumers of various financial products and services, as well as to ensure a regulated development of the financial markets, which is essential for the growth of the economy. Currently, there are four regulators, viz.,

1. Reserve Bank of India (RBI) that regulates the banking system, as well as money markets;
2. Securities and Exchange Board of India (SEBI) that regulates the securities markets;
3. Insurance Regulatory and Development Authority of India (IRDAI) that regulates the insurance market; and
4. Pension Fund Regulatory and Development Authority of India (PFRDA) that regulates the pension market.

These regulators come under the purview of the Ministry of Finance.

### 4.2 Role of Securities and Exchange Board of India

As mentioned earlier, securities markets in India are regulated by the Securities and Exchange Board of India (SEBI). It regulates, among other entities, mutual funds, depositories, custodians and registrars and transfer agents (RTAs) in the country.

The Preamble of the Securities and Exchange Board of India describes the basic functions of the Securities and Exchange Board of India as "...to **protect the interests of investors** in securities and to **promote the development** of, and to **regulate the securities market** and for matters connected therewith or incidental thereto".

The regulations cover three important aspects to achieve the above objectives:

- Disclosures by issuers of securities, e.g. companies that issue shares or debentures, and mutual funds that issue mutual fund units
- Efficiency of transactions in the securities markets
- Low transaction costs

Apart from the above, various other areas also warrant regulations, such as:

- Deliberate speculation in stock markets
- Insider trading
- Excessive risks taken by mutual funds
- Inadequate collateral by issuers of debt securities

If such activities are unchecked, the trust of the investors would be lost in the functioning of the markets, which eventually may lead to drying up of precious financial resources. This would further dry up the investment activity, or channelling of household savings in capital markets that the economy needs for growth.

#### 4.2.1 Regulatory reforms by SEBI

SEBI issued the mutual fund regulations in 1996 in the form of SEBI (Mutual Funds) Regulations, 1996. Since then, there have been many amendments through various regulations and circulars. In all the cases, the objective has always remained to protect the interests of the mutual fund investors, and to empower investors to take informed investment decisions. The regulations have covered many aspects such as investor services, accounting of NAV, valuation norms, disclosures and investment norms.

The various provisions of the regulations can be broken down into the following categories, with a brief discussion of what they cover:

Different types of Regulation Categories	Areas covered
Scheme related documents	<p>The regulatory provisions cover various aspects related to various scheme related documents, including the objectives and content of the respective documents.</p> <p>These also cover the frequency of publication of the respective documents that ensures the relevant information is up-to-date.</p>
Conversion and consolidation of existing schemes	The relevant regulations/guidelines/circulars define the manner in which the scheme mergers or consolidation

Different types of Regulation Categories	Areas covered
	should take place such that the interests of all unitholders are protected.
New products	These regulations govern the new product categories that may be approved from time to time. For example, in the recent past, there have been product launches under new categories such as Infrastructure Debt Funds.
Risk management system	<p>Mutual funds are repositories of a large volume of client data. Also, huge sums of money are involved in investment through mutual funds. Therefore, robust operational risk management systems are warranted and SEBI has issued detailed guidelines for governance of these aspects.</p> <p>SEBI regulations and circulars also mandate exposure limits for investments by mutual fund schemes to ensure that investors get a diversified portfolio and the schemes remain true-to-label.</p>
Disclosures and reporting norms	<p>Mutual funds are among the best investment vehicles and one of the reasons for this is the 'transparency' factor. SEBI has issued many guidelines to ensure proper disclosures and reporting norms.</p> <p>These norms mandate the different kinds of disclosures along with the manner and frequency of reporting. In many cases, SEBI has provided the format in which the disclosures must be made such that the investor gets appropriate, and adequate information in a timely manner to enable the investor to take an informed investment decision.</p>
Governance norms	These provisions are very exhaustive and cover many areas of governance, from fund level governance norms that include formation of audit and valuation committees, role of independent directors and trustees to scheme level governance norms that include minimum number of investors in a scheme; benchmarking of scheme's

Different types of Regulation Categories	Areas covered
	performance; systems audit of mutual funds, to the role of mutual funds in corporate governance.
Secondary market activities	These provisions pertain to the secondary market activities by the mutual funds in all the markets—equity, debt, government securities, and derivatives.
Net Asset Value (NAV)	NAV disclosures, rounding-off of NAV, cut-off time for various commercial transactions, time stamping and uniformity in calculation of sale and purchase price are the areas covered through regulatory provisions under this head.
Valuation	Valuation of various securities in which the mutual fund scheme has invested.
Loads, fees and expenses	Regulatory provisions impose limits to various loads, fees, and expenses. These provisions also cover disclosure of commission payable to distributors.
Dividend distribution procedure	The procedure for distribution of dividend, the norms defining the calculation of distributable surplus, out of which the dividend can be paid out have been laid out in regulations, guidelines and circulars.
Investment by schemes	Guidelines and circulars for investment restrictions and investment limits by mutual fund schemes.
Advertisements	As the name suggests, these regulatory provisions govern what the advertisements can cover and what they cannot; the frequency of statutory advertisements; inclusion of disclaimers and risk factors in various advertisements, etc.
Investor rights and obligations	These provisions cover various matters pertaining to the investor rights including despatch of account statements or redemption pay-outs, penalty in case of delays, instant access facility in case of liquid funds, etc.

Different types of Regulation Categories	Areas covered
Certification and registration of intermediaries	The requisite certification and registration norms for the intermediaries are covered here, including the need and process for the certification examination and continuous professional education (CPE).
Transaction in mutual fund units	These provisions cover the transactions through stock exchanges and other similar platforms, the kind of documents that the AMC/RTA need to preserve, KYC norms, etc.
Categorisation of mutual fund schemes	SEBI circular on mutual fund scheme categorization and rationalization aimed towards conversion and consolidation of existing schemes and new products. The objective was to reduce the number of schemes to one per category in the open-ended arena, so that investors do not get confused. However, that required consolidation through merger of certain schemes with other schemes. The SEBI regulations and circulars detail the procedure of such scheme mergers, as well as the disclosures of performance of such schemes. The circular on scheme categorization and rationalization, mandated that there can be only one scheme per category within the fund house. Various other provisions such as definition of various categories based on market capitalization were included to bring-in uniformity.
Segregated Portfolio	<p>During the 2018 credit crisis, SEBI laid down the provision for creating segregated portfolios for protecting the interests of the unitholders and giving fair treatment to all investors in case of a credit event and to deal with liquidity risk.<sup>15</sup></p> <p>In the year 2008, when there was global liquidity crisis, SEBI brought many reforms such as disallowing premature redemption in case of Fixed Maturity Plans</p>

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<sup>15</sup> Creation of segregated portfolio is a mechanism to separate distressed, illiquid assets from other more liquid assets in a mutual fund portfolio to deal with a situation arising due to a credit event.

Different types of Regulation Categories	Areas covered
	(FMPs), and disallowing the phrase “liquid plus” while naming mutual fund schemes.
Scheme Performance	SEBI has mandated that the scheme performance should be compared with the total return index, as against the price return index. A Price Return Index considers only the price movement of its constituents and thus captures only the capital gains of the constituents. On the other hand, a Total Returns index considers all dividends/interest payments that are generated from the basket of components that make up the index in addition to the capital gains. The cash flows are presumed to be notionally reinvested on their ex-date into the basket of underlying components that make up the index. A mutual fund scheme takes into consideration, capital gains as well as the dividend earnings/interest income of the instruments in which it has invested while calculating the return generated by the scheme. TRI is more appropriate as a benchmark to compare the performance of mutual fund schemes. Therefore, SEBI stipulated that all Mutual Fund schemes be benchmarked against Total Return Indices from February 01, 2018 onwards. <sup>16</sup>

Advertisements, valuation of securities, calculation of NAV—each of these aspects related to mutual funds are very tightly regulated. Such approach ensures that the Indian mutual fund industry remains one of the most regulated and transparent investment options for investors.

#### 4.2.2 Mutual Funds Regulations

The applicable guidelines for mutual funds are set out in SEBI (Mutual Funds) Regulations, 1996, as amended from time to time. Some aspects of these regulations are discussed in various sections of this workbook. An updated and comprehensive list of circulars issued by SEBI can be found in the Mutual Funds section of SEBI’s website: [www.sebi.gov.in](http://www.sebi.gov.in). Master Circulars, which capture the essence of various circulars issued from time to time, may be downloaded from [www.sebi.gov.in](http://www.sebi.gov.in).<sup>17</sup>

<sup>16</sup> [https://www.sebi.gov.in/legal/circulars/jan-2018/benchmarking-of-scheme-s-performance-to-total-return-index\\_37273.html](https://www.sebi.gov.in/legal/circulars/jan-2018/benchmarking-of-scheme-s-performance-to-total-return-index_37273.html)

<sup>17</sup> Candidates are advised to read the SEBI master circular on mutual funds issued from time to time along with other circulars issued by SEBI.

Wherever applicable, mutual funds need to comply with regulations issued by other regulators also. For instance, RBI regulates the money market and foreign exchange market in the country. Therefore, mutual funds need to comply with RBI's regulations regarding investment in the money market, investments outside the country, investments from people other than Indians resident in India, remittances (inward and outward) of foreign currency etc.

Stock Exchanges are regulated by SEBI. Every stock exchange has its own listing, trading and margining rules. Mutual Funds need to comply with the rules of the exchanges with which they choose to have a business relationship i.e. for listing the units of the mutual fund schemes launched by them.

#### **4.2.3 Investment restrictions and portfolio diversification norms for mutual fund schemes**

Mutual fund is a managed investment vehicle. It is a pass-through vehicle—in that the risks and the returns are passed on to the unitholders. The investors have no control, over the investment management of the mutual fund. It is in this context that SEBI has laid down regulations pertaining to investment universe, restrictions and portfolio diversification for investment by mutual fund schemes. Such regulations intend to control the risks taken by the mutual fund managers.

The SEBI Regulations provide for various limits to the kind of investments that are possible in mutual fund schemes. In few cases, there are also aggregate limits for all schemes of a mutual fund. The regulator's objective behind setting these limits is to ensure mitigation of risks in the scheme and protecting the investor's interests. The restrictions specified apply at the time of making the investment. Some of the important restrictions specified are:

##### ***General Restrictions***

- The Mutual Fund will buy and sell securities on delivery basis. Securities purchased will be transferred in the name of the Mutual Fund because of the respective scheme.
- The Mutual Fund shall not advance any loans.
- The scheme will not invest in the unlisted or privately placed securities of any associate or group company of the sponsor. Investment in the listed securities of the group companies of the sponsor will be limited to 25 percent of the net assets.
- The scheme may invest in other schemes of the same Mutual Fund or other Mutual Funds. This will be limited to not more than 5 percent of the net asset value of the scheme. No fees will be charged on such investments. This does not apply to Fund of Funds.
- The Mutual Fund under all its schemes shall not own more than 10 percent of a company's paid up capital bearing voting rights. Provided no sponsor of a mutual

fund, its associate or group company including the Asset Management Company of the fund, through the schemes of the mutual fund or otherwise, individually or collectively, directly or indirectly, have 10 percent or more of the shareholding or voting rights in the asset management company or the trustee company of any other mutual fund.

***Restrictions pertaining to investment in Debt Securities:***

- A mutual fund scheme shall not invest more than 10 percent of its NAV in debt instruments comprising money market instruments and non-money market 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 12 percent of the NAV of the scheme with the prior approval of the Board of Trustees and Board of Directors of the asset management company provided that:
  - that such limit shall not be applicable for investments in Government Securities, treasury bills and collateralized borrowing and lending obligations.
  - investments 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 SEBI.
  - the schemes already in existence shall with an appropriate time and in the manner, as may be specified by the SEBI, conform to such limits.
- A mutual fund scheme shall not invest in unlisted debt instruments including commercial papers, except Government Securities and other money market instruments provided:
  - the Mutual Fund Schemes may invest in unlisted non-convertible debentures up to a maximum of 10 percent of the debt portfolio of the scheme subject to such conditions as may be specified by SEBI from time to time.
- Parking of funds in Short-term deposits with all scheduled commercial banks shall be limited to 15 percent of the net assets of the scheme. This can be raised to 20 percent with the approval of the trustees. No management fee will be charged for such investments by the scheme. The Scheme cannot invest in the short-term deposits of a bank that has invested in the scheme. The Trustees/Asset Management Companies shall ensure that no funds of a scheme is parked in short term deposits of a bank which has invested in that scheme. Trustees/AMCs shall also ensure that the bank in which a scheme has short term deposits do not invest in the said scheme until the scheme has short term deposits with such bank.

***Restrictions pertaining to investment in Equity:***

- All investments by a mutual fund scheme in equity shares and equity related instruments shall only be made provided such securities are listed or to be listed.
- The ELSS notification requires that atleast 80 percent of the ELSS funds should be invested in equity and equity-linked securities.
- The Scheme shall not invest more than 10 percent of its NAV in the equity shares and equity related instruments of a company. The limit is not applicable for investments in index/sector/industry specific schemes.

***Restrictions pertaining to investment in REITs and InvITs:***

- No mutual fund under all its schemes shall own more than 10 percent of units issued by a single issuer of REIT and InvIT; and
  - A mutual fund scheme shall not invest – (i) more than 10 percent of its NAV in the units of REIT and InvIT; and (ii) more than 5 percent of its NAV in the units of REIT and InvIT issued by a single issuer. The limits mentioned above are not applicable for investments in case of index funds or sector or industry specific scheme pertaining to REIT and InvITs.

**4.2.4 SEBI Advertisement Code for Mutual Funds**

The important provisions pertaining to SEBI's Advertising Code for mutual funds (MFs) are listed below:

- Advertisements shall be accurate, true, fair, clear, complete, unambiguous and concise.
- Advertisements shall not contain statements which are false, misleading, biased or deceptive, based on assumption/projections and shall not contain any testimonials or any ranking based on any criteria.
- Advertisements shall not be so designed as likely to be misunderstood or likely to disguise the significance of any statement. Advertisements shall not contain statements which directly or by implication or by omission may mislead the investor.
- Advertisements shall not carry any slogan that is exaggerated or unwarranted or slogan that is inconsistent with or unrelated to the nature and risk and return profile of the product.
- No celebrities shall form part of the advertisement.

- Advertisements shall not be so framed as to exploit the lack of experience or knowledge of the investors. Extensive use of technical or legal terminology or complex language and the inclusion of excessive details which may detract the investors should be avoided.
- Advertisements shall contain information which is timely and consistent with the disclosures made in the Scheme Information Document, Statement of Additional Information and the Key Information Memorandum.
- No advertisement shall directly or indirectly discredit other advertisements or make unfair comparisons.
- Advertisements shall be accompanied by a standard warning in legible fonts which states 'Mutual Fund investments are subject to market risks, read all scheme related documents carefully.' No addition or deletion of words shall be made to the standard warning.

In audio-visual media-based advertisements, the standard warning in visual and accompanying voice over reiteration shall be audible in a clear and understandable manner. For example, in standard warning both the visual and the voice over reiteration containing 14 words running for at least 5 seconds may be considered as clear and understandable. Advertisement issued by mutual funds shall be in terms of Sixth Schedule of SEBI (Mutual Fund) Regulations, 1996. In addition to the provisions of the Sixth Schedule, mutual funds shall comply with the following:

- The dividends declared or paid shall also be mentioned in Rupees per unit along with the face value of each unit of that scheme and the prevailing NAV at the time of declaration of the dividend.
- While advertising pay out of dividends, all advertisements shall disclose, immediately below the pay-out figure (in percentage or in absolute terms) that the NAV of the scheme, pursuant to payment of dividend would fall to the extent of pay-out and statutory levy (if applicable).

## **Advertisement Guidelines for Mutual Funds<sup>18</sup>**

### **A. Disclosing performance related information of mutual fund schemes:**

- When the mutual fund scheme has been in existence for more than three years:
  - Performance advertisement of mutual fund schemes shall be provided in terms of CAGR for the past 1 year, 3 years, 5 years and since inception.
  - Point-to-point returns on a standard investment of Rs. 10,000 shall also be shown in addition to CAGR for the scheme to provide ease of understanding to retail investors.

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<sup>18</sup> Vide SEBI Circular: CIR/IMD/DF/23/2017 dated March 15, 2017 ([https://www.sebi.gov.in/legal/circulars/mar-2017/review-of-advertisement-guidelines-for-mutual-funds\\_34367.html](https://www.sebi.gov.in/legal/circulars/mar-2017/review-of-advertisement-guidelines-for-mutual-funds_34367.html))

- It should be clearly mentioned whether the disclosed performance is of regular or direct plan of the Mutual Fund. A footnote should clearly mention that different plans have different expense structures.
- If the same fund manager has not managed the scheme for the full period for which the information is being published in the advertisement, the same should be disclosed in the footnote.
- When a scheme has been in existence for more than 1 year but less than 3 years or 5 years, the same shall be mentioned as a footnote in the performance advertisement of the Mutual Fund scheme.
- Where the scheme has been in existence for less than one-year, past performance shall not be provided.
- In the case of money market schemes or cash and liquid schemes, wherein investors have very short investment horizon, the performance can be advertised by simple annualization of yields if a performance figure is available for at least 7 days, 15 days and 30 days. Further, it should not give an unrealistic or misleading picture about the performance or future performance of the scheme.
- For the sake of standardization, a similar return in INR and by way of CAGR must be shown for the following apart from the scheme benchmarks:

<b>Scheme Type</b>	<b>Benchmark</b>
Equity scheme	Sensex or Nifty
Long term debt fund	10 year dated Gov security
Short-term debt fund	1 year T-Bill

- When the performance of a particular mutual fund scheme is advertised, the advertisement shall also include the performance data of all the other schemes managed by the fund managers of that particular scheme. Such performance data of the other schemes managed by the fund manager shall be provided as follows:
  - Performance of other schemes managed by the fund manager, along-with their respective scheme's benchmark, shall be provided in terms of CAGR for a period of 1 year, 3 years and 5 years.
  - In case the number of schemes managed by a fund manager is more than six, then the AMC may disclose the total number of schemes managed by that fund manager along with the performance data of top 3 and bottom 3 schemes (in addition to the performance data of the scheme for which the advertisement is being made) managed by that fund manager in all performance related advertisements. However, in such cases, AMCs shall ensure that true and fair view of the performance of the fund manager is communicated by providing additional disclosures, if required.
  - If a mutual fund scheme has not been managed by the same fund manager for the full period of information being published in the advertisement, the same should be disclosed in a footnote.

- Further, for advertisement published in internet-enabled media, mutual funds shall be permitted to provide an exact website link to such summarized information of performance of other schemes managed by the concerned fund manager.

### **Celebrity endorsements of Mutual Funds at industry level**

- SEBI has permitted celebrity endorsements at industry level for the purpose of increasing awareness of Mutual Funds as a financial product category. However, such celebrity endorsements of Mutual Funds at industry level are subject to the following conditions:
  - The celebrity endorsements shall not promote a scheme of a particular Mutual Fund or be used as a branding exercise of a Mutual Fund house/AMC.
  - Expenses towards such celebrity endorsements shall be limited to the amounts that are aggregated by Mutual Funds at industry level for the purpose of conducting investor education and awareness initiatives.
  - Prior approval of SEBI shall be required for issuance of any endorsement of Mutual Funds as a financial product, which features a celebrity for the purpose of increasing awareness of Mutual Funds.

### **SEBI Guidelines for Circulation of Unauthenticated News**

SEBI has issued guidelines to all market intermediaries relating to circulation of unauthenticated news through various modes of communication. Following are the guidelines stipulated by SEBI:

- Proper internal code of conduct and controls should be put in place by market intermediaries registered with SEBI. Employees/temporary staff/voluntary workers etc. employed/working in the offices of market intermediaries should not encourage or circulate rumours or unverified information obtained from client, industry, any trade or any other sources without verification.
- Access to Blogs/Chat forums/Messenger sites etc. should either be restricted or under supervision or access should not be allowed.
- Logs for any usage of such Blogs/Chat forums/Messenger sites (called by any nomenclature) have to be treated as records and the same should be maintained as specified by the respective Regulations which govern the concerned intermediary.
- Employees should be directed that any market related news received by them either in their official mail/personal mail/blog or in any other manner, should be forwarded only after the same has been seen and approved by the concerned Intermediary's Compliance Officer. If an employee fails to do so, he/she shall be deemed to have violated the various provisions contained in SEBI Act/Rules/Regulations etc. and shall

be liable for action. The Compliance Officer shall also be held liable for breach of duty in this regard.

#### **4.2.5 Investors' Rights & Obligations**

Mutual fund investors are entitled to some important rights which are meant to protect the investments and bring more transparency to the mutual fund investors. These rights are bifurcated into two parts—AMC related rights and Fund related rights. Some of these rights have been discussed below.

##### ***Right to beneficial ownership***

Unit-holders have proportionate right to the beneficial ownership of the assets of the scheme. Investor can ask for a Unit Certificate for his Unit-holding. Investors also have the option to receive allotment of mutual fund units of open ended and closed end schemes in their demat account. The mutual fund/AMC is bound to co-ordinate with the RTA and Depository to facilitate this.<sup>19</sup> Units of all mutual fund schemes held in dematerialised form are freely transferable.<sup>20</sup>

##### ***Right to change the distributor***

Investors can choose to change their distributor or opt for direct investing. This needs to be done through a written request by the investor. In such cases, AMCs will need to comply, without insisting on any kind of 'No Objection Certificate' from the existing distributor.

##### ***Right to Inspect documents***

Unit-holders have the right to inspect key documents such as the Trust Deed, Investment Management Agreement, Custodial Services Agreement, RTA agreement and Memorandum & Articles of Association of the AMC.

##### ***Right to appoint nominees***

The investors can appoint upto 3 nominees, who will be entitled to the 'Units' in the event of the demise of the investors. The investor can also specify the percentage distribution between the nominees. If no distribution is indicated, then an equal distribution between the nominees will be presumed.

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<sup>19</sup> In the case of unit-holding in demat form, the demat statement given by the Depository Participant would be treated as compliance with the requirement of Statement of Account.

<sup>20</sup> However, in case of Equity Linked Savings Scheme (ELSS), free transferability of units (whether in demat or physical form) is curtailed for the statutory minimum holding period.

### ***Right to pledge mutual fund units***

Investors can pledge their mutual fund units. This is normally done to offer security to a financier.

### ***Right to grievance redressal***

There is a formal grievance redressal policy for investors. SEBI has mandated that the status of complaints redressed should be published by each AMC in their annual report. The same should be available on the website of the mutual fund and on AMFI's website. It should provide the status of the number of complaints received by the AMC, the time taken to resolve the complaints and the status of pending complaints.

The scheme related documents also have details of the number of complaints received and their disposal. Pending investor complaints can be a ground for SEBI to refuse permission to the AMC to launch new schemes.

### ***Rights of investors in context of change in Fundamental Attributes***

If there is a change in the fundamental attributes of a mutual fund scheme, then the unitholders are provided the option to exit at the prevailing NAV without any exit load. This exit window has to be open for at least 30 days. The Trustees/AMC have to send a written communication about the change in fundamental attributes of a scheme to all the unit holders and have to advertise about the change in fundamental attribute in an English daily newspaper having nationwide circulation and, in a newspaper, published in the language of the region where the head office of the mutual fund is located.

### ***Rights to terminate appointment of an AMC***

75 percent of unit holders can terminate the appointment of an AMC. Also, 75 percent of the unitholders (unitholding) can pass a resolution to wind up a scheme. The Trustees are bound to obtain consent of the unit-holders:

- Whenever required to do so by SEBI, in the interest of the unit-holders.
- Whenever required to do so by 75 percent of the unit-holders (in practice, Unit-holding) of the scheme.
- When the trustees decide to wind-up or prematurely redeem the scheme.

If an investor feels that the trustees have not fulfilled their obligations, then he can file a suit against the trustees for breach of trust. Under the law, a trust is a notional entity, therefore investors cannot sue the trust but they can file suits against trustees.

### **Right to unclaimed amounts<sup>21</sup>**

AMC is expected to make a continuous effort to remind the investors through letters to claim their dues. The Annual Report has to mention the unclaimed amount and the number of such investors for each scheme. Recovery of unclaimed amounts by the investors is as follows:

- If the investor claims the money within 3 years, then payment is based on prevailing NAV i.e. after adding the income earned on the unclaimed money.
- If the investor claims the money after 3 years, then payment is based on the NAV at the end of 3 years.

Investors also have rights to various services such as receiving account statements, statement of portfolio, half yearly disclosures etc. To enhance transparency, SEBI has mandated mutual funds to disclose details of debt and money market securities transacted in their schemes portfolio, including inter-scheme transfers, on a daily basis with a time lag of 15 days in a prescribed format.<sup>22</sup>

### **Proceeds of Illiquid Securities**

It is possible that a security was treated as wholly or partly non-recoverable at the time of maturity or winding up of a scheme. The security may subsequently yield a higher amount to the scheme. Treatment of such excess is as follows:

- If the amounts are substantial, and recovered within 2 years, then the amount is to be paid to the old investors
- In other cases, the amount is to be transferred to the Investor Education Fund maintained by each mutual fund

### **4.3 Due Diligence Process by AMCs for Distributors of Mutual Funds**

Asset Management Companies and the Mutual Funds are regulated by SEBI through the SEBI (Mutual Funds) Regulations, 1996. The AMCs are vested with the responsibility of regulating the practices of the distributors. As part of that process, the AMCs are required to conduct a due diligence of their distributors. SEBI has issued a circular regarding the process for carrying out such an exercise. This has been discussed section 6.2 in Chapter 6 in detail.

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<sup>21</sup> The mutual fund has to deploy unclaimed dividend and redemption amounts in the money market and in a separate plan of Liquid scheme floated by mutual funds especially for investing the unclaimed amounts. AMC can recover investment management and advisory fees on management of these unclaimed amounts, at a maximum rate of 0.50 percent per annum and there shall be no exit loads charged on this plan.

<sup>22</sup> [https://www.sebi.gov.in/legal/circulars/sep-2020/review-of-debt-and-money-market-securities-transactions-disclosure\\_47465.html](https://www.sebi.gov.in/legal/circulars/sep-2020/review-of-debt-and-money-market-securities-transactions-disclosure_47465.html) (This shall come into effect from October 1, 2020).  
[https://www.sebi.gov.in/legal/circulars/oct-2020/circular-on-review-of-provisions-regarding-valuation-of-debt-and-money-market-instruments-due-to-the-covid-19-pandemic\\_47779.html](https://www.sebi.gov.in/legal/circulars/oct-2020/circular-on-review-of-provisions-regarding-valuation-of-debt-and-money-market-instruments-due-to-the-covid-19-pandemic_47779.html)

## 4.4 Investor Grievance Redress Mechanism

In the event of any issue with the AMC or mutual fund scheme, the investor can first approach the investor service centre. If the issue is not redressed, even after taking it up at senior levels in the AMC, then the investor can write to SEBI with the complaint details.<sup>23</sup>

### SEBI Complaint Redress System

SEBI Complaint Redress System (SCORES) is a web based centralized grievance redress system of SEBI. SCORES enables investors to lodge, follow up on their complaints and track the status of redressal of such complaints online on the website (<http://scores.gov.in>). This system enables the market intermediaries and listed companies to receive the complaints from investors, redress such complaints and report redressal. All the activities starting from lodging of a complaint till its closure by SEBI is online and works in an automated environment. An investor, who is not familiar with SCORES or does not have access to SCORES, can lodge complaints in physical form at any of the offices of SEBI. Such complaints are scanned and then uploaded in SCORES for processing.<sup>24</sup>

Entities against which complaints are handled by SEBI include:

- Listed companies/registrar & transfer agents
- Brokers/stock exchanges
- Depository participants/depository
- Mutual funds
- Portfolio Managers
- Other entities (KRAs, Collective investment scheme, Merchant banker, Credit rating, Foreign portfolio investor etc.)

## 4.5 AMFI Code of Conduct for Intermediaries

### 4.5.1 AMFI Code of Ethics (ACE)

One of the objectives of the Association of Mutual Funds in India (AMFI) is to promote the investors' interest by defining and maintaining high ethical and professional standards in the mutual fund industry. The AMFI Code of Ethics (ACE) sets out the standards of good practices

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<sup>23</sup> In this context, it should be noted that the principle of *caveat emptor* (let the buyer beware) applies to mutual fund investments. So, the unit-holder cannot seek legal protection on the grounds of not being aware, especially when it comes to the provisions of law, and matters fairly and transparently stated in the Scheme Documents. Unit-holders have a right to proceed against the AMC or trustees in certain cases. However, a proposed investor i.e. someone who has not invested in the scheme does not have the same rights.

<sup>24</sup> Candidates are advised to read [https://www.sebi.gov.in/legal/circulars/aug-2020/investor-grievances-redressal-mechanism-handling-of-scores-complaints-by-stock-exchanges-and-standard-operating-procedure-for-non-redressal-of-grievances-by-listed-companies\\_47325.html](https://www.sebi.gov.in/legal/circulars/aug-2020/investor-grievances-redressal-mechanism-handling-of-scores-complaints-by-stock-exchanges-and-standard-operating-procedure-for-non-redressal-of-grievances-by-listed-companies_47325.html)

to be followed by the Asset Management Companies in their operations and in their dealings with investors, intermediaries and the public.

SEBI (Mutual Funds) Regulation, 1996 requires all Asset Management Companies and Trustees to abide by the Code of Conduct as specified in the Fifth Schedule to the Regulation. **Appendix 1** has the details. The AMFI Code has been drawn up to supplement that schedule, to encourage standards higher than those prescribed by the Regulations for the benefit of investors in the mutual fund industry. **Appendix 2** has the details.

While the SEBI Code of Conduct lays down broad principles, the AMFI Code of Ethics (ACE) sets more explicit standards for AMCs and Trustees.

#### **4.5.2 AMFI's Code of Conduct for Intermediaries of Mutual Funds**

AMFI has also framed a set of guidelines and code of conduct for intermediaries (known as AMFI Guidelines & Norms for Intermediaries (AGNI)), consisting of individual agents, brokers, distribution houses and banks engaged in selling of mutual fund products. The Code of Conduct is detailed in **Appendix 3**.

In the event of breach of the Code of Conduct by an intermediary, the following sequence of steps is initiated by AMFI:

- Write to the intermediary (enclosing copies of the complaint and other documentary evidence) and ask for an explanation within 3 weeks.
- In case explanation is not received within 3 weeks, or if the explanation is not satisfactory, AMFI will issue a warning letter indicating that any subsequent violation will result in cancellation of AMFI registration.
- If there is a proved second violation by the intermediary, the registration will be cancelled, and intimation sent to all AMCs.

The intermediary has a right of appeal to AMFI.

## **Chapter 4-Sample Questions**

- 1. Which of the following regulates mutual funds in India?**
  - a. Securities and Exchange Board of India
  - b. Association of Mutual Funds in India
  - c. Asset Management Companies
  - d. Board of Trustees of mutual funds
  
- 2. Mutual funds can buy and sell securities only on delivery basis. State whether this statement is True or False.**
  - a. True
  - b. False
  
- 3. What minimum percentage of the mutual fund scheme corpus must be invested in equity and related instruments in case of Equity Linked Savings Schemes (ELSS)?**
  - a. 65 percent
  - b. 70 percent
  - c. 80 percent
  - d. 100 percent
  
- 4. Which of the following statements is 'True' with respect to celebrity endorsement for mutual funds?**
  - a. SEBI has permitted celebrity endorsement at the industry level for the purpose of increasing the awareness of mutual funds
  - b. SEBI has permitted celebrity endorsements for promotion of individual mutual fund schemes
  - c. Celebrities can endorse only NFOs
  - d. Celebrities can endorse only on-going mutual fund schemes
  
- 5. Investors have the right to specify upto \_\_\_ nominees for their mutual fund investment folios.**
  - a. Zero
  - b. One
  - c. Two
  - d. Three

## CHAPTER 5: SCHEME RELATED INFORMATION

### LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Mandatory Documents
  - Scheme Information Document
  - Statement of Additional Information
  - Key Information Memorandum
- Non-Mandatory Documents

### 5.1 Mandatory Documents

“Mutual fund investments are subject to market risk. Please read all scheme related documents before investing.” These lines are mentioned in all mutual fund related communications. So, what are the scheme related documents?

The legal documents that provide the information that the investor requires is available in the scheme related documents (Scheme Information Document, Statement of Additional Information) and the Key Information Memorandum.

Scheme related documents can be used for taking an informed investment decision. The suitability of a mutual fund scheme to an investor depends upon the features of the scheme and matching it to the needs of the investor from the investment.

Investors need to note that their investments are governed by the principle of *caveat emptor* i.e. let the buyer beware. An investor is presumed to have read and understood the scheme related documents before investing in a mutual fund scheme. In fact, since this is a contractual arrangement, the person signing the application form has legally accepted the terms of the offer. Therefore, an investor cannot claim at a future date of being unaware of a fact that was disclosed in the scheme related documents.

There are primarily two important documents for understanding about the mutual fund scheme:

- a) **Scheme Information Document (SID)**, which has details of the particular scheme
- b) **Statement of Additional Information (SAI)**, which has statutory information about the mutual fund or AMC, that is offering the scheme.

It stands to reason that a single SAI is relevant for all the schemes offered by a mutual fund. In practice, SID and SAI are two separate documents, though the legal technicality is that SAI is part of the SID.

Both documents are prepared in the format prescribed by SEBI and submitted to SEBI. The contents need to flow in the same sequence as in the prescribed format. The mutual fund is permitted to add any other disclosure, which it feels, is 'material' for the investor.

Since investors are not sophisticated experts of finance or law, the documents are prepared in simple language, and in clear, concise and easy to understand style.

While SEBI does not approve or disapprove the Scheme Related Documents, it gives its observations. The mutual fund needs to incorporate these observations in these documents. Thus, the Documents in the market are "vetted" by SEBI, and not approved by SEBI.

Draft SID and SAI are public documents, available for viewing on SEBI's website ([www.sebi.gov.in](http://www.sebi.gov.in)). The final documents (after incorporating SEBI's observations) have to be hosted on AMFI's website ([www.amfiindia.com](http://www.amfiindia.com)) two days before the issue opens. Every mutual fund, on its website, provides for download of these documents for all its current schemes.

### ***Objective of the scheme related documents***

SID and SAI together are the primary source of information for any investor—existing as well as prospective. These are the operating documents that describe the product.

Since the investor is required to make an informed investment decision, these documents serve the purpose of providing the required information in an easy to understand language.

The units of the scheme are offered to the investor through the scheme related documents. By signing the application form and making a payment, the investor is accepting the offer, and by issuing units against such an acceptance, the mutual fund then completes the contract. Thus, the scheme related documents contain information that forms the basis of the contractual relationship between the investor and the fund.

#### **5.1.1 Scheme Information Document**

The Scheme Information Document (SID) sets forth concisely the information about the scheme that a prospective investor ought to know before investing. An SID remains effective until a 'material change' (other than a change in fundamental attributes and within the purview of the SID) occurs and thereafter changes are filed with SEBI and communicated to the investors or publicly notified by advertisements in the newspapers, subject to the applicable Regulations.

### ***Contents of Scheme Information Document (SID)***

It is essential to read and understand the SID. SID format is provided in **Appendix 4**. Refer to this appendix or download SID from the website of any mutual fund and go through the sections discussed below for a better understanding of how this document can be used to understand the features of a mutual fund scheme.

The **cover page** has the name of the scheme followed by its type viz—Open-ended/Close-ended/Interval (the scheme structure), Equity/Debt/Liquid/Hybrid etc. (the expected nature of scheme portfolio). It also mentions the face value of the Units being offered, relevant NFO dates (opening, closing, re-opening), date of SID, name of the mutual fund, and name and contact information of the AMC and trustee company. The cover page has the following standard clauses, which every investor ought to note “The particulars of the Scheme have been prepared in accordance with the Securities and Exchange Board of India (Mutual Funds) Regulations 1996, as amended till date, and filed with SEBI, along with a Due Diligence Certificate from the AMC. The units being offered for public subscription have not been approved or recommended by SEBI nor has SEBI certified the accuracy or adequacy of the Scheme Information Document”. For details refer to Appendix 4.

The Scheme Information Document is structured in the following manner:

- Table of Contents
- Highlights
- Introduction
  - Risk Factors
    - Standard
    - Scheme-specific
  - Provisions regarding minimum number of investors in the scheme
  - Any other special considerations
  - Definitions
  - Due Diligence Certificate (issued by the AMC)
- Information about the scheme
  - Name and type of the scheme
  - Investment Objectives and Policies
  - Asset Allocation Pattern
  - Where will the scheme invest?
  - Investment Strategy
  - Fundamental Attributes
  - Benchmark
  - Managers of the Scheme
  - Investment Restrictions
  - Performance track record of the scheme

- Units and Offer
- Fees & Expenses
- Rights of Unit-holders
- General Unit-holder information
- Penalties, Litigation etc.

The content of SID is discussed below in details. The following discussion looks at how the SID can be used for taking an informed investment decision. The suitability of a mutual fund to an investor depends upon the features of the scheme and matching it to the needs of the investor from the investment. The principal questions that an investor needs to find answers for and the sections of the SID where they can be found are described below.

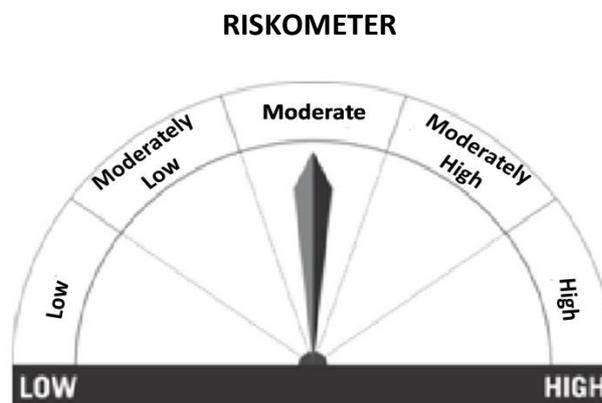
### Eligible investors

The segment on New Fund Offer (NFO) and Ongoing Offer Details in Section III, Sub-section A and B respectively of the Scheme Information Document (SID) provides a list of categories of investors eligible to invest in the scheme. The section also lists the persons who are not eligible to invest in the scheme.

### Scheme suitability

The suitability of the scheme depends upon multiple factors such as the financial need of the investor from the investment, the risk and return preferences, the investment horizon and other individual preferences. The details of the scheme that has to be matched with the investor's preferences are found in the following sections.

- (a) **The Riskometer and Statement of the suitability of the scheme** is available on the front page of the SID. To enable investors to take informed decision regarding their investments, a pictorial representation of the risk to the principal invested in a mutual fund product is depicted using a 'Riskometer'. The pictometer will categorize the risk in the scheme at one of five levels of risk, as shown in the picture below.



The above riskometer indicates that investors should understand that their principal will be at moderate risk. There is also a written statement of the risk to the principal below the 'Riskometer'.<sup>25</sup>

Level of Risk	Definition	Example of the Type of Mutual Fund
Low	Principal at low risk	Overnight Fund/Liquid Fund
Moderately Low	Principal at moderately low risk	Fixed Maturity Plans/Capital Protection Oriented Scheme
Moderate	Principal at moderate risk	Income Fund/Conservative Monthly Income Plans
Moderately High	Principal at moderately high risk	Index Fund/Exchange Traded Fund/Equity Dividend Yield Fund/ Solution oriented schemes
High	Principal of high risk	Sector Fund/Thematic Fund

(b) **The risks in the scheme** are listed in the segment on **Risk Factors in Section I, Sub-section A of the SID**. This section includes standard or general risk factors that affect all mutual fund schemes. These include risks that arise from the nature of mutual fund investments such as the possibility of volatility in the value of the units of the scheme. As value of the underlying securities in the portfolio changes, there is no guarantee or assured returns in the scheme. The sponsors are not responsible or liable for any loss arising out of the operations of the scheme beyond the contribution made by each sponsor towards setting up the scheme. The past performances are only indicative and does not guarantee the future performance of the schemes. Even specific risk factors to the mutual fund scheme are listed in this section. The specific risk factors are the risks that arise out of the type of investment the schemes will make. Investments in fixed income securities may have credit risks, interest rate and price risks, liquidity risks, pre-payment risks, reinvestment risks. Equity and equity-related securities are prone to risks of price volatility, unlisted securities have a high liquidity risk, listed securities may also be subject to liquidity risk from lower trading volumes. Investment in foreign securities, securitized instruments, derivatives and others will also have risks that are specific to those types of investments. The strategies adopted by the scheme's fund managers will also affect the risk in the scheme.

The risk mitigation strategies adopted by the fund management to control and manage the risks associated with investing in specific types of securities are described in the SID.

<sup>25</sup> Candidates are advised to read the circular 'Product Labeling in mutual funds—riskometer' dated October 5, 2020. This will come into effect from January 1, 2021. [https://www.sebi.gov.in/legal/circulars/oct-2020/circular-on-product-labeling-in-mutual-fund-schemes-risk-o-meter\\_47796.html](https://www.sebi.gov.in/legal/circulars/oct-2020/circular-on-product-labeling-in-mutual-fund-schemes-risk-o-meter_47796.html)

- (c) The **Type of Scheme** describes the nature of the scheme briefly. It categorizes the scheme as open-ended or close-ended/interval/balanced/income/equity or debt/liquid/ETF oriented. The information is available in the segment on '**Information about the Scheme**' under **Section II, Sub-section A in the SID**.
- (d) The segment on 'Information about the Scheme' under **Section II, Sub-section B** of the SID also describes the **Investment Objective** of the scheme that helps investors match their objective to that of the scheme. Schemes may also define a primary objective and a secondary objective. This description helps investors determine whether the scheme is suitable for their needs. The Investment objective is also available in the segment on Highlights/Summary of the Scheme at the beginning of the Scheme Information Document.
- (e) The segment on 'Information about the Scheme' under **Section II, Sub-section C** of the SID describes the **Asset Allocation** of the scheme, which is the proportion of the net assets of the scheme that will be invested in different asset classes such as equity, debt and others. Apart from the asset allocation, the **level of risk in each of these asset classes** is provided to help investors assess the level of risk in the scheme as also to understand the nature of returns of the scheme.
- (f) The scheme information document also describes the types of instruments that the scheme is likely to invest in. **Section II, Sub-section D** of the SID gives details of the **regulatory restrictions** on the investments that the scheme will make.
- (g) The **Investment Strategy** that will be followed by the scheme is detailed under **Section II, Sub-section E** of the SID. This section informs investor about the philosophy adopted to identify securities to be included in the portfolio, rebalancing the portfolio and approach to selling investments held. All these factors will affect the risk and suitability of the scheme to the investor. The investment management structure created in the Asset Management Company to make investment decisions is also detailed in the SID.

All these elements of the scheme help an investor decide on the suitability of the scheme.

### **Buying units of scheme from mutual fund**

The Type of Scheme will determine when the investor can invest in the scheme. If it is an open-ended scheme, then the investor can buy units of the scheme during the New Fund Offer (NFO) period and in the continuing investment period as defined in the Scheme Information Document at the applicable NAV. In case of a closed-ended scheme, the investor can buy units of the scheme from the mutual fund only during the NFO. In case of Interval

schemes the investors can buy units directly from the mutual fund at the time of the NFO and during the Specified Transaction Periods at the applicable NAV.

This information is available on the **cover page of the Scheme Information Document (SID)**. The description of the scheme as open-ended/close-ended/interval, along with a line on when the units will be offered by the mutual fund gives the information that the investor requires. **Part A and B of Segment III of the SID** which deals with the details of the **Units and Offer** also provide information about when the investor can invest in the scheme.

### **Applying for Units of a mutual fund scheme**

The information available in the Statement of Additional Information (SAI) and the Scheme Information Document (SID) have to be read together to get all the information on how to apply for the units of a scheme.

The information available in the SID under **Section III, Sub-section A and B** respectively for NFOs and Ongoing Offer read along with the information in **Section II** of the SAI provide information on who can invest, information to be provided in the application form, points at which the application can be submitted, the modes of payments for purchases made and the details to be provided for each option available for payments and restricted modes such as third party payments along with exceptions, the mandatory information to be provided such as Permanent Account Number (PAN), bank account details and compliance with Know Your Customer (KYC) norms and exceptions to the rules (if any), the cut-off time for submission of applications, facilities and modes available for transacting in the units, regulations specific for any special category of investors such as minors, NRI and PIO investors, the facilities available to investors such as holding investments in demat form, and any other information that a prospective investor may require.

### **Transactions: purchase and repurchase prices**

The information available in the SID under **Section III, Sub-section A and B** respectively for NFOs and Ongoing Offer provide the information on the price at which investors can purchase and redeem units. This price will depend upon the applicable NAV for the transaction, which in turn will depend upon the cut-off time prescribed for the particular type of scheme and the transaction value.

### **Load Structures**

The segment on load structures under **Segment IV, sub-section C** of the SID describes the impact of loads on the redemption price of units.

### **Investment limits: maximum and minimum amount an investor can invest**

The segment on **Highlights/Summary** of the scheme available at the beginning of the SID and the information available in the SID under **Section III, Sub-section A and B** respectively for NFOs and Ongoing Offer provides details of the minimum amount of purchase that has to be made and the minimum balance that has to be maintained in the folio. The minimum amount for which redemption requests have to be made is also mentioned.

### **Plans and options available under the scheme**

The segment on **Highlights/Summary** of the scheme available at the beginning of the SID and the information available in the SID under **Section III, Sub-section A and B** respectively for NFOs and Ongoing Offer provides details of the different plans, Regular and Direct, for making the investment. Each plan offers options such as dividend pay-out and growth, dividend re-investment and dividend sweep, the details of which are also provided.

### **Modes of transaction**

The segment on '**How to Apply**' found in **Segment II** of the SAI provides information on the various ways in which the investor can transact with the mutual fund. This includes transacting directly with the mutual fund either physically or via Internet, through channel distributors, electronic mode, stock exchanges and others. The information is also available under **Section III** of the SID.

### **Liquidity and Redemption in a scheme**

The segment on **Highlights/Summary** of the scheme available at the beginning of the SID provides a summary of the Liquidity in the investment in the scheme. The information available under **Section III** of the SID provides details of the price for redemption, the cut-off time for submitting the requests and how the request can be made and the modes by which the payments will be made for different categories of investors.

### **Fees, expenses, transaction charges**

**Section IV** of the SID details the different categories of expenses, fees and loads that affect the returns to the investors in the scheme. The fees are charged to the scheme and the NAV reflects the adjustment. The loads are paid by each investor out of their investment value at the time of exit. Examples provided in this section make it easier for the investor to understand the impact. Information on the transaction charges that the investor directly pays is mentioned in the segment on **Highlights/Summary** of the scheme available at the beginning of the SID.

## **Special products and facilities**

**Section III on Units and Offer** in the SID discusses special products and facilities available to the investors in the scheme such as systematic investment plans, systematic transfer plans, triggers, switch options, dividend transfer plans and such.

## **Sources of information**

The information available under **Section III** of the SID provides details of the periodic information that the mutual fund will provide to the investor on the investments held in their folio through an account statement or other communication. Apart from account specific information, **sub-section C** of the section also details the periodic disclosures that the investor can access on the current value of the units, performance of the scheme and portfolio of the scheme. The performance of the scheme and that of its benchmark is provided in **Sub-Section J** of **Section II** the SID.

## **Calculation of the scheme's Net Asset Value (NAV) per unit**

**Sub-section D** of **Section III** of the SID provides the details of computation of the NAV.

## **Tax implications**

**Section III, sub-section C** of the SID also gives the prevalent tax laws applicable to investing in mutual funds in brief.

## **Fundamental Attributes**

These are discussed in Section I of SID, sub-section F. It is important to understand the fundamental attributes (core aspects of the scheme) should be in the SID. This is explained in Box 5.1

### **Box 5.1 Fundamental Attributes**

Within the SID, there is an important section on fundamental attributes of a scheme with following parameters:

(i) Type of a scheme

- Open ended/Close ended/Interval scheme
- Sectoral Fund/Equity Fund/Balance Fund/Income Fund/Index Fund/Any other type of Fund

(ii) Investment Objective

- Main Objective - Growth/Income/Both.
- Investment pattern - The tentative Equity/Debt/Money Market portfolio break-up with minimum and maximum asset allocation, while retaining the option to alter the asset allocation for a short term period on defensive considerations.

(iii) Terms of Issue

- Liquidity provisions such as listing, repurchase, redemption.
- Aggregate fees and expenses charged to the scheme.
- Any safety net or guarantee provided.

According to 18(15A) of SEBI (Mutual Funds) Regulations, 1996, the Trustees are required to ensure that no change in the fundamental attributes of the Scheme(s) or the trust or fee and expenses payable or any other change which would modify the scheme shall be carried out unless:

- A written communication about the proposed change is sent to each Unit-holder and an advertisement is given in one English daily newspaper having nationwide circulation as well as in a newspaper published in the language of the region where the Head Office of the mutual fund is situated; and
- The Unitholders are given an option for a period of 30 days to exit at the prevailing Net Asset Value without any exit load.

### 5.1.2 Statement of Additional Information

Statement of Additional Information (SAI), has statutory information about the mutual fund or AMC, that is offering the scheme. Therefore, a single SAI is relevant for all the schemes offered by a mutual fund.

#### ***Content of Statement of Additional Information***

Every mutual fund, on its website, provides for download of its SAI. However, investors have a right to ask for a printed copy of the SAI. Through AMFI website ([www.amfiindia.com](http://www.amfiindia.com)), investors can access the SAI of all the mutual funds. The prescribed SAI format is in **Appendix 5**. Refer to this appendix or download SAI from the website of any mutual fund and go through the sections discussed below for a better understanding of how these documents can be used to understand the features of a mutual fund scheme.

<b>Content of SAI</b>	<b>Description of Content</b>
<b>Constituents of the mutual fund</b>	<p><b>Section I of the SAI</b> gives complete details of the constituents of the mutual fund--Sponsors, AMC and Trustee Company, of service providers {Custodian, Registrar &amp; Transfer Agent, Statutory Auditor, Fund Accountant (if outsourced) and Collecting Bankers}.</p> <p>This includes their experience, condensed financial information (for schemes launched in last 3 financial years), key personnel, rights and obligations and other information the investor may require to evaluate the investment.</p>
<b>How to Apply</b>	<p><b>Section II of the SAI</b> provides guidance on how to apply.</p>
<b>Rights of Unit-holders</b>	<p>The information is available in <b>Section III of the SAI</b>. It details the rights to beneficial ownership of the assets of the scheme, timelines for servicing investor applications and acknowledgements, right to receive information and disclosures and to exercise the option to exit in the event of changes in the scheme, and other rights of investors.</p>

<b>Content of SAI</b>	<b>Description of Content</b>
<b>Investment Valuation Norms</b>	<b>Section IV</b> of the <b>SAI</b> provides the details of the regulatory specifications on how different securities in the portfolio will be valued. The rules for valuation are standardized by the regulator, SEBI.
<b>Tax, Legal &amp; General Information</b>	<b>Section V</b> of the SAI provides information on legal aspects of the investment that deal with nominations, transfer and transmission of units, investment by minors, pledge/lien on units and others. Also, this section provides details regarding taxation and other general information.
<b>Investor Grievance</b>	<b>Sub-section C of Section V of the SAI</b> provides details of how the investor can register a grievance.

### 5.1.3 Key Information Memorandum

While an investor is expected to read all the scheme related documents, circulation of the same along with the application forms is too difficult and costly, especially if the printed forms are to be distributed. In order to ensure the investor gets access to sufficient information in spite of such a constraint, a Key Information Memorandum (KIM) is mandatorily circulated along with the application form.

KIM is essentially a summary of the SID and SAI. It contains the key points of these documents that are essential for the investor to know to make a decision on the suitability of the investment for their needs. It is more easily and widely distributed in the market. As per SEBI regulations, every application form is to be accompanied by the KIM.

The prescribed KIM format is provided in **Appendix 6**. Refer to this appendix or download KIM from the website of any mutual fund and go through the sections discussed below for a better understanding of how these documents can be used to understand the features of a mutual fund scheme.

Some of the key items contained in the KIM are as follows:

- Name of the AMC, mutual fund, Trustee, Fund Manager and scheme
- Dates of Issue Opening, Issue Closing and Re-opening for Sale and Re-purchase
- Investment Objective
- Asset allocation pattern of the scheme

- Risk profile of the scheme i.e. a snapshot of the risk to the principal invested, the suitable investment horizon for investment and the type of securities that the scheme will invest in.
- Plans and Options
- Benchmark Index
- Dividend Policy
- Performance of scheme and benchmark over last 1 year, 3 years, 5 years and since inception.
- Expenses of the scheme
- Information regarding registration of investor grievances

#### **5.1.4 Addendum**

While the SID, SAI and KIM need to be updated periodically, the interim changes are updated through the issuance of such addendum. The addendum is considered to be a part of the scheme related documents, and must accompany the KIM.

#### ***5.1.5 Updation of Scheme Documents—Regulatory provisions***

##### ***Updation of SID***

If a scheme is launched in the first 6 months of the financial year (say, May 2019), then the first update of the SID is due within 3 months of the end of the financial year (i.e. by June 2020). If a scheme is launched in the second 6 months of the financial year (say, December 2019), then the first update of the SID is due within 3 months of the end of the next financial year (i.e. by June 2021). Thereafter, SID is to be updated every year.

At the same time, in case of change in the fundamental attributes, the SID has to be updated immediately after the lapse of the time period given to existing investors to exit the scheme.

In case of any other change:

- It will be printed on a separate piece of paper (addendum) and distributed along with the SID, until the SID is updated.
- If a change is superseded by a further change (for instance, change in load), then addenda are not required for the superseded change i.e. addenda is only required to disclose the latest position.
- The change is to be advertised in an English newspaper having nation-wide circulation, and in a newspaper of the language of the region where the head office of the mutual fund is located.
- The change is to be mentioned in the website of the mutual fund.

### ***Updation of SAI***

- Regular update has to be done by the end of 3 months of every financial year. Material changes have to be updated on an ongoing basis and uploaded on the websites of the mutual fund and AMFI.

### ***Updation of KIM***

- KIM is to be updated at least once a year. As in the case of SID, KIM is to be revised in the case of change in fundamental attributes.

### **5.1.6 Other Mandatory information/disclosure**

While the scheme information documents provide mandatory information that help a prospective investor to make informed investment decision, the existing investors in a mutual fund scheme also need to track the progress of their investments.

There are two key disclosures that an investor should receive for that purpose, viz., the current value of one's investments, and information about where the scheme has invested.

The current value of investments is a function of the number of units in an investor's account and the NAV per unit. In order to get the current value of the investments, one has to multiply the number of units with the NAV.

$\text{Current value of investments} = \text{Unit balance in the investor's account} \times \text{current NAV}$
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This means that an investor should be able to regularly know the NAV. The unit balance can be seen from the latest account statement that one would have got. Chapter 9 has a detailed discussion on when and how an investor gets the account statement.

### ***Disclosure of Daily NAV***

Each scheme's NAV is required to be disclosed at the end of each business day. The same is published on the website of the AMC. The Mutual Fund declares the Net Asset Value of the scheme on every business day on AMFI's website [www.amfiindia.com](http://www.amfiindia.com) (as per the time limit for uploading NAV defined in the applicable guidelines) and also on their website.<sup>26</sup>

In case of open ended schemes, the NAV is calculated for all business days and released to the Press. In case of closed ended schemes, the NAV is calculated at least once a week.

With the availability of historical NAV, an investor should also be able to calculate how a scheme has performed over whatever period one wants to check for.

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<sup>26</sup> In order to enable consideration of all trades during a day for valuation, it has been decided to extend the present timeline upto 11.00 p.m. for uploading the NAVs of all schemes (except of fund of fund) on the website of AMFI and respective AMCs. (Vide SEBI Circular dated September 24, 2019).

## Disclosure of Total Expense Ratio

One of the important factors that impacts the scheme's NAV is the Total Expense Ratio (TER), charged to the scheme. Though, the same is very tightly regulated through SEBI regulations, the investor should know about the scheme expense ratio. SEBI has mandated that the Asset Management Companies (AMCs) should prominently disclose on a daily basis, the Total expense ratio (scheme-wise, date-wise) of all schemes under a separate head – "Total Expense Ratio of Mutual Fund Schemes" on their website. The same must also be published on AMFI website. The AMCs are also required to send the update to the investors through email whenever there is a change in the expense ratio. The format of disclosure of TER of mutual fund schemes is exhibited below in Table 5.1.<sup>27</sup>

**Table 5.1 Total Expense Ratio (TER) for Mutual Fund Scheme**

Name of Scheme : XYZ										
Date (DD/MM/ YYYY)	Regular Plan					Direct Plan				
	Base TER (%)	Additional expense as per Regulation 52(6A)(b) (%) of Mutual Funds	Additional expense as per Regulation 52(6A)(c) (%) of Mutual Funds	GST (%)	Total TER (%)	Base TER (%)	Additional expense as per Regulation 52(6A)(b) (%) of Mutual Funds	Additional expense as per Regulation5 2(6A)(c) (%) of Mutual Funds	GST (%)	Total TER (%)
01/03/20 19										
02/03/20 19										
03/03/20 19										
...										
...										

Any change in the base TER (i.e. TER excluding additional expenses provided in Regulation 52(6A)(b), 52(6A)(c) of SEBI (Mutual Funds) Regulations, 1996 and Goods and Services Tax on investment and advisory fees) in comparison to the previous base TER charged to any scheme/plan has to be communicated to investors of the scheme/plan through notice via email or SMS at least 3 working days prior to effecting such change. Further, the notice of change in base TER should be updated on the AMC website at least 3 working days prior to effecting such change. A decrease in TER should be immediately communicated to investors of the scheme through email or SMS and uploaded on the website.

<sup>27</sup> [https://www.sebi.gov.in/legal/circulars/jun-2018/total-expense-ratio-for-mutual-funds\\_39187.html](https://www.sebi.gov.in/legal/circulars/jun-2018/total-expense-ratio-for-mutual-funds_39187.html)  
[https://www.sebi.gov.in/legal/circulars/oct-2018/total-expense-ratio-ter-and-performance-disclosure-for-mutual-funds\\_40766.html](https://www.sebi.gov.in/legal/circulars/oct-2018/total-expense-ratio-ter-and-performance-disclosure-for-mutual-funds_40766.html)

### **Scheme-wise dashboard on mutual fund website**

Each AMC is also required to publish a scheme performance dashboard on the website, and update it on a regular basis. The dashboard highlights how various schemes of the mutual fund have performed over various holding periods. The scheme performance data is also available on AMFI website.<sup>28</sup>

Most AMCs allow this dashboard to be downloaded in a tabular form. This contains the following information about the schemes of the mutual fund:

- Scheme name
- Scheme classification and category: For example, Equity multi-cap scheme; or Solution oriented scheme–retirement fund
- Type of scheme: Open-ended or close-ended
- Investment objective of the scheme
- Name of the fund manager
- Benchmark index (including additional benchmark, if any)
- Exit load and lock-in period (if any)
- Plans and options: For example, direct and regular plans; dividend and growth options, etc.
- Minimum investment amount
- Month-end AUM
- TER
- Scheme inception date
- Month-end portfolio
- Scheme performance

Such a dashboard allows an investor to make an easy comparison of schemes across the mutual fund.

### ***Portfolio disclosure***

This is a list of securities where the corpus of the scheme is currently invested. The market value of these investments is also stated in portfolio disclosures. Unitholders, whose email address is registered with the fund, in those cases, the AMCs shall send half yearly portfolio via email within 10 days from the end of each half year. The half yearly portfolio of the schemes is available on the AMFI's website and website of AMC on or before the 10th day of

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<sup>28</sup> <https://www.amfiindia.com/research-information/other-data/mf-scheme-performance-details>

succeeding month. The advertisement for the same is required to be published by the fund in all India edition of at least two daily newspapers, one each in English and Hindi.<sup>29</sup>

### ***Financial results***

The mutual fund shall before the expiry of one month from the close of each half year, (Mar 31<sup>st</sup> and Sep 30<sup>th</sup>) shall display the unaudited financial results on AMC website, the advertisement in this reference will be published by the fund in at least one English daily newspaper having nationwide circulation and in a newspaper having wide circulation published in the language of the region where the head office of fund is situated.

### ***Annual reports and related disclosures***

Annual report or abridged summary is required to be hosted on AMCs website and on the website of AMFI. This is sent by email to the investors who have registered their email id with the fund, no later than four months from the date of closure of the relevant financial year i.e. March 31 each year. Investors' who have not registered their email-id have an option of receiving a physical copy of the Annual report or Abridged summary thereof. The advertisement in this reference is required to be published by the mutual fund in all India edition of at least two daily newspapers, one each in English and Hindi.

## **5.2 Non-Mandatory Disclosures**

### ***Fund Factsheet***

One of the most popular document from the mutual fund is the monthly Fund Factsheet. This document is extensively used by investors, fund distributors, fund rating agencies, research analysts, media and others to access information about the various schemes of the mutual fund. While it is not a regulatory requirement to publish the monthly fact sheet, it is a market practice followed by all the fund houses, on a voluntary basis. Since fund factsheet is a marketing and information document, various SEBI regulations pertaining to information disclosure are applicable to it.

The fund factsheet contains the basic information of each scheme such as the inception date, corpus size (AUM), current NAV, benchmark and a pictorial depiction of the fund's style of managing the fund. The fund's performance relative to the benchmark is provided for the different periods along with the benchmark returns, as required by SEBI's regulations. The factsheet also provides the SIP returns in the scheme, portfolio allocation to different sectors

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<sup>29</sup> Mutual funds now have to disclose details of debt and money market securities transactions, including inter-scheme transfers, on a daily basis with a time lag of 15 days. Earlier, fund houses were required to disclose such transactions with a time lag of 30 days. SEBI has prescribed a new format for such disclosures. In this format, fund houses will have to mention the name of the security, type of security, most conservative rating of security at the time of transaction, name of the rating agency and transaction type. This is to enhance transparency in debt funds. This is effective from October 1, 2020. Candidates are advised to read: [https://www.sebi.gov.in/legal/circulars/sep-2020/review-of-debt-and-money-market-securities-transactions-disclosure\\_47465.html](https://www.sebi.gov.in/legal/circulars/sep-2020/review-of-debt-and-money-market-securities-transactions-disclosure_47465.html)

and securities. However, some fund houses do not disclose the entire portfolio but only the top 10 holdings.

In the factsheet, security wise as well as sector wise allocation is provided for equity schemes. Some factsheets also disclose the derivatives exposure taken by the mutual fund schemes. In the debt funds, the factsheet discloses the rating profile of the various securities, and a snapshot of exposure of the scheme to various rating baskets.

Portfolio features such as the price-earnings ratio (PE), Beta and other risk measures such as standard deviation and Sharpe ratio (in case of equity funds), credit rating profile, average maturity and duration (in case of debt funds) are also available in the factsheet. The factsheet also provides investment details such as the minimum investment amount, the plans and options available in the scheme, the loads and expenses and systematic transaction facilities available in the fund.

## **Chapter 5: Sample Questions**

- 1. “Please read the scheme related documents carefully” – which documents does this line refer to?**
  - a. Scheme Information Document and audited balance sheet of the Asset Management Company
  - b. Trust deed and Key Information Memorandum
  - c. Statement of Additional Information and fund fact sheet
  - d. Scheme Information Document and Statement of Additional Information
  
- 2. Which of the following statements is ‘TRUE’ with respect to the Scheme Information Document (SID) and Statement of Additional Information (SAI)?**
  - a. These two documents are prepared in the format prescribed by Association of Mutual Funds in India as part of AMFI’s Code of Conduct
  - b. These two documents are prepared in the format prescribed by Association of Mutual Funds in India as part of AMFI’s Best Practices Circular
  - c. These two documents are prepared in the format prescribed by Securities and Exchange Board of India
  - d. Each Asset Management Company is free to prepare these documents in the format they desire
  
- 3. How often should the Key Information Memorandum (KIM) be updated?**
  - a. At least once a month
  - b. At least once every six months
  - c. At least once a year
  - d. It need not be updated after it is issued once
  
- 4. As per the SEBI guidelines, how often should the mutual fund scheme’s portfolio be published?**
  - a. Monthly
  - b. Half-yearly
  - c. Annually
  - d. Never
  
- 5. Which among the following is not a statutory document?**
  - a. Fund factsheet
  - b. Statement of Additional Information
  - c. Scheme Information Document
  - d. Key Information Memorandum

## CHAPTER 6: FUND DISTRIBUTION AND CHANNEL MANAGEMENT PRACTICES

### Learning Objectives:

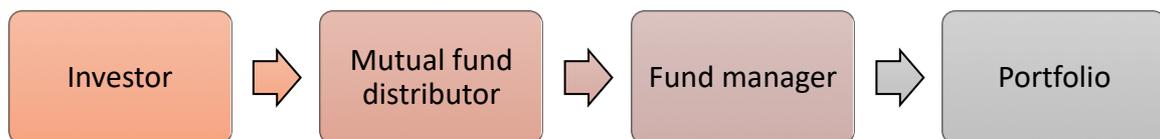
After studying this chapter, you should know about:

- Role and importance of mutual fund distributors
- Different kinds of mutual fund distributors
- Modes of distribution
- Pre-requisites to become a mutual fund distributor
- Revenue of a mutual fund distributor
- Commission disclosure mandated by SEBI
- Due Diligence Process by AMCs for Distributors of Mutual Funds
- Nomination facilities for mutual fund distributors
- Change of distributors

### 6.1 The role and importance of mutual fund distributors

An investor needs to invest the money in a portfolio of various investment options to achieve financial goals. This process of building a portfolio could be achieved with the help of selection of a basket of mutual fund schemes. However, one may still need help in constructing a portfolio with the help of an expert. This expert could be a mutual fund distributor.

**Chart 6.1: Mutual Fund Investors, professionals and portfolio**



In Chart 6.1, two professionals have been shown between the investor and her investment portfolio, viz., a mutual fund distributor, and a fund manager. This fund manager could be a mutual fund manager managing a mutual fund portfolio in line with the scheme's investment objectives, as discussed earlier.

The fund manager analyses various inputs and data points including the company specific or industry specific information, and economy wide factors. The analysis may include about liquidity aspects in the market, and the mood of the market participants. After such a detailed

analysis, the fund manager constructs a portfolio of securities in line with the stated objective of the mutual fund scheme.

On the other hand, the mutual fund distributor's job is to assess the needs, limitations, resources and financial goals of the investor. This analysis would help the mutual fund distributor arrive at a suitable asset allocation plan for the investor. Armed with this, the distributor then goes on to identify mutual fund schemes, which are appropriate for the investor in the given situation.

Look at this in another way, the mutual fund distributor analyses the situation of the investor; whereas the fund manager analyses the market factors. Both the professionals play important roles in helping the investor achieve one's financial goals.

With that background look at various categories of mutual fund distributors.

## **6.2 Different kinds of mutual fund distributors**

Mutual funds are distributed in India to the investors through multiple channels, viz., individual mutual fund distributors, bank branches, national distributors through their branches or their sub-agents, post offices, and directly by the AMCs. While the category of distributors is also varied, the platforms used are also many. Funds may be distributed through the traditional method of using paper-based application forms, or through electronic platforms such as the websites, mobile phones and the stock exchanges.

Let us first look at the different categories and their characteristics.

### **6.2.1 Individual players**

India has a long history of distribution of financial products through individuals. Both Life Insurance Corporation of India Ltd (LIC), and Unit Trust of India (UTI) depended on a huge force of individual agents. While the two institutions made various products and solutions available, the agency force (i.e. individual agents) ensured these products reached the households. These same agents also distributed the small savings products, and to that extent, they played a huge role in bringing household savings into financial products.

Almost all of them operated as individuals, and single-handedly, without any staff or skeleton staff, mainly to handle the paperwork. Even today, this is a very large part of the distribution link between the asset management companies and the investors. Quite a few new mutual fund distributors start their business this way – single-handedly, as individuals.

Later, some of them expand and grow into larger entities. While the former is known as the "individual" channel, the rest can be called the "non-individual" channel.

The traditional non-institutional channels operate through different business models. These could be as under:

- Through their own branch offices and employees
- Through a network of sub-agents

### **6.2.2 Non-individual entities**

Non-individual entities include partnerships, regional distributors, national distributors, NBFCs, banks, stock brokers, etc. Out of these, the distribution companies and banks are sometimes referred as institutional distributors.

In both the cases, the investor is serviced by an individual—be it an employee of the firm or a sub-agent. However, the difference lies in the operations of the firm and its cost structure—the former incurs fixed expenses of running the large operations, whereas the latter have higher variable costs. The employees earn through salary, whereas the sub-agents earn commission, which is linked to the business generated.

Within the non-individual distributors, there are different business models.

#### ***Banks***

**Banks** have emerged as a prominent channel for distribution of mutual fund products to their account holders. Within the banking structure, the multinational banks were the first to enter the business of mutual fund distribution. The private sector banks and the public-sector banks entered the business much later. Nowadays, even some co-operative banks are also distributing mutual funds. Banks employ different business units catering to different client segments, viz., retail banking and wealth management or priority banking or private banking. The categorization is based on the wealth of the clients or the surplus available for investment in financial assets.

Mutual funds have built relationships with PSU banks that have a wide reach in non-urban centres to distribute mutual fund products through them. Also, private and foreign banks actively participate in the distribution process of mutual fund products.

Many others like stock brokers and NBFC also use a similar classification between retail clients and wealthy clients. While some **NBFCs and stock brokers** reach out to service their clients through their own employees, some have empanelled sub-agents. One may also call it an agency channel. These sub-agents are not employees of the firm, but purely work as an extended distribution arm.

While the banks and NBFCs may operate at a national level, there could be some other firms that only distribute financial products. Some of these firms may have national presence, while

some others may operate within a region. These are often referred as **national distributors or regional distributors** in the mutual fund industry.

Some new players have entered the fray of late. These are the e-commerce platforms and few other online distributors that also distribute mutual fund schemes. These players operate through the internet without having physical office for the clients to visit.

### **6.3 Modes of distribution**

Traditionally, not just mutual funds, but all financial products were distributed through the use of application forms printed on paper. This process involved carrying physical forms to the client's place and then depositing those forms at the respective official points of acceptance (OPOAs). With the advent of internet and mobile phones, the distribution channel shifted to the digital mode. Of late, the balance is shifting towards digital transactions, though the physical paper-based transactions continue in a significant way.

Many distributors, and their investors still prefer the paper mode, whereas the new age Internet based businesses, viz. e-commerce platforms, and online distributors operate entirely through the digital mode.

On the other hand, there are a few that employ a hybrid mode, where some transactions take place digitally, some others happen physically.

The different models of online distribution are discussed below.

#### **6.3.1 Online Channel Partners**

The advent of internet has changed the way business is conducted in many industries, and mutual fund distribution is no different. The distributors are able to expand their business beyond geographical boundaries. Investors, also prefer to transact through the internet, rather than the cumbersome paper work and dependence on distributor. A few distributors offer transaction support through their own websites.

#### **6.3.2 Stock Exchange Platforms**

SEBI has facilitated buying and selling of the units of open-ended mutual funds through the stock exchanges. Exchanges have developed mutual fund transaction engines for the purpose. The low cost and deeper reach of the stock exchange network enables increased level of participation of retail investors in mutual funds. AMCs are required to list the units of close-ended and interval schemes on a stock exchange and the units of ETFs are also bought and sold in the stock exchange.

Both National Stock Exchange (NSE) and Bombay Stock Exchange (BSE) have extended their trading platforms to help the stock exchange brokers become a channel for investors to

transact in Mutual Fund units. NSE's platform is called NMF II Platform. BSE's platform is BSE StAR Mutual Funds Platform.

NMF II platform of NSE has two versions one for trading members and one for distributors. All trading members of the stock exchange who have registered with AMFI as Mutual Fund Distributor and have signed up with the respective mutual fund can offer transactions through this facility to their investors. The units can also be transacted on these platforms through clearing members of the stock exchange. Depository participants can process redemption requests only. The list of eligible schemes for transaction on these platforms are notified by the respective mutual funds. These eligible schemes are not listed on the stock exchange. Similarly, distributors having valid AMFI registration can seek limited purpose membership of the Exchange to transact in Mutual Fund units only.

The stock exchanges only offer a transaction platform, but they do not replace the RTAs. Since this is essentially an order routing system between the investors and the AMC, the exchanges do not offer settlement guarantee. Responsibility for settlement is with the AMC. However, the normal stock exchange redressal mechanism would be available to address any investor complaints.

SEBI vide its circular dated February 26, 2020, has allowed the investors to directly access the infrastructure of stock exchanges to purchase and redeem mutual fund units directly from the mutual fund/asset management companies.

### **6.3.3 MF Utilities**

MF Utilities (MFU) is a transaction aggregating platform that connects investors, RTAs, distributors, banks, AMCs and others. MFU facilitates the distributors with online access to submit investor transactions. This platform provides them with a single point for time-stamping of transactions, document submission, paperless transaction facility, and login facility for their clients.

Investors who register on the MFU are allotted a Common Account Number (CAN) under which all their mutual fund holdings are consolidated. Investors have to be KYC compliant to register for a CAN. If an investor is not already KYC compliant, then the MFU will facilitate KYC registration along with the allotment of 'CAN'.

The MFU offers a Common Transaction Form to transact in multiple schemes across participating mutual funds using a single form. The form can be submitted through a mutual fund distributor or to neutral Points of Service (PoS) and others irrespective of the RTA servicing the mutual fund. MFU offers multiple modes of payments for investment through physical and electronic means. MFU allows a single payment for multiple subscriptions made

under a single form. The existing mutual fund holding is mapped to the CAN based on PAN, holding pattern and other parameters. Investors may have multiple CANs based on combination of holdings and mode of holding. Investors can also request online access through which they can submit transactions, view holdings and lodge and track complaints. The bank and nomination details provided to the MFU at the time of registering for the CAN will override the information provided in the folios.

### **6.3.4 Computer-based and Mobile-based Apps offered by distributors**

Apart from the above platforms and the websites of distributors, the transaction facilities are now available on the mobile devices – the smart phones, feature phones, and tablet computers. This makes it even more convenient than going to a website.

### **6.3.5 Electronic platforms created by the AMCs**

Apart from the above, various AMCs have also created their own facilities like web-based and mobile-based applications that facilitate various transactions. Many AMCs also offer transaction facilities through SMS and WhatsApp.

## **6.4 Pre-requisites to become Distributor of a Mutual Fund**

An Asset Management Company may appoint an individual, bank, non-banking finance company or distribution company as a distributor. SEBI has mandated mutual fund distributors, agents or any persons employed or to be employed in the sale and/or distribution of mutual fund products, to have a valid certification from the National Institute of Securities Markets (NISM) by passing NISM Series-V-A: Mutual Fund Distributors Certification Examination.

In order to be eligible to sell or market mutual funds, the following are compulsory:

- **Obtaining NISM Certification**
  - The individual needs to pass the NISM certification examination mandated by SEBI.
  - For persons who have attained the age of 50 years or who have at least 10 years of experience in the securities markets in the sale and/ or distribution of mutual fund products as on May 31, 2010, can obtain the certification either by passing the NISM certification examination **or** qualifying for Continuing Professional Education (CPE) by obtaining such classroom credits as may be specified by NISM from time to time.<sup>30</sup>

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<sup>30</sup> SEBI Gazette Notification Ref. No. LAD-NRO/GN/2010-11/09/6422 dated May 31, 2010.  
<http://www.nism.ac.in/nism18042016/index.php/circulars/173-sebi-notification-on-nism-series-v-a-mutual-fund-distributors-dated-may-31-2010>

- **Know Your Distributor Requirements**

As part of SEBI's drive to streamline the distribution process of mutual fund products, AMFI has introduced the KYD process to verify the correctness of the information provided in the registration documents and to have verification of the ARN holders.<sup>31</sup>

The process consists of document verification and bio-metric process.

- **Self-attested copy** of the PAN card and specific documents as proof of address to be submitted along with application form at the CAMS-PoS (Computer Age Management Services-Points of Service). The original documents have to be presented for verification.
- **Bio-metric process** consists of taking the impression of the index finger of the right hand of the ARN holder. This is done at the PoS at the time of submission of documents (both for new registrations and renewal of ARN). In case of non-individual distributors, bio-metric process will be conducted on specified authorized persons.
- An acknowledgement confirming the completion of KYD process is received from the CAMS-PoS.
- The existing ARN holders have to send the photocopy of the acknowledgement to all the AMCs with whom they are empanelled.

- **Obtaining AMFI Registration Number**

After obtaining the certification and completing KYD requirements, the next stage is to register with AMFI. On registration, AMFI allots an AMFI Registration Number (ARN). Individuals from the exempted category (i.e. who have attained the age of 50 years or have at least 10 years of experience as of May 31, 2010) can obtain the ARN without passing the certifying examination, provided they have attended the prescribed CPE program.

- **Empanelment with AMCs**

Armed with the ARN No., the distributor/stock exchange broker can get empanelled with any number of AMCs. Alternatively, they can become agents of a distributor who is already empanelled with AMCs. Empanelment with the AMC or enrolment as an agent

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<sup>31</sup> The new cadre of distributors are not required to comply with KYD/ bio-metrics requirements. However, they are required to submit self-attested copies of identity proof (photo PAN card of individual applicants/ in case of Proprietary concern, PAN card of the Proprietary Concern (if available) or Photo PAN Card of the Proprietor) and address proof, as mentioned in KYD application form.

of an empanelled distributor is compulsory to be able to sell mutual fund schemes and earn the commissions.

Institutions that are into distribution of mutual funds need to register with AMFI. The employees of these institutions need to clear the NISM Series V-A: Mutual Fund Distributors Certification Examination and obtain an Employee Unique Identification Number (EUIN) from AMFI. The Intermediaries have to ensure that the employees quote the EUIN in the Application Form for their client's investments. There is no separate ARN required for these employees, since they operate under the ARN of the institution that they are working for.

#### **6.4.1 Procedure for getting empanelled as a mutual fund distributor with AMC**

Empanelment with an AMC is a simple process. There is a Request for Empanelment Form to be filled-in. This provides for basic details, such as:

- Personal information of applicant—Name of person, Age, Trade Name, Contact Information, ARN, PAN, Income tax category (such as Resident Individual, Company, Non-Resident Indian, Foreign Company).
- Names and contact information of key people handling sales and operations.
- Business details, such as office area, number of branches, number of employees, geographical area covered, years of experience, number of investors, number of agents, fund houses already empanelled in, size of AUM etc..
- Bank details and preferences regarding Direct Credit of brokerage in the bank account.
- Preferences regarding receiving information from the AMC.
- Nominee
- The applicant also needs to sign a declaration, which provides for the following:
  - Correctness and completeness of information provided
  - Commitment to keep all the transactional information confidential
  - Commitment to abide by instructions given, as also statutory codes, guidelines and circulars
  - Not to issue advertisement or publicity material other than that provided by the AMC or pre-approved by the AMC
  - Ensure that the risk factors are mentioned along with performance and other related information
  - Provide all the information and documents that the AMC may ask for from time to time
  - Ensure that all employees who are engaged in selling or marketing of mutual funds have an EUIN.
  - Undertake not to rebate commission back to investors, or attract investors through temptation of rebate/gifts, pass back of commission etc.
  - Power to the AMC to terminate the empanelment at any time

- Some AMCs directly empanel only distributors who are likely to generate adequate business – and request others to work under one or the other empanelled distributors.
- At times, AMCs link the levels of commission to the volumes generated. In such cases, an agent might find it beneficial to work under an established distributor.

While many of the above clauses would be included in the application forms, there is no standard format, and each asset management company use their own format for collecting such details, as well as for empanelment of distributors.

## **6.5 Revenue for a mutual fund distributor**

The mutual fund distributor earns revenue in the form of commission income for distribution of the mutual fund products/schemes. The commission may be linked to either the transaction or to the assets under management. Both these models have been explained below.

When an individual transacts on the stock exchange through a stock broker to buy or sell a stock, the individual pays brokerage commission to the broker. This is an example of transaction linked commission. On the other hand, the income to the Asset Management Company accrues in the form of a percentage to the assets under management. In other words, the transaction-based commission accrues at the time of a transaction, whereas the AUM-linked commission is payable on an on-going basis, so long as the investor remains invested. As is evident, the transaction-based payment would largely be paid in one shot, the AUM-linked commission would be payable over a period, and hence the commission would be payable periodically. At the same time, there could be some arrangements wherein the AUM-based commission is upfronted, which means the expected future AUM-based commission for a certain period may be paid upfront at the time of purchase.

The mutual fund distributor could earn income in both ways in the earlier days. However, now the only way a distributor can earn commission income is in the form of trail commission, which is payable as a percentage of assets under management. As per SEBI circular dated October 2018, AMCs shall adopt full trail model of commission in all schemes, without payment of any upfront commission or upfronting of any trail commission, directly or indirectly, in cash or kind, through sponsorships, or any other route.

However, upfronting of trail commission is allowed only in case of inflows through Systematic Investment Plans (SIPs) of upto Rs. 3,000 per month for an investor investing in mutual fund schemes for the first time. If an investor starts multiple SIPs, the upfront commission can be paid only in case of the SIP starting on the earliest date. In respect of inflows through SIPs, a

carve out has been considered for new investors to the mutual fund industry<sup>32</sup>. This carve out means upfronting of trail commission (payment of expected future trail commission upfront at the time of the transaction), based on SIP inflows, shall be upto 1 percent payable yearly in advance for a maximum period of three years. The need for 'carve out' would be reviewed by SEBI as and when required and in case of misuse of the carve out for SIPs, the same would be discontinued and appropriate action would be taken against the errant participants.

The following carve out to be implemented by the AMCs:

- The upfronting of trail commission is applicable for SIP of up to Rs. 3000 per month, per scheme, for an investor who is investing for the first time in Mutual Fund schemes.
- For a new investor, as identified above, only the first SIP(s) purchased by the investor shall be eligible for upfronting. In this regard, if multiple SIP(s) are purchased on different dates, the SIP(s) in respect of which the installment starts on the earliest date shall be considered for upfronting.
- The upfront trail commission to be paid from AMC's books.
- The said commission to be amortized on daily basis to the scheme over the period for which the payment has been made. A complete audit trail of upfronting of trail commissions from the AMC's books and amortization of the same to scheme(s) thereafter to be made available for inspection.
- The said commission will be charged to the scheme as 'commissions' and should also account for computing the TER differential between regular and direct plans in each scheme.
- The commission paid to be recovered on pro-rata basis from the distributors, if the SIP is not continued for the period for which the commission is paid.

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<sup>32</sup> SEBI circular no. SEBI/HO/IMD/DF2/CIR/P/2018/137 dated October 22, 2018 and Vide SEBI Circular No.: SEBI/HO/IMD/DF2/CIR/P/2019/42 on Review on Commission, Expenses, Disclosure norms etc. - Mutual Fund dated March 25, 2019.

### 6.5.1 Concept of Trail Commission

**Trail commission** is calculated as a percentage of the net assets attributable to the Units sold by the distributor. The commission payable is calculated on the daily balances and paid out periodically to the distributor as per the agreement entered into with AMC.

The trail commission is normally paid by the AMC on a quarterly basis or monthly basis. Since it is calculated on net assets, distributors benefit from increase in net assets arising out of valuation gains in the market.

For example, suppose an investor has bought 1000 units at Rs. 10 each. The distributor who procured the investment may have been paid an initial commission calculated as a percentage on 1000 units X Rs. 10 i.e. Rs 10,000.

Later, suppose the NAV of the scheme goes up to Rs.15. Trail commission is payable on 1000 units \* Rs 15 i.e. Rs 15,000 – not the Rs 10,000 mobilised. In short, trail commission depends on the NAV.

Further, unlike products like insurance, where agent commission is paid for a limited number of years, a mutual fund distributor is paid trail commission for as long as the investor's money is held in the fund.

Such indexing of agent commissions to the current value of the investment, and the absence of a time limitation to earning it, are unique benefits that make it attractive for distributors to sell mutual funds.

Let us take an example here. A distributor mobilised a sum of Rs. 10 lakh on a particular day when the scheme's NAV was Rs. 10.0000. The total units allotted were 1,00,000.

In this case (Rs. 10,00,000 / Rs. 10.0000). We have assumed a trail commission rate of 1% p.a. in this case. Given below is the table showing calculation of trail commission for the month of July 2019. (All NAVs are randomly generated, and not of any actual scheme).<sup>33</sup>

No. of units allotted = 1,00,000 at NAV of Rs. 10.0000

Trail Commission is 1 percent of Value i.e. Rs.10,00,000 and subsequently as the NAV changes, the value changes.

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<sup>33</sup> This is taken only for the purpose of the calculation and in no way is any indication of the trail commission payable.

**Table 6.1 Calculation of trail commission for distributors**

<b>Date</b>	<b>NAV (A)</b>	<b>Value (B)</b>	<b>Trail commission (B*1%/365)</b>
01-Aug-19	10.0000	10,00,000.00	27.40
02-Aug-19	10.0270	10,02,698.66	27.47
03-Aug-19	10.0270	10,02,698.66	27.47
04-Aug-19	10.0270	10,02,698.66	27.47
05-Aug-19	9.9140	9,91,396.69	27.16
06-Aug-19	9.9888	9,98,879.74	27.37
07-Aug-19	9.9114	9,91,144.38	27.15
08-Aug-19	10.0835	10,08,348.30	27.63
09-Aug-19	10.1522	10,15,224.62	27.81
10-Aug-19	10.1522	10,15,224.62	27.81
11-Aug-19	10.1522	10,15,224.62	27.81
12-Aug-19	10.1522	10,15,224.62	27.81
13-Aug-19	9.9837	9,98,374.86	27.35
14-Aug-19	10.0792	10,07,920.67	27.61
15-Aug-19	10.0792	10,07,920.67	27.61
16-Aug-19	10.0897	10,08,968.80	27.64
17-Aug-19	10.0897	10,08,968.80	27.64
18-Aug-19	10.0897	10,08,968.80	27.64
19-Aug-19	10.1038	10,10,377.83	27.68
20-Aug-19	10.0837	10,08,365.86	27.63
21-Aug-19	10.0114	10,01,135.92	27.43
22-Aug-19	9.8527	9,85,267.02	26.99
23-Aug-19	9.9143	9,91,432.35	27.16
24-Aug-19	9.9143	9,91,432.35	27.16
25-Aug-19	9.9143	9,91,432.35	27.16
26-Aug-19	10.1285	10,12,853.10	27.75
27-Aug-19	10.1683	10,16,828.15	27.86
28-Aug-19	10.1171	10,11,710.96	27.72
29-Aug-19	10.0137	10,01,367.16	27.43
30-Aug-19	10.0849	10,08,494.98	27.63
31-Aug-19	10.0849	10,08,494.98	27.63
Total trail commission for the period:			853.13

In the above example, the trail commission is calculated for each day using the below formula:

$\text{Trail commission for the day} = \text{AUM} \times \text{trail commission rate p.a./365}$
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Since the trail commission rate is mentioned as percent per annum, the same needs to be divided by 365 to arrive at the daily trail commission amount.

Smart distributors have accumulated a portfolio of loyal investors to whom they offer superior service. The trail commission on these investments ensures a steadily rising income for the distributor. Additional investments from the same investors, and other investors referred by the current investors, help them grow the portfolio.

A point to note is that the commission is payable to the distributors to mobilise money from their clients. Hence, no commission is payable to the distributor for their own investments (self-business).

Regulations require distributors to disclose to their investor all commissions in the form of trail commissions or any other form payable to them from similar competing schemes of different mutual fund from amongst which the particular scheme was recommended to the investor.

#### **Example of upfronting of trail commission<sup>34</sup>**

As discussed earlier, SEBI has allowed the payment of upfront commission in certain cases. The same can be understood by making suitable modifications to the example of trail commission shown above. If the trail commission payable for the first month was to be upfronted, the distributor is likely to receive the commission of Rs. 849.32. The same is calculated as under:

Investment amount: Rs. 10,00,000

Trail commission rate: 1 percent p.a.

Trail commission for a year: Rs. 10,00,000 X 1 percent = Rs. 10,000

Trail commission for a day: Rs. 10,000/365 = Rs. 27.397 (Trail for a year is divided by the number of days in a year)

Trail commission for August 2019 = Rs. 27.397 X 31 (there are 31 days in July, hence the daily trail commission amount is multiplied by 31) = Rs. 849.31

As can be seen here, the distributor gets upfront commission without factoring in the change in NAV over the period. This is logical. Since the commission is paid upfront, there is no way to reliably predict the daily NAV movement for the period for which trail is upfronted.

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<sup>34</sup> This is for illustration purpose only.

### 6.5.2 Additional commission for promoting mutual funds in small towns

With a view to promoting mutual funds in smaller towns, SEBI has allowed mutual funds to charge additional expenses, which can be used for distribution related expenses, including distributor commission. This means that the distributors mobilising funds from investors located in B-30 locations (cities and towns beyond the top 30 locations) would earn higher commission. We will cover the details of additional expenses later in Chapter 7.

### 6.5.3 Transaction Charges

To cater to people with small saving potential and to increase reach of mutual fund products in urban areas and smaller towns, SEBI has allowed a transaction charge per subscription of Rs. 10,000/- and above to be paid to distributors of the mutual fund products. However, there shall be no transaction charges on direct investments. The transaction charge, if any, is deducted by the AMC from the subscription amount and paid to the distributor; and the balance amount is invested.

Type of Investor	Transaction Charges (Rs.) (for purchase/subscription of Rs. 10,000 and above)
First time mutual fund investor	Rs. 150/-
Investor other than first time mutual fund investor	Rs. 100/-

The transaction charge is deducted from the gross investments of the investor and paid to the distributor and the balance shall be invested. The statement of accounts (SoA) shows the net investment made as the gross subscription less transaction charge and provides the number of units allotted against the net subscription.

For example, for an investment of Rs. 25,000 at NAV of Rs. 43.21 came from a first-time mutual fund investor. Then the transaction charge would be deductible at Rs. 150. In this case, the number of units allotted would be  $(Rs. 25,000 - Rs. 150) \div Rs. 43.21$  i.e. 575.098.

In case of investments through SIP, transaction charges are deducted only if the total commitment (i.e. amount per SIP instalment x number of instalments) amounts to Rs. 10,000 or more. The Transaction Charge is deducted in four equal instalments.

However, transaction Charges will not be deducted for the following:

- Purchase/Subscription submitted by investor at the designated collection centres or through AMC's website and which are not routed through any distributor.
- Purchase/ Subscription through a distributor for an amount less than Rs. 10,000;
- Transactions such as Switches, STP i.e. all such transactions wherein there is no additional cash flow at a mutual fund level similar to purchase/subscription.
- Purchase/Subscriptions through any stock exchange.

- Distributors who have chosen the 'opt-out' option i.e. decided not to charge transaction charges based on type of the product e.g. they can decide not to charge it for debt schemes. However, the 'opt-out' shall be at distributor level and not investor level i.e. a distributor cannot charge one investor and choose not to charge another investor.
- Transactions such as Redemptions and SWPs i.e. all such transactions involving cash outflows from mutual funds.

### ***Provision of opt-in and opt-out***

Distributors have the option of opting out of charging transaction charges. But such opting out shall be applicable only at distributor level. This means that the distributor cannot choose to charge transaction charge from one investor and not from another. Distributors will also have the option to opt in or opt out of levying the transaction charge based on the type of product.

Transaction charges do not apply to transactions other than purchases/subscriptions that result in fresh inflows. Transactions like switches, systematic transfers, dividend transfers, dividend re-investment are not eligible for transaction charges. Similarly, purchases or subscriptions routed through the stock exchange are not eligible for transaction charges.

The first holder/sole applicant/guardian on behalf of a minor has to declare their status as a new investor across mutual funds or as an existing investor by ticking the appropriate box in the application form. Accordingly, the applicability of the transaction charges is determined. The Permanent Account Number (PAN)/PAN Exempted KYC Reference Number (PEKRN) will be used to identify the investor as new/existing investor. If no declaration is provided by the investor in the application form then the investor will be considered as an existing investor.

At this stage, it is important to note here that the commission earned by the distributor may be subject to Goods and Services Tax (GST), as applicable.

### **6.5.4 Applicability of GST on distributors commission**

The Goods and Services Tax (GST) became applicable with effect from July 2017. GST is payable by any person making taxable supplies of goods/services and whose annual turnover exceeds Rs. 20 lakhs. Additionally, on certain goods and services specified by the Government, tax is to be paid by the recipient, under reverse charge instead of the supplier.

A mutual fund distributor, who has registered and obtained a GST number would be required to raise an invoice for the commission, and pay the GST to Government. At the same time, as per Section 9(4) of the CGST Act and Section 5(4) of the IGST Act, the registered recipient is liable to pay tax on procurements from unregistered suppliers under reverse charge mechanism.

Normally, the supplier of goods and services pays the GST on supply to the Government. The supplier adds this amount in the bill, while charging the customer (recipient of goods or services). However, in the reverse charge mechanism, the recipient of the goods and services pays the said tax to the Government.

Accordingly, the AMC / MF is liable to pay GST under reverse charge on commission paid to unregistered distributors.<sup>35</sup>

## **6.6 Commission Disclosure mandated by SEBI**

SEBI has mandated Mutual Funds/AMCs to disclose on their respective websites the total commission and expenses paid to distributors who satisfy one or more of the following conditions with respect to non-institutional (retail and HNI) investors:

- i. Multiple point of presence (More than 20 locations)
- ii. AUM raised over Rs. 100 crore across industry in the non-institutional category but including high networth individuals (HNIs).
- iii. Commission received of over Rs. 1 crore p.a. across industry
- iv. Commission received of over Rs. 50 lakhs from a single Mutual Fund/AMC.

Mutual Funds/AMCs shall also submit the above data to AMFI. AMFI shall disclose the consolidated data in this regard on its website.

In addition to the total commission and expenses paid to distributors, mutual funds / AMCs need to make additional disclosures regarding distributor-wise gross inflows (indicating whether the distributor is an associate or group company of the sponsor(s) of the mutual fund), net inflows, average assets under management and ratio of AUM to gross inflows on their respective website on a yearly basis.

In case the data indicates that a distributor has an excessive portfolio turnover ratio, i.e. more than two times the industry average, AMCs conduct an additional due-diligence of such distributors. Mutual Funds/ AMCs are required to submit the above data to AMFI and a consolidated data with respect to the same will be disclosed on AMFI website.

## **6.7 Due Diligence Process by AMCs for Distributors of Mutual Funds<sup>36</sup>**

SEBI has mandated AMCs to put in place a due diligence process to regulate distributors who qualify any one of the following criteria:

- a. Multiple point presence (More than 20 locations)

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<sup>35</sup> Refer to the Goods and Services Tax – FAQs for distributors on AMFI's website.

<https://www.amfiindia.com/Themes/Theme1/downloads/home/AMFI-GST-FAQs.pdf>

<sup>36</sup> Refer SEBI Circular No. CIR/IMD/DF/13/2011 dated August 22, 2011.

- b. AUM raised over Rs. 100 crore across industry in the non-institutional category but including high networth individuals (HNIs)
- c. Commission received of over Rs. 1 Crore p.a. across industry
- d. Commission received of over Rs. 50 Lakhs from a single mutual fund

At the time of empanelling distributors and during the period i.e. review process, mutual funds/AMCs have to undertake a due diligence process to satisfy 'fit and proper' criteria that incorporate, amongst others, the following factors:

- a. Business model, experience and proficiency in the business.
- b. Record of regulatory/statutory levies, fines and penalties, legal suits, customer compensations made; causes for these and resultant corrective actions taken.
- c. Review of associates and subsidiaries on above factors.
- d. Organizational controls to ensure that the following processes are delinked from sales and relationship management processes and personnel:
  - i.) Customer risk / investment objective evaluation.
  - ii.) MF scheme evaluation and defining its appropriateness to various customer risk categories.

In this respect, customer relationship and transactions shall be categorized as:

- a. Advisory – where a distributor represents to offer advice while distributing the product, it will be subject to the principle of 'appropriateness' of products to that customer category. Appropriateness is defined as selling only that product that is identified as best suited for investors within a defined upper ceiling of risk appetite. No exception shall be made. (See Box 6.2: Do mutual funds adviser their clients?)
- b. Execution Only – in case of transactions that are not booked as 'advisory', it shall still require:
  - i. If the distributor has information to believe that the transaction is not appropriate for the customer, a written communication be made to the investor regarding the unsuitability of the product. The communication shall have to be duly acknowledged and accepted by investor.
  - ii. A customer confirmation to the effect that the transaction is 'execution only' notwithstanding the advice of inappropriateness from that distributor be obtained prior to the execution of the transaction.
  - iii. That on all such 'execution only' transactions, the customer is not required to pay the distributor anything other than the standard flat transaction charges.
- c. There shall be no third categorization of customer relationship / transaction.
- d. While selling mutual fund products of the distributors' group/affiliate/associates, the distributor shall make disclosure to the customer regarding the conflict of interest arising from the distributor selling such products.

Compliance and risk management functions of the distributor shall include review of defined management processes for:

- a. The criteria to be used in review of products and the periodicity of such review.
- b. The factors to be included in determining the risk appetite of the customer and the investment categorization and periodicity of such review.

Other kind of due diligence performed are:

- i. Review of transactions, exceptions identification, escalation and resolution process by internal audit.
- ii. Recruitment, training, certification and performance review of all personnel engaged in this business.
- iii. Customer on-boarding and relationship management process, servicing standards, enquiry / grievance handling mechanism.
- iv. Internal / external audit processes, their comments / observations as it relates to MF distribution business.
- v. Findings of ongoing review from sample survey of investors.

Mutual funds/AMCs may implement additional measures as deemed appropriate to help achieve greater investor protection.

#### **Box 6.1: Do mutual fund distributors advise their clients?**

SEBI Investor Adviser Regulations, 2013 exempt distributors of mutual funds from registration as investment advisers, so long as the distributor is providing any investment advice to one's clients incidental to the primary activity of distribution of funds.

At the same time, the due diligence process mentioned above also defines the customer relationships or transactions only in two ways, viz. advisory, or execution only. In both the cases, however, the common thing for the mutual fund distributor is to see whether the product is suitable for the client or not. No third categorization of customer relationships or transactions is allowed. The distributor must perform analysis of suitability.

Ensuring suitability is also a part of the SEBI (Prohibition of Fraudulent and Unfair Trade practices relating to securities market) (Amendment) Regulations, 2012. This amendment to the regulation included mis-selling in units of a mutual fund scheme within the ambit of the mis-selling regulation. The regulation defines mis-selling in units of mutual fund schemes as any of the below:

1. Making a false or misleading statement, or
2. Concealing or omitting material facts of the scheme, or
3. Concealing the associated risk factors of the scheme, or
4. Not taking reasonable care to ensure suitability of the scheme to the buyer.

A look at the above provisions would help one understand the role of a mutual fund distributor. If a mutual fund distributor does not take care of the above, one would be considered to be involved in mis-selling activities.

At this stage, it is important to note here that the advice offered by mutual fund distributors is incidental to the business of fund distribution, and hence the distributors cannot project themselves as investment advisors or financial planners. Please refer to the AMFI guidance on MFD nomenclature dated October 20, 2020<sup>37</sup>.

### **6.8 Nomination facilities to Agents/Distributors and Payment of Commission to Nominee<sup>38</sup>**

The livelihood of a large number of mutual fund distributors (self-employed individuals) depend on the commission income primarily the trail commission. The mutual fund distributor builds his long term source of income by bringing-in business. In case of the death of a mutual fund distributor (MFD), there would be a loss of income for his/her family. Therefore, to provide protection against loss of income to the mutual fund distributor's family, AMFI has advised its members (AMCs) to offer nomination facility to the AMFI registered mutual fund distributors, as a uniform practice across the industry to enable the nominee to receive commission. Therefore, the AMCs provide nomination facility to the mutual fund distributors at the time of empanelment.

Accordingly, commissions are paid to the nominees or legal heirs (where no nominee is registered) of the deceased MFDs. The AMCs may require the legal heirs to produce necessary documents evidencing legal heirship/succession where nomination is not registered. Such commission shall be payable till such time the ARN code of the deceased agent/distributor is not changed by the investor. However, no new business is permitted under the ARN code of the deceased MFD. Also, no new systematic transactions or changes to existing systematic transactions can be registered under the ARN code of the deceased MF.

However, the distributors are encouraged to provide nominations to reduce the unnecessary hurdles which the legal heirs of a deceased distributor may face in obtaining legal heir certificate/succession certificate etc. Wherever the nominees are registered, the payment of commission can be made to the registered nominees, without the requirement of legal heir certificate, succession certificate etc. on submission of necessary documents such as death certificate.

- A nominee/legal heir need not be an ARN holder to claim and receive the commission.
- Commission can be paid to the nominee/legal heir only for those assets which were procured by the deceased MFD during the validity of his ARN prior to his/her demise. ARN of the deceased agent/distributor should be valid on the date of demise of ARN

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<sup>37</sup> [https://www.amfiindia.com/Themes/Theme1/downloads/circulars/AMFICircular19dated20-Oct-2020\\_AMFIGUIDANCEONMFDNOMENCLATURE.pdf](https://www.amfiindia.com/Themes/Theme1/downloads/circulars/AMFICircular19dated20-Oct-2020_AMFIGUIDANCEONMFDNOMENCLATURE.pdf)

<sup>38</sup> <https://www.amfiindia.com/Themes/Theme1/downloads/circulars/CIRARN151213.pdf> and <https://www.amfiindia.com/Themes/Theme1/downloads/circulars/AMFICircular135BP872020-21.pdf> (dated July 16, 2020)

holder and commission payment/ ARN should not have been suspended by AMFI, for whatsoever reason, at the time of demise of ARN holder. The future expiry of the ARN of the deceased agent/distributor post his demise is not taken into account for continued payment of upfront and trail commission to the nominee/legal heir. Commission can be paid to the nominee till AUM under the ARN of the deceased ARN holder becomes nil.

- Nominee shall receive the commissions only as trustee for the legal heirs of the deceased MFD.
- Nominees or legal heirs are not allowed to transfer the assets to his/her account unless specific request is received from the investors in this regard. In case a specific request is received from the investor, the assets can be transferred provided the nominee or legal heir is a valid ARN Holder.

Nominee/legal heir of the ARN holder are required to intimate AMFI about demise of ARN holder along with a true copy of death certificate duly attested by Gazetted Officer. On receipt of such intimation, AMFI will intimate all AMCs about the demise of the ARN holder. However, this is not applicable for Overseas Distributors.

For being eligible for transfer of AUM of the of the deceased mutual fund distributor -

(a) ARN of the deceased agent / distributor should have been valid on the date of demise of the distributor and his/her commission payment/ ARN should not have been suspended for any reason whatsoever, at the time of his/her demise.

(b) the Nominee/ legal heir should have a valid ARN as on the date of request for transfer of AUM and should be KYD compliant. and should have submitted his/her annual declaration(s) of self-certification (where applicable) due as on the date of request for transfer of AUM. Also, his/her ARN should not have been suspended by AMFI for any reason whatsoever.

2. Only those assets which were procured by the deceased Agent / Distributor prior to his/her demise and during the validity of his/her ARN can be transferred to the ARN of the nominee/ legal heir.<sup>39</sup>

## **6.9 Change of distributor**

While the trail commission is payable to the distributor for mobilisation of money from the investors, the other purpose of the same is also to ensure that the investor continues to receive regular updates and various services from the distributor. The distributor also keeps getting the compensation for such efforts. However, the mutual fund industry allows the investor to change the distributor, without specifying any reason.

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<sup>39</sup> Candidates are advised to read Annexure B of AMFI Circular dated July 16, 2020:  
<https://www.amfiindia.com/Themes/Theme1/downloads/circulars/AMFICircular135BP872020-21.pdf>

In order to remove any possibility of any wrongdoing, e.g. inducing or forcing the investor to request a change of distributor code in the folio, the industry has taken a decision. In case of change of distributor code in a folio, no commission would be payable to any distributor, neither the old one nor the new one.

Investors can choose to change their distributor or go direct. This needs to be done through a written request by the investor. In such cases, AMCs will need to comply, without insisting on any kind of 'No Objection Certificate' from the existing distributor. In such a case, the commission would not be payable to either of the distributors– the old or the new. Such provisions ensure two things simultaneously. While the investor reserves the right to change the distributor, a distributor is discouraged to lure a client to change the code. At the same time, if a distributor has opted for voluntary cessation of business, the investor should not be left in the lurch. Hence, if the change of distributor code is initiated by the investor on account of voluntary cessation of business by the distributor, the new distributor would get the trail commission.

A distributor can initiate a change in the distributor code in the folios of one's clients on account of any of the following:

- i. Change in the name/legal status of the distributor (such as an individual MF distributor converting his MF distribution business to a partnership firm, a partnership firm converting itself into Limited Liability Partnership (LLP), a private limited company converting itself into a public limited company or vice versa);
- ii. Merger/acquisition/consolidation/transfer of business/new code acquired within the same group in case of non-individual distributors;
- iii. Transfer of AUM consolidation initiative within the same family/close relatives in case of individual distributors; and
- iv. Transfer of business by individual distributors

In no other circumstances, such a change would be allowed.

At the same time, the transfer of AUM can happen only if the entire AUM is getting transferred from the existing distributor, and only in the name of a valid ARN holder, who is KYD compliant. The old ARN has to be surrendered and no further business can be done under that ARN, once the AUM transfer is complete. AMFI has prescribed detailed procedure for effecting such a change.

**Chapter 6-Sample questions:**

- 1. Only individuals are allowed to distribute mutual funds in India. State whether True or False.**
  - a. True
  - b. False
  
- 2. Mutual Fund Distributors Certification Examination offered by \_\_\_\_\_ is required for becoming a mutual fund distributor.**
  - a. Securities and Exchange Board of India
  - b. National Institute of Securities Markets
  - c. Association of Mutual Funds in India
  - d. National Skills Development Corporation
  
- 3. In what form do mutual fund distributors earn revenue?**
  - a. Commission from mutual funds for distribution of the schemes
  - b. Fees collected from the investors
  - c. Commission received from Association of Mutual Funds in India
  - d. Investment advisory fee from mutual funds
  
- 4. Mutual fund distributors can only earn upfront commission from the mutual funds. State whether True or False.**
  - a. True
  - b. False
  
- 5. Mutual fund distributors earn no commission when the investor chooses to invest in “direct” plans. State whether True or False.**
  - a. True
  - b. False

## CHAPTER 7: NET ASSET VALUE, TOTAL EXPENSE RATIO AND PRICING OF UNITS

### Learning Objectives:

After studying this chapter, you should learn about:

- Fair Valuation Principles and relevance for investors
- Computation of Net Assets of mutual fund scheme
- Dividends & Distributable Reserves
- Concept of Entry and Exit Load and its impact on NAV
- Key accounting and reporting requirements applicable to mutual funds
- NAV, Total expense ratio and pricing of units for the Segregated Portfolio

### 7.1 Fair Valuation Principles

An investor in a mutual fund scheme is the beneficial owner of the units one has bought. Expand this further, and it means that the ownership of the mutual fund scheme is collectively in the hands of all the investors at any point in time. At the same time, the investors can sell their units and new investors can buy. Thus, periodically, the ownership could also change. In such a case, it becomes very important that any investor in the scheme gets a fair price for one's investments.

In order to ensure such a fair treatment to all investors, SEBI has laid down certain fair valuation principles.

The asset management companies are required to compute and carry out valuation of investments made by its scheme(s) in accordance with the investment valuation norms specified in the Eighth Schedule of SEBI (Mutual Funds) Regulations, 1996. The primary objective behind introduction of these principles was to ensure fair treatment to all investors including existing investors as well as investors seeking to purchase or redeem units of mutual funds in all schemes at all points of time. At the same time, the valuation principles also address the mis-pricing risk and reduce the vulnerability of short-term debt oriented schemes to redemption pressure.

The 10 principles as laid out by SEBI are as under:

**Principle No.1:**

The valuation of investments shall be based on the principles of fair valuation i.e. valuation shall be reflective of the realizable value of the securities/assets. The valuation shall be done in good faith and in true and fair manner through appropriate valuation policies and procedures.

**Principle No.2:**

The policies and procedures approved by the Board of the Asset Management Company shall identify the methodologies that will be used for valuing each type of securities/assets held by the mutual fund schemes. Investment in new type of securities/assets by the mutual fund scheme shall be made only after establishment of the valuation methodologies for such securities with the approval of the Board of the asset management company.

**Principle No.3:**

The assets held by the mutual funds shall be consistently valued according to the policies and procedures. The policies and procedures shall describe the process to deal with exceptional events where market quotations are no longer reliable for a particular security.

**Principle No.4:**

The asset management company shall provide for the periodic review of the valuation policies and procedures to ensure the appropriateness and accuracy of the methodologies used and its effective implementation in valuing the securities/assets. The Board of Trustee and the Board of asset management company shall be updated of these developments at appropriate intervals. The valuation policies and procedures shall be regularly reviewed (at least once in a Financial Year) by an independent auditor to seek to ensure their continued appropriateness.

**Principle No.5:**

The valuation policies and procedures approved by the Board of asset management company should seek to address conflict of interest.

**Principle No.6:**

Disclosure of the valuation policy and procedures (with regard to valuation of each category of securities/assets where the scheme will invest, situation where these methods will be used, process and methodology and impact of implementation of these methods, if any) approved by the Board of the asset management company shall be made in Statement of Additional

Information, on the website of the asset management company/mutual fund and at any other place where the Board may specify to ensure transparency of valuation norms to be adopted by asset management company.

**Principle No.7:**

The responsibility of true and fairness of valuation and correct NAV shall be of the asset management company, irrespective of disclosure of the approved valuation policies and procedures i.e. if the established policies and procedures of valuation do not result in fair/ appropriate valuation, the asset management company shall deviate from the established policies and procedures in order to value the assets/ securities at fair value provided that:

- any deviation from the disclosed valuation policy and procedures may be allowed with appropriate reporting to Board of Trustees and the Board of the asset management company and appropriate disclosures to investors.

**Principle No.8:**

The asset management company shall have policies and procedures to detect and prevent incorrect valuation.

**Principle No.9:**

Documentation of rationale for valuation including inter scheme transfers shall be maintained and preserved by the asset management company as per Regulation 50 of SEBI (Mutual Fund) Regulations, 1996 to enable audit trail.

**Principle No.10:**

In order to have fairness in the valuation of debt and money market securities, the asset management company shall take in to consideration prices of trades of same security or similar security reported at all available public platform.

In addition to the above, a mutual fund may value its investments according to the Valuation Guidelines notified by SEBI. In case of any conflict between the Principles of Fair Valuation and Valuation Guidelines, the Principles of Fair Valuation detailed above shall prevail.

**Valuation**

A mutual fund scheme invests the investors' money in a portfolio of securities created and managed based on the investment objective and strategy of the scheme. The investments include securities, money market instruments, privately placed debentures, securitised debt instruments, gold and gold related instruments, real estate assets and infrastructure debt instruments and assets. The NAV of the scheme will depend upon the value of this portfolio,

which in turn, depends upon the value of the securities held in it. The valuation of these securities to determine the net asset value has to be done in accordance with the valuation guidelines laid down by SEBI and AMFI. This includes the following guidelines:

1. Traded Securities other than money market and debt securities:

- a. The securities shall be valued at the last quoted closing price on the stock exchange.
- b. When the securities are traded on more than one recognised stock exchange, the securities shall be valued at the last quoted closing price on the stock exchange where the security is principally traded. It would be left to the asset management company to select the appropriate stock exchange, but the reasons for the selection should be recorded in writing. There should, however, be no objection for all scrips being valued at the prices quoted on the stock exchange where a majority in value of the investments are principally traded.
- c. Once a stock exchange has been selected for valuation of a particular security, reasons for change of the exchange shall be recorded in writing by the asset management company.
- d. When on a particular valuation day, a security has not been traded on the selected stock exchange, the value at which it is traded on another stock exchange may be used.
- e. When a security is not traded on any stock exchange on a particular valuation day, the value at which it was traded on the selected stock exchange or any other stock exchange, as the case may be, on the earliest previous day may be used provided such date is not more than thirty days prior to the valuation date.

Non-traded Securities' other than money market and debt securities):

- f. When a security is not traded on any stock exchange for a period of thirty days prior to the valuation date, the scrip must be treated as a 'non-traded' scrip.
- g. Non-traded securities shall be valued "in-good faith" by the asset management company on the basis of appropriate valuation methods based on the principles approved by the Board of the asset management company. Such decision of the Board must be documented in the Board minutes and the supporting data in respect of each security so valued must be preserved. The methods used to arrive at values "in-good faith" shall be periodically reviewed by the trustees and reported upon by the auditors as "fair and reasonable" in their report on the annual accounts of the fund. For the purpose of valuation of non-traded securities, the following principles should be adopted: —

- i. equity instruments shall generally be valued on the basis of capitalization of earnings solely or in combination with the net asset value, using for the purposes of capitalization, the price or earning ratios of comparable traded securities and with an appropriate discount for lower liquidity;
  - ii. in respect of convertible debentures and bonds, the non-convertible and convertible components shall be valued separately. The non-convertible component should be valued on the same basis as would be applicable to a debt instrument. The convertible component should be valued on the same basis as would be applicable to an equity instrument. If, after conversion the resultant equity instrument would be traded pari passu with an existing instrument which is traded, the value of the latter instrument can be adopted after an appropriate discount of the non-tradability of the instrument during the period preceding the conversion while valuing such instruments, the fact whether the conversion is optional should also be factored in;
  - iii. in respect of warrants to subscribe for shares attached to instruments, the warrants can be valued at the value of the share which would be obtained on exercise of the warrant as reduced by the amount which would be payable on exercise of the warrant. A discount similar to the discount to be determined in respect of convertible debentures [as referred to above] must be deducted to account for the period which must elapse before the warrant can be exercised;
2. Value of Gold: the gold held by a gold exchange traded fund scheme shall be valued at the AM fixing price of London Bullion Market Association (LBMA) in US dollars per troy ounce for gold having a fineness of 995.0 parts per thousand, subject to the conditions mentioned in valuation guidelines issued by SEBI in SEBI (MF Regulations), 1996.

## **7.2 Computation of Net Assets of Mutual Fund Scheme and NAV**

### **7.2.1 Net Assets of Scheme**

Let us understand the concept with a simple example.

Investors have bought 20 crore units of a mutual fund scheme at Rs. 10 each. The scheme has thus mobilized 20 crore units X Rs. 10 per unit i.e. Rs 200 crore.

An amount of Rs. 140 crore, invested in equities, has appreciated by 10 percent.

The balance amount of Rs 60 crore, mobilized from investors, was placed in bank deposits.

Interest and dividend received by the scheme is Rs 8 crore, scheme expenses paid is Rs 4 crore, while a further expense of Rs 1 crore is payable.

If the above details are to be captured in a listing of assets and liabilities of the scheme, it would read as follows:

<b>Particulars</b>	<b>Amount (Rs. crore)</b>
<b><u>Liabilities</u></b>	
Unit Capital (20 crore units of Rs 10 each)	200
Profits {Rs 8 crore (interest and dividend received) minus Rs 4 crore (expenses paid) minus Rs 1 crore (expenses payable)}	3
Capital Appreciation on Investments held (10 percent of Rs 140 crore)	14
<b>Unit-holders' Funds in the Scheme</b>	<b>217</b>
Expenses payable	1
<b>Scheme Liabilities</b>	<b>218</b>
<b><u>Assets</u></b>	
Market value of Investments (Rs 140 crore + 10 percent)	154
Bank Deposits {Rs 60 crore (original) plus Rs 8 crore (interest and dividend received) minus Rs 4 crore (expenses paid)}	64
<b>Scheme Assets</b>	<b>218</b>

The unit-holders' funds in the scheme is commonly referred to as "net assets". The assets of the scheme are the investments held by it. This along with the accrued income which include dividend or interest due on securities held in the portfolio but not yet received, and receivables, such as amount due on shares sold, constitute the total assets. The scheme may have some short-term liabilities and accrued expenses. The current liabilities include payables for securities bought and borrowings for period not exceeding six months to meet liquidity needs.

As is evident from the table:

- Net assets include the amount originally invested, the profits booked in the scheme, as well as the appreciation in the investment portfolio.
- Net assets increase when the market prices of securities held in the portfolio increase, even if the investments have not been sold and profits realized.
- A scheme cannot show better profits by delaying payments. While calculating profits, all the expenses that relate to a period need to be considered, irrespective of whether or not the expense has been paid. In accounting language, this is called accrual principle.
- Similarly, any income that relates to the period will boost profits, irrespective of whether or not it has been actually received in the bank account. This again is in line with the accrual principle.

### 7.2.2 Net Asset Value

In the market, when people talk of NAV, they refer to the value of each unit of the scheme. This is equivalent to:

Unit-holders' Funds in the Scheme (Net Assets) ÷ No. of outstanding Units

In the above example, it can be calculated as:

Rs 217 crore ÷ 20 crore

i.e. Rs 10.85 per unit.

An alternate formula for calculating NAV is:

(Total Assets minus Liabilities other than to Unit holders) ÷ No. of outstanding Units

i.e. (Rs 218 crore – Rs 1 crore) ÷ 20 crore

i.e. Rs 10.85 per unit.

From the above, it follows that:

- Higher the interest, dividend and capital gains earned by the scheme, higher would be the NAV.
- Higher the appreciation in the investment portfolio, higher would be the NAV.
- Lower the expenses, higher would be the NAV.

The summation of these three parameters gave us the *profitability metric* as being equal to:

(A)+ Interest income

(B) + Dividend income

(C) + Realized capital gains

(D) + Valuation gains

(E) – Realized capital losses

(F) – Valuation losses

(G) – Scheme expenses

**Example 1: Calculate the NAV given the following information:**

- Value of stocks: Rs. 150 crore
- Value of bonds: Rs. 67 crore
- Value of money market instruments: Rs. 2.36 crore
- Dividend accrued but not received: Rs. 1.09 crore
- Interest accrued but not received: Rs. 2.68 crore
- Fees payable: Rs. 0.36 crore
- No. of outstanding units: 1.90 crore

NAV = (Value of stocks + Value of bonds + Value of money market instruments + Dividend accrued but not received + Interest accrued but not received – Fees payable) / No. of outstanding units

$$\text{NAV} = (150 + 67 + 2.36 + 1.09 + 2.68 - 0.36) / 1.90 = 222.77 / 1.90 = \text{Rs. } 117.25$$

**Example 2: Calculate the NAV given the following information:**

- Value of stocks: Rs. 230 crore
- Value of money market instruments: Rs. 5 crore
- Dividend accrued but not received: Rs. 2.39 crore
- Amount payable on purchase of shares: Rs. 7.5 crore
- Amount receivable on sale of shares: Rs. 2.34 crore
- Fees payable: Rs. 0.41 crore
- No. of outstanding units: 2.65 crore

NAV = (Current value of investments held + Income accrued + Current assets – Current liabilities – Accrued expenses) / No. of outstanding units

Income accrued is the dividend declared but not received. Expenses accrued include fees payable.

The NAV is calculated as:

$$\text{NAV} = (230 + 5 + 2.39 + 2.34 - 7.5 - 0.41) / 2.65 = 231.82 / 2.65 = \text{Rs. } 87.48$$

### **7.2.3 Mark to Market**

The process of valuing each security in the investment portfolio of the scheme at its current market value is called '*mark to market*' i.e. marking the securities to their market value. Why is this done?

The NAV is meant to reflect the true worth of each unit of the scheme, because investors buy or sell units on the basis of the information contained in the NAV. If investments are not marked to market, then the investment portfolio will end up being valued at the cost at which each security was bought. Valuing shares of a company at their acquisition cost, say Rs.15, is meaningless, if those shares have appreciated to, say Rs. 50. If the scheme were to sell the shares at the time, it would recover Rs. 50 and not Rs. 15. When the NAV captures the movement of the share from Rs.15 to Rs. 50, then it is meaningful for the investors.

What happens if the portfolio was not marked to market and investors are issued units post the NFO also at the face value of the unit?

Consider the following example:

Unit Capital	Rs. 1,00,000
Face Value per unit	Rs. 10
No. of units issued (Unit Capital / Face Value per unit)	10,000 units (Rs. 1,00,000/ Rs. 10 per unit)
Net Asset of the scheme	Rs. 1,50,000
Net Asset Value (Net Asset of the scheme/ No. of units issued)	Rs. 15 (Rs. 1,50,000/ 10,000)

### **CASE 1**

Assume an investor buys 100 units when the NAV is Rs. 15 and the units are issued to him at the face value of Rs. 10. Post the purchase, the schemes numbers will be as follows:

Particulars	Value	Calculation
Unit Capital	Rs. 101000	Rs. {100000 + (100 * 10)}
No. of outstanding units	10100 units	(10000 + 100) units <b>OR</b> (Rs. 101000 / Rs. 10 per unit)
Net Assets	Rs. 151000	Rs. {150000 + (100 * 10)}
Net Asset Value (NAV)	<b>Rs. 14.95</b>	Rs. (151000 / 10100)

### **CASE 2**

Assume an investor redeems 100 units when the NAV is Rs. 15 and the units are redeemed at the face value of Rs. 10. Post the redemption the schemes numbers will look as follows:

Particulars	Value	Calculation
Unit Capital	Rs. 99000	Rs. {100000 – (100 * 10)}
No. of outstanding units	9900 units	(10000 – 100) units <b>OR</b> (Rs. 99000 / Rs. 10 per unit)
Net Asset	Rs. 149000	Rs. {150000 – (100 * 10)}
Net Asset Value	<b>Rs. 15.05</b>	Rs. (149000 / 9900)

Issuing fresh units at a price lower than the NAV will result in the post issue NAV coming down for all investors (Case 1). Redeeming units at price lower than the NAV will increase the NAV for the remaining investors (Case 2).

Thus, marking to market helps investors buy and sell units of a scheme at fair prices, which are determined based on transparently calculated and freely shared information on NAV. Such mark-to-market based NAV also helps in assessing the performance of the scheme/fund manager.

## 7.2.4 Total Expenses in Mutual Fund Scheme

### *Types of Expenses*

All types of expenses incurred by the Asset Management Company have to be clearly identified and appropriated for all mutual fund schemes.

**Investment and Advisory Fees** are charged to the scheme by the AMC. The details of such fees are fully disclosed in the Scheme Information Document.

### **Recurring Expenses**

In addition to the investment and advisory fee, the AMC may charge the mutual fund scheme with recurring expenses including:

- marketing and selling expenses including agents' commission, if any
- brokerage and transaction cost
- registrar services for transfer of units sold or redeemed
- fees and expenses of trustees
- audit fees
- custodian fees
- costs related to investor communication
- costs of fund transfer from location to location
- costs of providing account statements and dividend/redemption cheques and warrants
- insurance premium paid by the fund
- winding up costs for terminating a fund or a scheme
- costs of statutory advertisements
- in case of a gold exchange traded fund scheme, recurring expenses incurred towards storage and handling of gold
- in case of a capital-oriented scheme, rating fees
- in case of a real estate mutual fund scheme, insurance premia and costs of maintenance of the real estate assets (excluding costs of development of such assets) over and above the expenses specified in Regulation 52 of SEBI (Mutual Fund) Regulations, 1996 to the extent disclosed in the scheme documents.
- listing fees, in case of schemes listed on a recognised stock exchange
- in case of schemes investing in exchange traded commodity derivatives, recurring expenses incurred towards storage and handling of the underlying goods, due to physical settlement of such contracts.

Any expense other than investment advisory fee and recurring expenses shall be borne by the asset management company or trustee or sponsors.

In case of a scheme other than an index fund scheme or an exchange traded fund, where, as per the scheme information document, the scheme will invest a minimum of sixty-five per cent of its net assets in equity and equity related instruments, the scheme will be considered as equity oriented scheme for the purpose of limits of total expense ratio as specified in the SEBI Mutual Fund Regulations, 1996.

The total expense ratio of the scheme excluding issue or redemption expenses, whether initially borne by the mutual fund or by the asset management company, but including the investment management and advisory fee shall be subject to the following limits:

(a) in case of fund of funds scheme

(i) investing in liquid schemes, index fund scheme and exchange traded funds, the total expense ratio of the scheme including weighted average of the total expense ratio levied by the underlying scheme(s) shall not exceed 1.00 per cent of the daily net assets of the scheme.

(ii) investing a minimum of sixty-five per cent of assets under management in equity oriented schemes as per scheme information document, the total expense ratio of the scheme including weighted average of the total expense ratio levied by the underlying scheme(s) shall not exceed 2.25 percent of the daily net assets of the scheme.

(iii) investing in schemes other than as specified above, the total expense ratio of the scheme including weighted average of the total expense ratio levied by the underlying scheme(s) shall not exceed 2 per cent of the daily net assets of the scheme.

Provided that the total expense ratio to be charged over and above the weighted average of the total expense ratio of the underlying scheme shall not exceed two times the weighted average of the total expense ratio levied by the underlying scheme(s), subject to the overall ceilings as stated above.

(b) in case of an index fund scheme or exchange traded fund, the total expense ratio of the scheme including the investment and advisory fees shall not exceed 1.00 per cent of the daily net assets.

(c) in case of open ended schemes other than as specified for fund-of-fund and index fund schemes, the total expense ratio of the scheme shall not exceed the following limits:

<b>Assets under Management Slab (Rs. Crore)</b>	<b>Total Expense Ratio limits for Equity oriented schemes (in percent)</b>	<b>Total Expense Ratio limits for other than equity oriented schemes (in percent)</b>
On the first Rs. 500 crore of the daily net assets	2.25	2.00
On the next Rs 250 crore of the daily net assets	2.00	1.75
On the next Rs 1,250 crore of the daily net assets	1.75	1.50
On the next Rs 3,000 crore of the daily net assets	1.60	1.35
On the next Rs 5,000 crore of the daily net assets	1.50	1.25
On the next Rs.40,000 crores of the daily net assets	Total expense ratio reduction of 0.05 percent for every increase of Rs.5,000 crores of daily net assets or part thereof.	
On the balance of assets	1.05	0.80

(d) in case of close ended and interval schemes,

(i) the total expense ratio of equity oriented scheme(s) shall not exceed 1.25 per cent of the daily net assets of the scheme.

(ii) the total expense ratio of close ended and interval scheme(s) other than schemes specified in clause d (i) above shall not exceed 1.00 per cent of the daily net assets of the scheme.

In addition to the above-mentioned limits, the following expenses may be charged to the scheme:

- i. Brokerage and transaction cost incurred for the purpose of execution of trade and is included in the cost of investment to the extent of 0.12 percent for cash market transactions and 0.05 percent for derivatives transactions.
- ii. If the new inflows from beyond top 30 cities are at least
  - (a) 30 percent of gross new inflows in the scheme or
  - (b) 15 percent of the average assets under management (year to date) of the scheme,

whichever is higher, funds can charge additional expense of up to 0.30 percent of daily net assets of the scheme.<sup>40</sup>

In case inflows from beyond top 30 cities is less than the higher of (a) or (b) above, the additional total expense on daily net assets of the scheme shall be charged as follows:

<sup>40</sup> Top 30 cities based on Association of Mutual Funds in India (AMFI) data on 'AUM by Geography – Consolidated Data for Mutual Fund Industry' as at the end of the previous financial year.

Daily net assets X 30 basis points X New inflows from beyond top 30 cities

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365\* X Higher of (a) or (b) above

\* 366, where applicable

The additional TER on account of inflows from beyond top 30 cities so charged shall be credited back to the scheme in case the said inflows are redeemed within a period of 1 year from the date of investment. The additional expenses incurred towards different heads i.e. (a) investment and advisory fee and (b) recurring expenses must be utilised for distribution expenses incurred for bringing inflows from such cities.

- iii. Mutual funds are also allowed to charge any additional expenses, incurred under the various heads of permitted recurring expenses and investment and advisory fees, not exceeding 0.05 percent of daily net assets of the scheme. However, the schemes wherein exit load is not levied/not applicable, the above-mentioned additional expenses shall not be charged to the schemes.

Expenditure in excess of the said prescribed total expense ratio limit has to be borne by the AMC.

AMCs need to prominently disclose on a daily basis, the TER (scheme wise, date wise) of all schemes under a separate head – “Total Expense Ratio of Mutual Fund Schemes” on their website and on the website of AMFI in downloadable spreadsheet format.<sup>41</sup>

### **7.3 Dividends & Distributable Reserves**

As seen earlier, in the calculation of net assets, investments are taken at their market value. This is done, to ensure that sale and re-purchase transactions are effected at the true worth of the unit, including the gains on the investment portfolio.

Similarly, it was seen that income and expense are accounted on the basis of accrual principle. Therefore, even though they may not have been received or paid, they are accrued as income or expense, if they relate to a period until the accounting date.

Unlike accrued income (which is receivable - it is only a question of time) and accrued expense (which is payable - it is only a question of time), valuation gains in the scheme’s portfolio may never get translated into real gains - it is NOT just a question of time. The securities need to be sold, for the scheme to be sure about the capital gains i.e. the capital gains need to be *realized*.

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<sup>41</sup> For more details, SEBI Circular No. SEBI/HO/IMD/DF2/CIR/P/2018/18 dated February 05, 2018 can be referred.

Since the investments in the portfolio are not yet sold, the gains in them are on paper - they are not *realised*. They will be realized, when those investments are sold.

SEBI guidelines stipulate that dividends can be paid out of *distributable reserves*. In the calculation of distributable reserves:

- All the profits earned (based on accrual of income and expenses as detailed above) are treated as available for distribution.
- Valuation gains are ignored. But valuation losses need to be adjusted against the profits.
- That portion of sale price on new units, which is attributable to valuation gains, is not available as a distributable reserve.

This conservative approach to calculating distributable reserves ensures that dividend is paid out of real and realized profits, after providing for all possible losses.

The trustees shall decide the quantum of dividend and the record date. The record date is the date used as cut-off to determine the eligibility to receive the dividend by investors based on the register of unit holders. The NAV will be adjusted at the end of the record date to reflect the pay out of dividend. Within one day of the trustees' decision, the AMC shall issue a public communication giving the details of the dividend including the record date. The record date shall be five calendar days from the issue of the notice by the AMC. The public notice should clearly state that the NAV will decline pursuant to the dividend pay-out and any statutory levy.

The need for notice is not necessary for schemes/plans such as liquid schemes or other debt schemes with dividend distribution frequency ranging from daily to monthly. The SID should have requisite disclosures in this regard. Listed schemes shall follow the requirements stipulated in the listing agreement for the purpose of declaring and distributing dividends.

There is no assurance or guarantee to Unitholders as to the rate or quantum of dividend distribution that it will be paid regularly.

#### **7.4 Concept of Entry and Exit Load and its impact on NAV**

A distinctive feature of open-ended schemes is the ongoing facility to acquire new units from the scheme (sale transaction) or sell units back to the scheme (re-purchase transaction).

In the past, schemes were permitted to keep the Sale Price higher than the NAV. The difference between the Sale Price and NAV was called the "entry load". If the NAV of a scheme was Rs 11.00 per unit, and it were to charge entry load of 1 percent, the Sale Price would be Rs 11 + 1 percent on Rs 11 i.e. Rs 11.11. Since entry load is no longer permitted, the Sale Price is same as the NAV.

Schemes are permitted to keep the re-purchase Price lower than the NAV. The difference between the NAV and re-purchase Price is called the “exit load”. If the NAV of a scheme is Rs. 11.00 per unit, and it were to charge exit load of 1 percent, the re-purchase Price would be Rs. 11 – 1 percent on Rs. 11 i.e. Rs. 10.89.

Schemes can also calibrate the load when investors offer their units for re-purchase. Investors would be incentivized to hold their units longer, by reducing the load as the unit holding period increased. For instance, load would be 4 percent if the investor were to exit in year 1, 3 percent if the investor were to exit in year 2, and so on.

Earlier, schemes had the flexibility to differentiate between different classes of investors within the same scheme, by charging them different levels of load. Further, all the money collected as loads were available for the AMC to bear various selling expenses. There were liberal limits on how much could be charged as loads.

However, the current position is that:

- SEBI has banned entry loads. So, the Sale Price needs to be the same as NAV (subject to deduction of applicable transaction charges, if any, as discussed in the next section).
- While charging exit loads, no distinction will be made among unitholders on the basis of the amount of subscription. While complying with the same, any imposition or enhancement in the load shall be applicable only on prospective investments. The parity among unitholders on exit load shall be made applicable at portfolio level.
- No exit load will be charged on bonus units and units allotted on reinvestment of dividend.
- Exit loads have to be credited back to the scheme immediately i.e. they are not available for the AMC to bear selling expenses.
- Upfront commission to distributors will be paid by the investor directly to the distributor, based on his assessment of various factors including the service rendered by the distributor.

Now that the schemes cannot have an entry load, the sale price would be equal to the scheme NAV. Say for example, if an investor invests Rs. 25,000 in a scheme with NAV of Rs. 43.21, she will get 578.570 units (i.e. Rs. 25000 / Rs. 43.21).

It would be important to note here that the transaction charges would have no impact on the NAV per unit or the price of purchase. These charges would only impact the cost for the investor.

## **7.5 Key Accounting and Reporting Requirements**

- The accounts of the schemes need to be maintained distinct from the accounts of the AMC. The auditor for the AMC has to be different from that of the schemes.

- Norms are prescribed on when interest, dividend, bonus issues, rights issues etc. should be reflected for in the accounts.
- NAV is to be calculated upto 4 decimal places in the case of index funds, liquid funds and other debt funds.
- NAV for equity and balanced funds is to be calculated upto at least 2 decimal places.
- Investors can hold their units even in a fraction of 1 unit. However, current stock exchange trading systems may restrict transacting on the exchange to whole units.
- The frequency of disclosures of NAV, Portfolio and Scheme accounts was discussed earlier.

## **7.6 NAV, Total expense ratio and pricing of units for the Segregated Portfolio<sup>42</sup>**

To ensure fair treatment to all investors in case of a credit event and to deal with liquidity risk, SEBI has permitted creation of segregated portfolio of debt and money market instruments by mutual funds schemes.

The key provision with respect to the NAV, TER and pricing of units are:

- AMC shall not charge investment and advisory fees on the segregated portfolio. However, TER (excluding the investment and advisory fees) can be charged, on a pro-rata basis only upon recovery of the investments in segregated portfolio.
- The Net Asset Value (NAV) of the segregated portfolio shall be declared on a daily basis. Adequate disclosure of the segregated portfolio shall appear in all scheme related documents, in monthly and half-yearly portfolio disclosures and in the annual report of the mutual fund and the scheme.

Segregated portfolio is discussed in details in Chapter 10.

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<sup>42</sup> Vide SEBI circular dated December 28, 2018, 'credit event' was considered for creation of segregated portfolio in mutual fund schemes. Segregated portfolio shall mean a portfolio, comprising of debt or money market instrument affected by a credit event, that has been segregated in a mutual fund scheme. However, vide circular dated November 7, 2019, SEBI has permitted creation of segregated portfolio of unrated debt or money market instruments by mutual fund schemes of an issuer that does not have any outstanding rated debt or money market instruments. However, this is allowed only in case of an actual default of either the interest or principal amount.

## Chapter 7: Sample Questions

1. **As per the fair valuation principles laid out by SEBI, it is mandatory to disclose the valuation policy in \_\_\_\_\_.**
  - a. Statement of Additional Information
  - b. Statement of Accounts sent to investors periodically
  - c. Fund fact sheet
  - d. The fair valuation principles are not to be put in public
  
2. **Investors have bought 20 crore units of a mutual fund scheme at Rs. 10 each. The scheme has thus mobilized 20 crore units X Rs. 10 per unit i.e. Rs 200 crore. An amount of Rs. 140 crore is invested in equities. The balance amount of Rs 60 crore, mobilized from investors, was placed in bank deposits. Interest and dividend receivable (accrued but yet not received) by the scheme is Rs 8 crore, scheme expenses payable (accrued but not paid yet) is Rs 4 crore. Calculate the scheme's NAV per unit.**
  - a. Rs. 20.40
  - b. Rs. 10.20
  - c. Rs. 20.00
  - d. Rs. 10.00
  
3. **What is the maximum Total Expense Ratio chargeable in case of index funds?**
  - a. 1 percent of the daily net assets
  - b. 1.5 percent of the daily net assets
  - c. It depends as the TER changes in line with the size of the scheme
  - d. Any amount that the AMC may deem appropriate
  
4. **In case of mutual fund schemes, dividends can be paid only out of \_\_\_\_\_.**
  - a. Premium reserve account
  - b. Unit capital
  - c. Distributable surplus generated by the scheme
  - d. Mark-to-market profits
  
5. **Mutual funds are allowed to charge differential exit loads based on the amount of investment.**
  - a. True
  - b. False

## CHAPTER :8 TAXATION

### Learning Objectives:

After studying this chapter, you should know about:

- Applicability of taxes in respect of mutual funds
- Capital Gains
- Dividend Income
- Difference between dividend distribution tax and capital gains tax
- Setting off Gains and Losses under Income Tax Act
- Securities Transaction Tax
- Tax benefits under Section 80 C of Income Tax Act, 1961
- Tax Deducted at Source

When anyone considers making an investment, one of the objectives is to get some investment returns. However, such returns on investments or income from investments may be subject to tax. The investor would get the income after payment of taxes. In such a case, it is important to understand the taxation associated with one's investments. This chapter covers the taxation in respect of mutual funds. As discussed earlier, mutual fund is an investment vehicle that invests in various investment options. Hence, a distributor of mutual funds must understand the tax applicable on the income of the mutual fund scheme, as well as the tax applicable on investments made by an investor in mutual fund schemes.

### 8.1 Applicability of taxes in respect of mutual funds

#### 8.1.1 Income from investment in mutual fund units

Investors must consider the effect of taxes on their investment returns. It is not how much you earn, but how much you keep after taxes that counts. As mutual fund is a pass-through vehicle, we must consider the income at two levels– income earned by the fund, and income earned by the investor.

#### 8.1.2 Income earned by mutual fund schemes

The schemes of the mutual funds invest in marketable securities like shares and debentures. These securities generate income in the form of dividend or interest. Apart from this, when the fund buys and sells the shares and debentures in the securities market, there could be capital gains or losses. Interest, dividend and capital gains form the income of the mutual fund.

As per the prevailing tax laws in India, a mutual fund's income is exempt from income tax, since mutual funds are constituted as trusts in India for the benefits of the unitholders. Section 10(23)(D) of the Income Tax Act exempts all the income earned by the mutual fund schemes from any tax.

### **8.1.3 Income earned by the investor from investment in mutual fund units**

We have already seen that the investor can choose from two options within the scheme, viz. dividend and growth. The one who has opted for dividend may get income in form of dividends, whereas the investor in the growth plan would not get any dividend whatsoever, irrespective of the profits earned by the fund.

The investor in growth plan would earn capital gains (or losses) whenever one sells the units of the scheme. On the other hand, the investor in the dividend plan may get dividend, as and when declared by the fund, as well as capital gains (or losses) when one sells the units.

Both these may have different tax treatment in comparison to the income that one earns through salary or professional fees and other means. The tax structure is different for different types of investors, as well as for different categories of funds, too.

Let us take a look at the applicable tax rates in case of capital gains and dividends. The tax rates would vary as under:

- **Type of income:** The capital gains are taxed differently in comparison to the dividend income. At the same time, within capital gains, short term capital gains attract different tax rates in comparison to long term capital gains.
- **Type of mutual fund schemes:** Income from equity-oriented mutual fund schemes is taxed at different rates in comparison to the non-equity-oriented schemes. The Income Tax Act defines two categories of mutual funds, viz., equity-oriented funds and non-equity-oriented funds. The schemes holding more than 65 percent of the assets under management in equity shares listed on recognised stock exchanges in India are classified as equity-oriented mutual fund schemes. All the other schemes are classified as non-equity-oriented schemes. For example, fund-of-funds investing in other equity mutual fund schemes, would be classified as non-equity-oriented schemes. Though the said scheme is eventually investing in equity assets (equity mutual funds), it is classified as a non-equity-oriented scheme for the purpose of income tax.
- **Type of investor:** The tax treatment may differ for Resident Indian Investors, NRIs, and non-individual investors. It must be noted that in case of joint holding, the income, be it capital gains or dividend, would be considered to have been earned by the first holder.

## 8.2 Capital Gains

When a unitholder sells units of the scheme, the selling price could be different from the price at which the units were bought. The difference between the purchase price of the units and the selling price of the units would be treated as capital gain (or loss). If the selling price is higher than the purchase price, there is an incidence of capital gain, whereas if the selling price is lower than the purchase price, there is capital loss. The capital gains are subject to tax. Capital gains tax is classified depending on the period of holding and the type of funds invested in.

Capital gains are classified into two categories: short term capital gains and long term capital gains. Long-term is defined as holding period of more than three years in case of non-equity-oriented funds, whereas the same more than 1 year in case of equity-oriented funds. Capital gains booked before completion of this period would be treated as short term capital gains.

Table 8.1 summarises the taxes applicable as per the prevailing tax laws:

**Table 8.1: Capital Gains Tax**

	<b>Equity-oriented funds</b>	<b>Non-equity-oriented funds</b>
<b>Short term capital gains</b>	15 percent	Marginal tax rate, as applicable for the investor
<b>Long term capital gains</b>	10 percent	20% with indexation benefits (see Box 8.1)

*Income tax at the rate of 10 percent (without indexation benefit) on long-term capital gains exceeding Rs.1 lakh provided transfer of such units is subject to STT.*

*Note: In addition to the above, surcharge and cess is applicable. The surcharge is calculated on the base tax and the cess is calculated on the aggregate of base tax and surcharge.*

Equity mutual funds were exempt from long term capital gains tax earlier. In the Union Budget of the year 2018, this was changed. Starting April 2018, long term capital gains became taxable at the rate of 10 percent. Relating to this, there are two important provisions that are discussed here:

1. **Grandfathering of capital gains:** Since the capital gains from equity assets were non-taxable till the announcement of the budget in 2018, a reintroduction of the tax would have meant that even the gains earned till then would also become taxable. This is equivalent to introducing tax with retrospective effect. In order to avoid such a situation, the Finance Minister introduced a clause, which came to be known as the “grandfathering of the capital gains”. This meant that the capital gains earned till January 31, 2018 would not be taxable, which means that for all the equity mutual funds that one has invested in, the valuation as on January 31, 2018 becomes the base

point. Gains would be calculated for the purpose of tax by taking the higher of the purchase price or the NAV as on January 31, 2018. The grandfathering benefit was offered in order to ensure that the effect of the tax is only on a prospective basis and not retrospective.

- a. The long term capital appreciation in the various investments in equity-oriented mutual funds was exempt from tax, as per the prevailing laws till the above change. If the appreciation prior to such an announcement was also subject to tax, it would tantamount to retrospective taxation.
- b. What this means is that if someone had invested Rs. 1,00,000 in an equity-oriented mutual fund scheme in 2017 (or any such period prior to the grandfathering date of January 31, 2018) and the value of the investments as on January 31, 2018 was Rs. 2,00,000.

Scenario: 1

If the investor sells the investments completely and realises a value of Rs. 1,80,000 on February 9, 2018 then the long term capital gains for the purpose of taxes would be considered to be zero, since the realised value is less than the value of investments on January 31, 2018 (i.e. the difference between the realised value of Rs. 1,80,000 and the value on January 31, 2018 – Rs. 2,00,000).

Scenario 2:

If the investor sells the investments completely and realises a value of Rs. 2,20,000; the long term capital gains for the purpose of taxation would be considered to be Rs. 20,000 (The difference between the realised value of Rs. 2,20,000 and the value on January 31, 2018 – Rs. 2,00,000).

2. **Exemption upto Rs. 1 lakh:** In case of long term capital gains arising out of equity shares and equity-oriented mutual funds, the tax is applicable only on the capital gains above Rs. 1 lakh. The first Rs. 1 lakh worth of long term capital gain from this category is tax-exempt.

For example, if an investor has earned a total long term capital gain worth Rs. 90,000 in a year, the entire capital gain would be exempt from tax. On the other hand, if the total capital gain is Rs. 1,10,000; the first Rs. 1,00,000 would be exempt from capital gains tax, but the next Rs. 10,000 would be subject to tax.

### Box 8.1 Understanding the benefit of indexation

As you can see in the table under the section on capital gains, the rate of tax on long term capital gains from non-equity-oriented funds is 20% with indexation. The concept of indexation is discussed below:

Indexation means that the cost of acquisition or the cost of purchase is adjusted upwards to reflect the impact of inflation. The Central Board of Direct taxes (CBDT) every year announces a number, known as the Cost Inflation Index (CII). There is one index number for each financial year. Let us see how it works through an example:

Assume that an investor invested a sum of Rs. 1,00,000 in a debt fund in the year 2015, and sold the same after 3 years. He got Rs. 1,25,000 as the redemption proceeds. This was an investment return of roughly 7.72%, as the capital gain is Rs. 25,000 on an investment of Rs. 1,00,000 in 3 years.

The above can be calculated by using the compound interest equation, as shown under:

$$A = P*(1+r)^n, \text{ wherein:}$$

A = amount accumulated at the end of the investment horizon = Rs. 1,25,000

P = amount invested = Rs. 1,00,000

r = return on investment, to be calculated

n = number of periods = 3 years

Solving the above equation for r, as under

$$A = P*(1+r)^n; \text{ hence } r = (A/P)^{(1/n)} - 1$$
$$r = (125000/100000)^{(1/3)} - 1 = 7.72\%$$

Though the actual gain is Rs. 25,000; tax is not payable on the entire gain, due to the benefit of indexation.

For the purpose of calculating taxability, the capital gain would be adjusted for indexation. This is done by adjusting the purchase price in the following manner:

*Indexed cost of acquisition = Actual cost of acquisition X [CII in the year of sale / CII in the year of purchase]*

*In our example, indexed cost of acquisition = Rs. 1,00,000 X [280/254] = Rs. 1,10,236.22<sup>1</sup>*

*The indexed capital gain would be Rs. 14,763.78 (Rs. 1,25,000.00 – Rs. 1,10,236.22)*

The rate of tax on the indexed capital gains is 20 percent, and thus the tax liability would be Rs. 2,952.76. As can be seen, this is a reasonably low rate of tax on the capital gain, and that too is payable only when the units are sold and the gains are booked.

*(Note: The above example is only for illustration purposes).*<sup>1</sup>Note: The cost inflation index values for the years 2015-16 (the year of purchase in our example), and 2018-19 (the year of sale) were 254 and 280 respectively.

Source: <https://www.incometaxindia.gov.in/Pages/utilities/Cost-Inflation-Index.aspx>

### 8.3 Dividend income

Dividend income from mutual funds used to be tax-free in the hands of the investor. There was no tax payable at all, irrespective of how much dividend one earned. However, the dividend would be paid to the investor after deduction of dividend distribution tax from the scheme itself. To that extent, although the dividend was tax-free, the NAV reduced to the extent of the dividend as well as the dividend distribution tax. Thus, this tax had an impact on the investor's after-tax returns.

In the Union Budget presented by the Finance Minister in February 2020, the situation changed. The dividend distribution tax has been done away with, whereas the dividend would henceforth be added to the taxable income of the assessee for the year. This means, the dividends would be taxable in the hands of the recipient at the applicable tax rate.

#### **What is the change for those who opted for dividend option in mutual funds?**

In the new regime, tax on dividend would be a function of the applicable rate of tax based on total income for the year, and hence the tax rate goes up for those in higher income. This means those who were in higher tax earlier might have paid a lower tax on the dividend income in comparison to their nominal rate of tax. This difference goes away. On the other hand, the investors, who were tax-exempt also had to still bear the impact of the dividend distribution tax in the earlier regime. Now with the changes proposed, the dividend income would be tax exempt for investors in various tax-exempt categories, for example: charitable trusts, mutual fund schemes and individuals in the tax exempt slab.

Let us understand one important difference between dividend distribution tax (old regime) and the tax on dividends in the hands of investors (new regime). The dividend distribution tax was not considered a tax in the hands of the investor, and hence it was not available as a setoff against any other tax liability. On the other hand, in the new regime, tax on dividends can be reduced through various exemptions and adjustments, as applicable.

It must also be noted here that both the dividend distribution tax (old regime) as well as the tax on dividend income in the hands of the investor (the new regime) are similar in the sense that the NAV of the scheme goes down more than the net-of-tax<sup>43</sup> amount received in the hands of the investor.

In the earlier regime:

*Drop in NAV = Dividend paid to the investor + dividend distribution tax*

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<sup>43</sup> The tax mentioned here refers to dividend distribution tax in the earlier regime, whereas under the new regime, it would be income tax

Thus, the dividend received by the investor would be net of the dividend distribution tax, which is lower than the drop in NAV.

Under the new regime:

*Post-tax dividend received by the investor = Dividend paid out by the scheme – Tax payable thereon, as per the applicable tax slab*

On the other hand, the growth option works out to be more tax-efficient. Since the mutual fund schemes are tax-exempt, and the capital gains are realized only when booked, one can allow the gains to run without worrying about tax on the same. This concept is known as deferment of taxes and allows one the benefit of compounding before tax.

#### 8.4: Stamp Duty on Mutual Fund Units

With effect from July 1, 2020, mutual fund units issued against Purchase transactions (whether through lump-sum investments or SIP or STP or switch-ins or dividend reinvestment) would be subject to levy of stamp duty\* @ 0.005% of the amount invested.<sup>44</sup> Transfer of mutual fund units (such as transfers between demat accounts) are subject to payment of stamp duty\* @ 0.015%. Box 8.1 provides some more details regarding stamp duty on mutual fund units.

##### **Box 8.1: Stamp Duty on MF units**

In adherence to the amendments carried out in the Indian Stamp Act in February 2019, stamp-duty is required to be paid for issue and transfer of Mutual Fund units with effect from 1 July 2020.

- Stamp duty @0.005% of the investment amount shall be applicable at the time of **issue of units** for both physical and demat units.
- Units will be allotted for the amount available post deduction of stamp duty.
- Stamp duty will be applicable to all transactions pertaining to scheme inflows:
  - Purchase
  - Additional Purchase
  - Dividend reinvestment
  - Systematic Investment Plan (SIP)
  - Systematic Transfer Plan (STP)
  - Dividend Transfer Plan (DTP).

This will also include triggers from past SIP/STP registrations.

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<sup>44</sup> Pursuant to Notification No. S.O. 4419(E) dated December 10, 2019 issued by Department of Revenue, Ministry of Finance, Government of India, read with Part I of Chapter IV of Notification dated February 21, 2019 issued by Legislative Department, Ministry of Law and Justice, Government of India on the Finance Act, 2019, and subsequent Notification dated March 30, 2020 issued by Department of Revenue, Ministry of Finance, Government of India.

## **8.5 Setting off of Capital Gains and Losses under Income Tax Act**

The Income Tax Act provides for taxation under various heads of income viz. salaries, income from house property, profits & gains of business or profession, capital gains, and income from other sources. In the normal course, one would expect that a loss in one head of income can be adjusted (set off) against gains in another head of income, since a person is liable to pay tax on the total income for the year. However, there are limitations to such set-off. A few key provisions here are:

- Capital loss, short term or long term, cannot be set off against any other head of income (e.g. salaries).
- Short term capital loss is to be set off against short term capital gain or long term capital gain.
- Long term capital loss can only be set off against long term capital gain.

Several other factors go into taxation or tax exemption. However, there are certain limits to the setting-off in case of mutual funds. This is discussed below.

### **Bonus Stripping**

Suppose an investor buys units of a scheme at Rs. 30. Thereafter, the scheme declares a 1:1 bonus issue i.e. the investor receives 1 new unit, for every unit that was bought earlier. Logically, the NAV of the scheme will halve, and it is likely that the units would now have a value of Rs. 15. At this stage, if the investor sells the original unit at Rs. 15, a loss of Rs 15 is incurred [Rs 30 (original purchase price for the Units) minus Rs 15 (currently realised)].

However, such capital loss is not available for setting off against capital gains, if the original units were bought within a period of 3 months prior to the record date for the bonus issue and sold off within a period of 9 months after the record date.

In such cases, the capital loss will be treated as the cost of acquisition of the bonus units.

## **8.6 Securities Transaction Tax**

When an investor sells units of an equity fund in the stock exchange, or offers them for re-purchase to the fund, he will have to incur Securities Transaction Tax (STT) i.e. STT is applicable only on redemption/switch to other schemes/sale of units of equity oriented mutual funds whether sold on stock exchange or otherwise.

STT is not applicable on purchase of units of an equity scheme. It is also not applicable to transactions in debt securities or debt mutual fund schemes.

### ***STT applicability for Investors in Equity oriented Mutual funds***

<b>Transaction</b>	<b>Rates (in percent)</b>	<b>Payable by</b>
Purchase of units of equity oriented mutual fund	Nil	Purchaser
Sale of units of equity oriented mutual fund (delivery based)	0.001	Seller
Sale of equity shares, units of business trust, units of equity oriented mutual fund (non-delivery based)	0.025	Seller
Sale of units of an equity oriented mutual fund to the mutual fund	0.001	Seller

### **8.7 Tax benefit under Section 80C of the Income Tax Act**

Certain mutual fund schemes, known as Equity Linked Savings Schemes (ELSS) are eligible for deduction under Section 80C of the Income Tax Act. As the name suggests, this is an equity-linked scheme, and hence the scheme invests in equity shares. The benefit is available upto Rs. 1.50 lacs per year per taxpayer in case of individuals and HUFs. The scheme has a lock-in period of three years from the date of investment.

Let us now understand some nuances of this.

First of all, this is one of the eligible investments under Section 80C, where the limit is to be shared across the eligible avenues. This means if someone has exhausted the limit under the said section through some other avenue, any investment in ELSS would not get any additional tax exemption, but the investment would still be locked-in for a minimum period of three years.

Second, if one is investing in this scheme through SIP, each investment would be locked-in from the date of the respective investment. The lock-in for the entire amount would not get over on completion of 3 years from the date of the first SIP instalment.

Third, if one opts for dividend reinvestment plan, each time a dividend is reinvested, the same would also attract a 3-year lock-in. Most AMCs have done away with this option in case of ELSS. They only allow growth option or dividend pay-out.

Fourth, the tax benefit would be available to the first holder, in case of a joint holding.

The Finance Minister, in the Union Budget 2020, proposed two parallel tax structures for the individual taxpayers. There is an old structure, which was applicable before the budget was presented that allowed different kinds of exemptions and deductions under various sections of the Income Tax Act. A parallel tax structure has been announced in Union Budget 2020,

that has more slabs, and lower rates of taxes for similar slabs. However, under the new regime, most exemptions have been removed. Those who opt for this new structure would not be able to take the benefit of tax-saving under Section 80C. Hence, for these investors, ELSS is just another equity-oriented mutual fund scheme that carries a lock-in provision.

### **8.8 Tax Deducted at Source**

There is no TDS on re-purchase proceeds to resident investors. However, for certain cases of non-resident investments, the same is applicable. The income tax regulations prescribe different rates, depending on the nature of the investor (Indian/ Foreign and Individual/Institutional), nature of investment (equity/debt) and nature of the income (dividend/capital gain). In case of dividends from mutual fund schemes, even for resident Indians, TDS is applicable. The tax is required to be deducted at 10 percent on the dividend amount if it exceeds Rs. 5,000.

Further, Government of India has entered into Double Taxation Avoidance Agreements (DTAA) with several countries. These agreements too, specify rates for Withholding Tax.

The TDS applicable for non-resident investors is the lower of the rate specified in the income tax regulations or the tax specified in the DTAA of the country where the investor is resident. The investor, however, will need to provide sufficient information and documents to satisfy the mutual fund that he is entitled to such concessional rate as is specified in the DTAA.

### **8.9 Applicability of GST**

AMC(s) can charge GST, as per applicable Taxation Laws, to the schemes within the limits prescribed under SEBI (Mutual Fund) Regulations.

- GST on fees paid on investment management and advisory fees shall be charged to the scheme in addition to the overall limits specified as per the Total Expense Ratio (TER) provisions.
- GST on all the fees other than investment and advisory fees shall be charged to the scheme within the maximum limit of TER.
- GST on exit load, if any, shall be deducted from the exit load and the net amount shall be credited to the scheme.
- GST on brokerage and transaction cost paid for execution of trade, if any, shall be within the limit of TER.
- The commission payable to the distributors of mutual funds may be subject to GST, as applicable in case of the ARN holder. Such tax cannot be charged to the scheme.

**Chapter 8: Sample Questions:**

- 1. What is the tax applicable on the income earned by the mutual fund schemes?**
  - a. It is a function of the type of income since dividends, short term capital gains and long term capital gains attract different tax rates
  - b. Income earned by a mutual fund is exempt from taxes
  - c. 10 percent plus surcharge and cess
  - d. It is a function of the marginal rate of tax applicable to the respective investor in the mutual fund scheme
  
- 2. Redemption from which of the following mutual fund schemes would attract Securities Transaction Tax (STT) for an investor?**
  - a. Multi-cap mutual fund
  - b. Government Securities Fund
  - c. Liquid Fund
  - d. Overnight Fund
  
- 3. In the non-equity oriented funds, the rate of long term capital gains tax is \_\_\_\_\_.**
  - a. 10 percent with indexation
  - b. 10 percent without indexation
  - c. 20 percent with indexation
  - d. 20 percent without indexation
  
- 4. In case of capital gains from mutual fund investments, Tax Deduction at Source (TDS) is applicable for: \_\_\_\_\_**
  - a. Minor through guardian
  - b. Non-Resident Indians (NRIs)
  - c. All investors, who have invested more than Rs. 5 lacs
  - d. TDS is not applicable in case of mutual funds
  
- 5. The Income Tax Act allows setting-off of the short term capital loss against long term capital gains. State whether True or False.**
  - a. True
  - b. False

## CHAPTER 9: INVESTOR SERVICES

### Learning Objectives:

After studying this chapter, you should know about:

- New Fund Offer Process
- NFO price and on-going price for subscription of mutual fund schemes
- Investment Plans and Options
- Allotment of mutual fund units to investors
- Content and periodicity of Statement of Account
- Mutual Fund Investor
- Application form of mutual funds
- Financial Transactions in mutual funds through online and physical mechanism
- Cut-off timing and Time stamping
- KYC requirements for mutual fund investors
- Different types of systematic transactions
- Operational aspects of Systematic Transactions
- Process of Non-Financial Transactions in Mutual Funds
- Change in Status of Special Investor Categories
- Investor transactions – turnaround times

Mutual fund is an investment vehicle for a large number of investors. In order to provide uniform experience, it is critical that various processes and investor services are standardized. Such standardization lends comfort to the investors since they know what to expect and when. They also know what not to expect in terms of services.

We would look at various investor services involved at various stages in the life of a mutual fund investment.

### 9.1 The NFO process

#### New Fund Offer

Units in a mutual fund scheme are offered to investors for the first time through a New Fund Offer (NFO). The following are a few key steps leading to the NFO:

- The Asset Management Company (AMC) decides on a scheme to take to the market. This is decided on the basis of inputs from the Chief Investment Officer (CIO) on investment objectives that would benefit investors, and inputs from the Chief Marketing Officer (CMO) on the interest in the market for the investment objectives.

- AMC prepares the Scheme Information Document for the NFO. This needs to be approved by the Trustees and the Board of Directors (BoD) of the AMC.
- The documents are then filed with SEBI. The observations that SEBI makes on the SID need to be incorporated. After approval by the trustees, the same can be issued in the market.
- The AMC decides on a suitable time-table for the issue, keeping in mind the market situation.
- The AMC launches its advertising and public relations campaigns to make investors aware of the NFO. These need to comply with SEBI's advertising code.
- The AMC holds events for intermediaries and the press to make them familiar with the scheme, its unique features, benefits for investors, etc.
- The Scheme Documents and Application Forms are distributed to market intermediaries, and circulated in the market, so that investors can apply in the NFO.

Three dates are relevant for the NFO of an open-ended scheme:

**NFO Open Date** – This is the date from which investors can invest in the NFO

**NFO Close Date** – This is the date upto which investors can invest in the NFO

**Scheme Re-Opening Date** – This is the date from which the investors can offer their units for re-purchase to the scheme (at the re-purchase price); or buy new units of the scheme (at the sale price). The AMC announces Sale and Re-purchase prices from the Scheme Re-Opening Date.

Close-ended Schemes have an NFO Open Date and NFO Close Date. But, they have no Scheme Re-opening Date, because the scheme does not sell or re-purchase units. Investors will need to buy or sell units from the stock exchange where the scheme is listed.

Under the SEBI guidelines, NFOs other than ELSS can remain open for a maximum of 15 days. Allotment of units or refund of moneys, as the case may be, should be done within 5 business days of closure of the scheme. Further, open-ended schemes have to re-open for sale/re-purchase within 5 business days of the allotment.

## **9.2 New Fund Offer Price/On-going Offer Price for subscription**

New Fund Offer (NFO) Price is the price per unit that the investors have to pay to invest during the NFO.

Ongoing price for purchase, redemption (sale) /switch outs (to other schemes/plans of the Mutual Fund) by investors is the price at which the investor purchases or receives redemptions/switch outs.

## 9.3 Investment Plans and Services

### 9.3.1 Direct and Regular Plans

Chapter 6 discussed various fund distribution practices. Investors have a choice of going through the distributors or invest directly through the AMC. Since the distribution services involve charges with respect to the various services provided by the distributor, any investor going direct is assumed to have decided not to avail those services. In such a case, the investor may not bear the cost of such services. Each mutual fund has to offer two plans to the investors, viz., regular plan and direct plan. Both these would have different total expense ratio (TER).

The direct plan shall have a lower expense ratio excluding distribution expenses, commission, etc., and no commission shall be paid from such plans. Since the TER is different in both cases, the plans will have separate NAVs.

It must be clearly understood that the direct plan is only for those investors, who purchase units directly from the fund and the same is not available for investors who route their investments through a distributor. If investment (purchase/repurchase) is routed through a distributor, then it is considered that one has chosen to invest in the Regular Plan.

Apart from these two plans at different NAVs, the AMC cannot offer separate plans based on expense ratio.

### 9.3.2 Dividend Pay-out, Dividend Re-Investment and Growth Options<sup>45</sup>

Most mutual fund schemes offer two options – Dividend and Growth. A third option, which is possible, is the Dividend re-investment Option. These are different options within a scheme having the same portfolio. Therefore, the portfolio returns are the same for all three options. However, they differ in the structure of cash flows and income accruals for the unit-holder, and therefore there is a difference in the unitholder's taxability, number of units held and value of those units. The post-tax return from each of these options will therefore be different.

In a ***dividend pay-out option***, the fund declares a dividend from time to time. Some schemes (liquid and debt funds with very short term maturity) even declare a dividend daily, subject to availability of profits. When a dividend is paid, the NAV of the units falls to that extent.

The reduced NAV, after a dividend pay-out is called ex-Dividend NAV. After a dividend is announced, and until it is paid out, it is referred to as cum-Dividend NAV.

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<sup>45</sup> Candidates are advised to read the Circular on 'Review of Dividend options, plans in case of mutual fund schemes dated October 5, 2020. The circular will come into effect from April 1, 2021.  
[https://www.sebi.gov.in/legal/circulars/oct-2020/circular-on-review-of-dividend-option-s-plan-s-in-case-of-mutual-fund-schemes\\_47795.html](https://www.sebi.gov.in/legal/circulars/oct-2020/circular-on-review-of-dividend-option-s-plan-s-in-case-of-mutual-fund-schemes_47795.html)

In a dividend pay-out option, the investor receives the dividend in his bank account. However, the dividend pay-out does not change the number of units held by the investor.

The dividend received in the hands of the investor does not bear any tax, as per the current tax laws.

In a **dividend re-investment option**, as in the case of dividend pay-out option, NAV declines to the extent of dividend. The resulting NAV is called ex-dividend NAV, like in case of dividend pay-out plan.

However, the investor does not receive the dividend in his bank account; the amount is re-invested in the same scheme and additional units are allotted to the investor. The reinvestment happens at the ex-dividend NAV. Thus, if dividend is Rs 2 per unit on a Unit-holder's 100 units, the dividend would amount to Rs 200. Assuming the ex-dividend NAV of the scheme is Rs 20, then  $\text{Rs } 200 \div \text{Rs } 20$  i.e. 10 units will be added to the unit-holder's portfolio.

In a **growth option**, dividend is not declared. Therefore, nothing is received in the bank account (unlike dividend pay-out option) and there is nothing to re-invest (unlike dividend re-investment option). The NAV would therefore capture the full value of the portfolio gains. As in the case of dividend pay-out option, there will be no accretion to the number of units held. The NAV of those units will however be higher, to reflect the gain in the portfolio.

Across the three options, the investor can also receive money by offering his/her units for re-purchase or selling them in the stock market. Taxability would depend on the scheme type and period of holding, as discussed earlier. Table 9.1 summarises, the implication of the 3 options and Illustration 9.1 explains the implications for investors who opt for these three different options.

**Table 9.1: Implications of different options in mutual funds**

Parameter	Dividend Pay-out Option	Dividend Re-investment Option	Growth Option
<i>Dividend received in bank account</i>	Yes	No	No
<i>Tax on Dividend</i>	Yes	Yes	N.A.
<i>Increase in number of units on account of re-investment of dividend</i>	No	Yes	No
<i>NAV change</i>	NAV declines to the extent of dividend.	NAV declines to the extent of dividend.	NAV captures the portfolio change entirely.

### **Illustration 9.1: Investment options for different investors**

Investor A, Investor B and Investor C invests in 100 units of a mutual fund scheme at a NAV of Rs.10 in the growth, dividend payout and dividend reinvestment option respectively. The NAV appreciates to Rs.12 and the mutual fund declares a dividend of 10 percent.

**a. What is the dividend amount that the investors are entitled to receive?**

The dividend amount is 10 percent of the face value of Rs.10, Re.1 per unit.

**b. Which of the investors in the scheme are entitled to receive the dividend?**

Investors in the dividend payout and dividend reinvestment option, i.e. investor B and Investor C are entitled to receive the dividend.

**c. How will the dividend be received by B and C?**

B will be paid out the dividend of Rs.100 (i.e. Re 1 X 100 units) while the dividend amount of Rs.100 due to C will be reinvested in the scheme at the ex-dividend NAV of Rs.11 (Rs.12 (NAV)- Re1 (Dividend))

**d. How many additional units will be received by C?**

Investor C will receive  $\text{Rs.100}/\text{Rs.11} = 9.09$  additional units on account of the dividend reinvested.

**e. What is the value of the investment and return earned by each investor calculated on the ex-dividend date?**

**Investor A:** The value of the investments is Rs.1200 (i.e. 100 units x Rs.12). Rs.200 is earned as capital gains from the appreciation in the NAV from Rs.10 to Rs.12

**Investor B:** The value of the investment is Rs.1100 (i.e. 100 units x Rs.11). Rs.100 is earned as dividend and Rs.100 as capital gains from the appreciation in the NAV from Rs.10 to Rs.11 (ex-dividend). The total return earned is Rs.200

**Investor C:** The value of the units is Rs.1200 (i.e. 109.09 units x Rs.11). The units held goes up after the re-investment of dividend to 109.09 units. The NAV comes down to Rs.11 after the payment of dividend. The returns earned are Rs.100 as capital gains on the original 100 units held and Rs.100 earned as dividends that is re-invested.

The post-tax returns to each of the investors will be different since the tax applicable on dividend and capital gains earned are different.

#### 9.4 Allotment of Units to the Investor

**NFO:** Since entry load is banned, units in an NFO are sold at the face value i.e. Rs. 10. So the investment amount divided by Rs. 10 would give the number of units the investor has bought.

Subject to the receipt of the specified minimum subscription amount for the scheme, full allotment is made to all valid applications received during the New Fund Offer. The Trustee reserves the right, at their discretion without assigning any reason thereof, to reject any application. Allotment is completed within 5 business days after the closure of the New Fund Offer. In case of applicant who have quoted their demat account, the units are credited within 2 working days to the demat account as per the depository account details as stated by the applicant in the application form.

Allotment of units and dispatch of allotment advice to FPIs (Foreign Portfolio Investors) is subject to RBI approval if required. Investors who have applied in non-depository mode are entitled to receive the account statement of units within 5 Business Days of the closure of the NFO Period. For applicants applying through the ASBA mode, on intimation of allotment by CAMS to the banker the investors account is debited to the extent of the amount due thereon.

**On-going offer:** The price at which units are sold to an investor as part of ongoing sales in an open-end scheme is the sale price, which in turn is the applicable NAV (currently entry load is not permitted by regulation, hence the sales price is equal to the NAV). The investment amount divided by the sale price would give the number of units the investor has bought. Thus, an investor who has invested Rs. 12,000, in a scheme where the applicable sale price is Rs 12, will be allotted  $\text{Rs } 12,000 \div \text{Rs } 12$  i.e. 1,000 units.

**In a rights issue,** the price at which the units are offered is clear at the time of investment. The investment amount divided by the rights price gives the number of units that the investor has bought. It may however be noted that rights issues, which are common for shares, are less meaningful for units of mutual fund schemes.

**In a bonus issue,** the investor does not pay anything. The fund allots new units for free. Thus, in a 1:3 bonus issue, the investor is allotted 1 new unit (free) for every 3 units already held by the investor. Since the net assets of the scheme remain the same – only the number of units' increases - the NAV will get reduced proportionately and the value of the investor's holding does not change as a result of the bonus issue.

On allotment, units are credited to the investor's demat account (if the investor has opted for receiving dematerialised units) as specified in the ASBA application form. The units of the Scheme held in the dematerialised form are fully and freely transferable.<sup>46</sup>

If application is rejected, full amount will be refunded within 5 business days from the date of closure of NFO. If refunded later than 5 business days, interest @ 15 percent p.a. for delay period will be paid and charged to the AMC.

## **9.5 Account statements for investments**

### **Monthly Statement of Account**

Mutual funds issue the Statement of Account every month if there is a transaction during the month. It shows for each transaction (sale/re-purchase), the value of the transaction, the relevant NAV and the number of units transacted. Besides, it also provides the closing balance of units held in that folio and the value of those units based on the latest NAV.

### **Annual Account Statement**

The Mutual Funds provide the Account Statement to the Unit-holders who have not transacted during the last six months prior to the date of generation of account statements. The Account Statement reflects the latest closing balance and value of the units prior to the date of generation of the account statement.

The account statements in such cases may be generated and issued annually. Alternately, soft copy of the account statements is sent to the investors registered e-mail address, instead of physical statement, if so mandated.

### **Consolidated Account Statement**

A Consolidated Account Statement (CAS) for each calendar month is sent by post/email on or before 10th of the succeeding month provided there has been a financial transaction in the folio in the previous month.

If an email id is registered with the AMC, only a CAS via email is sent. For the purpose of sending CAS, investors are identified across mutual funds by their Permanent Account Number (PAN). Where PAN is not available, the individual account statement is sent to the Unit holder, since a consolidated statement cannot be sent.

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<sup>46</sup> However, this is subject to lock-in period, if any and subject to lien, if any marked on the units in accordance with the provisions of SEBI (Depositories and Participants) Regulations, 1996 as may be amended from time to time and as stated in SEBI Circular No. CIR/IMD/DF/10/2010 dated August 18, 2010. Further, for the procedure of release of lien, the investors shall contact their respective DP. Also, when a person becomes a holder of the units by operation of law or upon enforcement of pledge, then the AMC shall, subject to production/submission of such satisfactory evidence, which in its opinion is sufficient, effect the transfer, if the intended transferee is otherwise eligible to hold the units.

Further, where there are no transactions in a folio during any six-month period, a CAS detailing holding across all schemes of all mutual funds at the end of every such six-month period (i.e. September/March), is sent by post/e-mail by the 10th day of the month following that half year, to all such Unit holders.

The periodicity and the time-limit within which these account statements have to be sent to the investors have been discussed later in this chapter.

## **9.6 Mutual Fund Investors**

### **Eligibility to Invest**

The following categories of people/entities are eligible to purchase units of most schemes of mutual funds:

#### ***Individual Investors***

They invest for their personal benefit or the benefit of their family. Following are the types of individual investors:

- Resident Indian adult individuals, above the age of 18: They can invest, either singly or jointly (not exceeding three names).
- Minors i.e. persons below the age of 18: Since they are not legally eligible to enter into a contract, they need to invest through their guardians.
- Hindu Undivided Families (HUFs): Here, family members pool the family money (inherited) for investments. The head of the family (called “Karta”) invests on behalf of the family. Against his name in the application, he would add the letters “HUF” to show that the investment belongs to the family.
- Non-Resident Indians (NRIs)/Persons of Indian Origin (PIO) resident abroad: Indian citizens, who are working abroad, and their family residing abroad, are typical NRIs who invest in India. Some Indians go on to become citizens of foreign countries such as US, Canada, New Zealand etc. Since India did not permit dual citizenship earlier, they needed to give up their Indian citizenship. However, their status as erstwhile Indians, entitles them to invest in mutual fund schemes on full repatriation or non-repatriation basis. As part of the documentation, they need to provide their PIO (Person of Indian Origin) Card/OCI (Overseas Citizenship of India) Card. NRI/PIO resident abroad have the facility of investing on repatriable basis i.e. when they sell their investments, the sale proceeds can be transferred abroad. Alternatively, they can invest on non-repatriable basis, in which case the proceeds from the sale of those investments cannot be remitted abroad.
- Foreign investors: They can invest in equity schemes of MFs registered with SEBI after completing KYC process.

### ***Non-individual Investors***

Here, the investments are made by organizations/institutions. Their authorized individuals sign the documents on behalf of the organizations/institutions they represent. Following are the types of non-individual investors:

- Companies / corporate bodies, registered in India
- Registered Societies and Co-operative Societies
- Trustees of Religious and Charitable Trusts
- Trustees of private trusts
- Partner(s) of Partnership Firms
- Association of Persons or Body of Individuals, whether incorporated or not
- Banks (including Co-operative Banks and Regional Rural Banks) and Financial Institutions and Investment Institutions
- Other Mutual Funds registered with SEBI
- Foreign Portfolio Investors registered with SEBI
- International Multilateral Agencies approved by the Government of India
- Army/Navy/Air Force, Para-Military Units and other eligible institutions
- Scientific and Industrial Research Organizations
- Universities and Educational Institutions
- Foreign portfolio investors who meet KYC requirements to invest in equity and debt schemes of Mutual Funds can invest through two routes:
  - Direct route - Holding MF units in demat account through a SEBI registered depository participant (DP).
  - Indirect route- Holding MF units via Unit Confirmation Receipt (UCR)

### ***Sources of Information on Eligibility to invest***

The individual investors eligible to invest as detailed above, can invest in any mutual fund scheme, unless the mutual fund comes out with a specific scheme, or a plan within a scheme, that is not intended for any category of investors.

The non-individual investors eligible to invest as detailed above, can invest in any mutual fund schemes. However, in some schemes, only specific classes of non-individual investors are permitted. For instance, some Gilt schemes have specific plans, which are open only for Provident Funds, Superannuation and Gratuity Funds, Pension Funds, Religious and Charitable Trusts and Private Trusts.

Therefore, it is a good practice to check the 'Who can Invest?' section of the Scheme Information Document (SID), especially for a first time investor.

## **9.7 Filling the Application Form for Mutual Funds**

The information required to be provided in the application form are discussed below.

### **Direct Plan and Regular Plan**

Investors have the option to invest (purchase or subscribe to mutual fund units) directly without routing the investment through a distributor (Direct Plan). In this case, the investor must mention “Direct” in the space provided in the application form for entering the AMFI Registration Number (ARN).

If the investment (purchase/subscription) is routed through a distributor/Advisor (Regular Plan) then the ARN/RIA number and other details have to be provided in the space provided for the same.

### **Unit Holder Information**

A mutual fund investment can have upto three holders. All the holders must be investors eligible to invest in a mutual fund. The folio is created in the name of the first holder who is the primary investor. All benefits of the investments such as dividends, redemption payments and tax benefits will go to the first holder.

The information to be provided includes name(s), nationality, identity proof and KYC compliance, signatures of all the holder(s), address and communication details of the first holder. In case of FPI/NRI/PIO investors, an overseas address must also be provided.

### ***Minor as a unit holder***

An investment made for a minor (less than 18 years) is done through a guardian who complies with the KYC and PAN requirements and all other formalities as if the investment was for themselves. The guardian is typically a natural parent or court appointed legal guardian. The documents to establish the natural relationship/legal guardianship (notarized photocopy of the court order) has to be provided at the time of investment. The date of birth of the minor has to be provided in the application form and the proof of age of the minor investor has to be given along with the application. An investment for a minor cannot have joint holders. On attaining maturity, the information of the erstwhile minor investor has to replace that of the guardian. KYC, PAN, Signature attested by banker and bank account details are updated in the folio. The guardian can no longer operate the folio and the account will be frozen for operations till the change of status of the erstwhile minor is updated.

### ***POA as a unit holder***

Similarly, a folio operated under a Power of Attorney (PoA), requires the PoA holder and issuer to comply with the KYC and PAN requirements and a certified copy of the PoA to be submitted to the mutual fund before the holder can operate the folio. The grantor or investor can continue to operate the account despite granting a PoA. The PoA holder can conduct all transactions except make or change nominations.

### ***Status of the Holder and Mode of Holding***

Other information that has to be provided includes the status of the first holder as an individual or non-individual and mode of holding and operating the account as single/joint/either or survivor. The selection has to be made at the time of application and may be altered at any point in time. If no selection is made, then the default option is applied. The default option is mentioned in the application form. Once a mutual fund folio is created as a jointly held account there can be no change in the joint holders. A joint holder cannot be deleted or a new one added, except in the event of death can a name be deleted.

Once the first holder's PAN is validated for KYC, the address provided in the KYC form will override the information provided in the application form.

### ***KYC Details***

The KYC acknowledgement letter as proof of compliance with the KYC norms by each holder has to accompany the application form. Also, additional KYC details are mandatorily collected in the application form relating to occupation, gross annual income or networth and politically exposed persons status for both individual and non-individual applicants.

### ***FATCA and CRS Details***

For applicants, including guardians, whose country of birth/citizenship/nationality/tax residency is other than India, the application requires additional information under Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standards (CRS). The information that is required is:

- Place/City of Birth, Country of Birth, Country of Citizenship/Nationality
- Is the investor's Tax Residency/Country of Birth/Citizenship/Nationality other than India (Yes or No)
  - If yes, indicate all countries in which the investor is resident for tax purpose and the associated Tax ID number (Details of Country of Tax Residency and Tax Payer Reference ID).

### ***Bank Account Details***

It is mandatory for investors to provide the bank details of the sole/first holder of the folio in the application form. This includes the name of the bank where the account is held, the branch and the city, the account number, type of account (current, savings, NRO, NRE, FCNR and others), MICR code and IFSC details.

For unitholders opting to hold the units in dematerialized form, the bank account details provided in the application form should match the details of the bank account that is linked to the demat account.

If the pay-out bank account is different from the bank account through which the payment for the purchase of the units was processed then additional documents to validate the pay-out account have to be provided along with the application form. This additional document may be an original cancelled cheque of the pay-out account where the account number and name of the first holder of the folio are printed on the face of the cheque, a self-attested copy of the bank pass book or bank statement showing the first holder's name and account, with entries not older than 3 months, or a letter on the bank letterhead providing the details of the account.

Dividends and redemption proceeds will be credited directly to the bank account via electronic modes such as direct credit, NEFT, NACH facility. Applicants can also choose to receive the payments through cheque/demand draft.

For Minors: Payment for investment should be made by means of a cheque, demand draft or any other mode shall be accepted from the bank account of the minor or from a joint account of the minor with the guardian only. For existing folios, the AMCs are required to insist upon a change of pay-out bank mandate before redemption is processed.<sup>47</sup>

### ***Investment Details***

Investors have to make their choice of scheme, plan, option and pay-out option at the time of making the application. Each scheme will offer a regular plan where the investment is routed through a distributor and a direct plan where the applicant invests directly without the assistance of a distributor.

The expense ratio for the regular plan is higher since there are distribution costs to be accounted for. Each scheme will also typically offer a growth option and a dividend option. The dividend option may offer a dividend pay-out and a dividend re-investment option. Under

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<sup>47</sup> SEBI Circular dated December 24, 2019.

the dividend pay-out option there may also be different frequencies of dividend payment offered.

While the scheme selection is mandatorily to be done by the applicant, however if the other selections are not made then the default option will apply. The default options will be clearly mentioned in the instructions listed in the application form.

### **Payment Details**

The details of the payment instrument the bank account through which the payment for the investments are being made has to be mentioned in the application form. The payment has to be made out to the account specified by the mutual fund in the application form. The application number or folio number should be mentioned on the reverse of the payment instrument. The bank through which the payment is made need not be the same as the bank account details provided in the application form to receive dividend and redemption proceeds.

### **Unit Holding Option**

Investors have the option to hold the units in physical mode or demat mode. If the units are to be held in a demat account then the details of the beneficiary account, name and ID of the depository participant (DP) has to be provided. The name(s), mode of holding, PAN details and bank account of the applicant will be verified against the depository data. A copy of the DP statement has to accompany the application to be able to verify the details of the account. The dividend and redemption proceeds will be paid out to the bank account linked to the demat account.

If an investor opts to hold the units in dematerialized form in an existing demat account, then the applicant(s) details provided in the application form has to be the same as that appearing in the demat account with the depository participant. The KYC performed by the depository participant will be considered as KYC verification done by the mutual fund. A copy of the Client Master Form/demat statement showing active demat account details should be provided for verification of details.

### **Nomination**

The applicant can make a nomination in favour of a maximum of three nominees and indicate the percentage to each nominee. The nomination can be made at the time of application or subsequently at any time. A folio held by a single holder should have a nomination made in the application. Some mutual funds may require the applicant to provide a separate declaration of the intention not to nominate. Others may have a provision that not providing

the nomination details may be considered as consent to proceed with the application without a nomination.

### **Minimum Investment**

The Scheme Information Document (SID) and Key Information Memorandum (KIM) provides information on the minimum application amount. Typically, the limit may be higher for the initial investment required to initiate the folio and lower for subsequent purchases. While investing, the investor needs to confirm that the investment meets the minimum investment limit set by the mutual fund for the scheme. The application has to be signed by all the holders irrespective of the mode of holding.

## **9.8 Financial Transactions with Mutual Funds**

Financial transaction in mutual funds include purchase of mutual fund units (initial purchase in an NFO and additional purchases in an ongoing offer), redemptions i.e. sale transactions and switches. These are explained below.

### ***Initial Purchase of Mutual Fund Units***

Fresh purchase or initial purchase of mutual fund units in a scheme can be made during the new fund offer (NFO) period or even subsequently in an open-ended scheme, during the open offer period. The mutual fund would need the completed application form with the prescribed documentation and the requisite investment amount, to allot an investment folio in the name of the investor.

Application forms are available with offices of AMCs, distributors and Investor Service Centres (ISCs). They are also downloadable from the websites of the AMCs concerned. The common application form, with Key Information Memorandum (KIM), is designed for fresh purchases i.e. instances where the investor does not have an investment account (technically called “folio”) with the specific mutual fund.

An existing investor can also use the application form to make fresh purchases in other schemes of the same mutual fund or even make additional purchases in a scheme. In this case, the assigned folio number has to be provided and all the personal information already captured under the folio will apply to the new investment being made also. The information on unit holders does not have to be provided again. The information provided in the application form is used to create the investor record or folio with the mutual fund.

### ***Additional Purchases***

Once an investor has a folio with a mutual fund, subsequent investments with the same mutual fund do not call for the full application form and documentation. Only a transaction slip needs to be filled giving the folio number, and submitted with the requisite payment. A transaction slip can be used to make additional purchases in an open-ended scheme in which the investor has already invested. It can also be used to make fresh purchases in another scheme of the same mutual fund under the same folio.

Most mutual funds send a transaction slip (with the investor's folio number pre-printed) along with the Statement of Account. Alternatively, blank transaction slip (without pre-printed folio number), which is available with branches of the AMC, distributors and ISCs, or downloadable from internet, can be used. An application form may also be used to make additional purchases and the investor can mention the existing folio number in the appropriate place provided for the same. The personal data and bank account details as they feature in the existing folio would apply to the additional investment being made and override any conflicting information provided in the application form. If the name of the holder in the folio does not match that provided in the application for additional investment then the application form may be rejected at the discretion of the AMC.

The investor needs to confirm that the investment is above the minimum investment limit set by the mutual fund for additional purchases in the scheme.

### ***Repurchase of Units***

The investor in an open-ended scheme can offer the units for repurchase to the mutual fund. The transaction slip needs to be filled out to effect the re-purchase. The folio number, names of the unit holders and the scheme, plan and option from which the redemption is requested should be clearly mentioned. The request should be signed according to the mode of holding of the folio. Investor has the option to decide on the repurchase amount (which is generally the case) or number of units offered for re-purchase. The re-purchase price is the applicable NAV (which is discussed later in this unit under 'Cut-off Time') less Exit Load.

If the investor has specified the re-purchase amount, then that amount divided by the re-purchase price would be the number of units that will be reduced from his folio.

If the investor has specified the number of re-purchase units, then those many units will be reduced from his folio; payment would be made equivalent to the number of units re-purchased, multiplied by the re-purchase price. Units will be redeemed on a First-in-First-Out (FIFO) basis.

If, while effecting the re-purchase, the investment holding in the folio goes below the minimum limit for maintaining the folio set by the mutual fund for the scheme, then all the units may be re-purchased and the investment folio of the investor may be closed.

The redemption request can be made physically by submitting the duly filled transaction slip at any of the Investor Service Centres, branch offices of the mutual fund.

Units held in dematerialized form have to be redeemed through the depository participant (DP). The investor has to submit the duly completed redemption form (available with the DP) to the DP. After verification, the DP will electronically execute the redemption request which will then be forwarded to the AMC/RTA. After verifying the redemption request, the AMC/RTA will make the payment to the investor's bank account registered with the demat account.

Units held in the demat account can also be redeemed by placing the redemption order through the stock broker. Along with this, a Delivery Instruction Slip (DIS) has to be submitted to the investor's DP to transfer the mutual fund units from the investor's demat account to the designated Clearing Member (CM) Pool account of the National Securities Clearing Corporation Limited (NSCCL)/BOI Shareholding Ltd. (BOISL). The redemption funds will be credited to the investor's stock broker's clearing bank account through the normal settlement process for onward payment to the investor.

### **Switch**

A *switch* is a redemption from one scheme and a purchase into another combined into one transaction.

#### **9.8.1 Payment Mechanism for mutual fund purchases**

Payments for mutual fund purchases need to be made through the banking channel modes that have been approved by the regulators. The acceptable modes of payments are through online transactions or different payment mechanism such as cheque, demand draft and cash etc.

### **Online Transactions**

Investors can conduct their mutual fund transactions online. The investor is required to fill the requisite details in an application form. Based on this, the investor is allotted a user name and password (Personal Identification Number – PIN). This can be used by the investor to make additional purchases of units in the mutual fund, or to request re-purchase of the units held in the mutual fund. Payment transactions are made through the internet banking facility provided by banks.

Digital payment mediums or electronic payment mediums use digital modes for making and receiving payments. There is no use of cash in physical form and the payment cycle is

completed online. Digital payments provide advantages of ease and speed of payment process, safety of funds and provide a record of funds usage. However, there is the risk of data theft and some of the modes of payment may be difficult for a person not comfortable with technology.

The Digital Payment Mediums available include the following:

### **Internet Banking**

Internet banking is the most commonly used digital payment service. It provides access to the banking services anywhere and at any time through the official website of the banking institution. Net banking allows fund transfers to own and third-party accounts, online bill payments, online shopping and other such facilities that involves making and receiving payments. The National Electronic Fund Transfer (NEFT) facility allows digital transfer of funds between bank accounts. The Immediate Payment Service (IMPS) is an instant interbank electronic fund transfer available to registered users of banks through mobile phones, net banking and ATMs.

Remittance can also be made directly to the bank account of the scheme through Real Time Gross Settlement (RTGS)/National Electronic Funds Transfer (NEFT) facilities (for transfers within India) or SWIFT transfer (for transfers from abroad). While RTGS transfers are instantaneous, NEFT transfers are batched together in the banking system, and effected at various times during the day. SWIFT transfers tend to pass through multiple banks in different geographies, and multiple levels within the same bank, resulting in delays. All banks and their branches are not enabled to provide electronic transfer facilities.

Before money is remitted directly to the mutual fund, it is advisable to get the proper bank account details from the AMC/distributor. The details of the mutual fund, such as account number, account name, IFSC details etc. are required to do an electronic transfer. Some mutual funds may provide this information in the application form. The bank will generate a unique transaction reference number. The acknowledgement from the bank for the transfer request has to be appended along with the application as proof of transfer. The account number mentioned in the transfer instruction copy provided as proof should have the first holder as one of the account holders.

National Automated Clearing House (NACH) is a centralised clearing system launched by the National Payments Corporation of India (NPCI). NACH aims to replace and consolidate multiple existing Electronic Clearing Service (ECS) systems across India and create a faster and more efficient clearing platform. It is a web based solution for Banks, Financial Institutions, Corporate and Governments, to facilitate interbank high volume, electronic transactions which are repetitive and periodic in nature. This has been introduced in place of ECS for repetitive payments. NACH have same day presentation and settlement, including returns processing.

The various facilities offered by NACH include standardisation and digitisation of mandates, overall simplification, reduction of operational cost, and minimisation of activation time. Existing ECS mandates are now been moved to the NACH platform, in partnership with the participating banks. However, no intervention from investors will be necessary in this regard.

The service is now active in all Indian banks with core banking facility. It comes in two variants – NACH Credit and NACH Debit. The significant benefits to bank customers include automatic debits from their account for bill payments (telephone, electricity, etc), loan instalments, insurance premiums, SIPs and more. Not only this, NACH is useful for corporate and financial institutions that make payments in bulk like dividend distributions, salaries, interests, pensions, etc.

**M-Banking** i.e. mobile banking is another convenient way for investment and transaction purpose.

**Stock exchange platform and MFU platform** are also used for purchase transactions. The details have been discussed in Chapter 6.

### **Unified Payment Interface**

The Unified Payment Interface (UPI) allows fund transfer between accounts through the mobile app. The users have to register for mobile banking facility to be able to use the app. There are many UPI apps available such as BHIM, banking applications, Aadhaar app etc. which one can download on their phone. After the application (app) is downloaded, a Virtual Payment Address (VPA) has to be created by going through an authentication process. This is like an email address and links the UPI app to the user's bank account through the mobile phone registered with the bank. The VPA can be changed if so desired. Multiple bank accounts can be linked to a VPA, but one account has to be designated as the default account. To make payments using the UPI, one needs the VPA of the payee. The user can also receive funds using the UPI. A new version of the UPI allows transfer of funds using the Aadhaar number instead of a VPA.

### **Application Supported by Blocked Amount**

Application Supported by Blocked Amount (ASBA) is a facility where the investment application in a New Fund Offer (NFO) is accompanied by an authorization to the bank to block the amount of the application money in the investor's bank account.

The benefit of ASBA is that the money goes out of the investor's bank account only on allotment. Until then, it keeps earning interest for the investor. Further, since the money

transferred from the investor's bank account is the exact application money that is due on account of the allotment, the investor does not have to wait for any refund.

### **Aadhaar Enabled Payment Service**

Aadhaar Enabled Payment Service (AEPS) allows bank to bank transaction using the Aadhaar number of the customer. The Aadhaar number has to be linked to the bank account to be able to use AEPS. The account holder can withdraw and deposit cash and transfer money to another account linked to the Aadhaar number. The AEPS uses the fingerprint of the individual as the password to authorize transactions and is thus a secure mode of transfer of funds.

### **National Unified USSD Platform**

National Unified USSD Platform (NUUP) based mobile banking allows transactions even without a smartphone and internet. The code \*99# dialled from the phone registered with a bank for a bank account allows transactions such as making payments, checking balances, fund transfers and getting a mini statement. Most leading banks support this service. NUUP is currently available in 11 regional languages.

### **Cards**

Cards are the most commonly used mode of digital payments. Debit cards are issued by banks to their account holders and allow card holders to carry out fund transactions linked to their bank account. Credit cards are issued by banks and other approved entities and allow credit card holders to use the card up to approved credit limits. Prepaid cards can also be used to make card payments. The cards are used by swiping it at the merchants' PoS device. A PIN may be required to confirm the transaction in case of a debit card. Online payments can also be made using cards. The drawback is that the merchant may have to pay a charge on each transaction done through credit cards. Mutual funds purchases using credit cards are not allowed.

### **E-Wallets**

E-Wallets are a virtual or digital version of the physical wallet. Money is loaded to the E-Wallet and used as required to make payments and transfer funds to other E-Wallets. However, they cannot be used to transfer money to a bank account. Using the E-Wallet does not require a PIN or Password which makes them susceptible to unauthorized use by anyone who can get access to the mobile phone on which the Wallet is stored. Wallets of banks, payment banks and e-commerce platforms are commonly called E-Wallets. The use of E-Wallets is subject to certain conditions like following regulations pertaining to cut-off timings, time stamping etc. MFs/AMCs shall ensure that total subscription through e-wallets for an investor is restricted

to Rs.50,000/- per investor per financial year. This limit of Rs.50,000/- would be an umbrella limit for investments by an investor through both E-Wallet and/or cash, per mutual fund per financial year. MFs/ AMCs shall ensure that only amounts loaded into e-wallet through cash or debit card or net banking, can be used for subscription to MF schemes. Any amount loaded into e-wallet through credit card, cash back, promotional scheme etc. are not allowed for subscription to MF schemes. Also no third party transactions are allowed through e-wallets.

Digital payments such as Net Banking, Debit cards, UPI are amongst the accepted modes of payment for mutual fund schemes currently.

**One-Time Mandate (OTM)** is a payment facility that investors can use to authorize their bank to process debits to their specified bank account raised by a specified mutual fund for purchase of units. The debits happen through the National Automated Clearing House (NACH). It eliminates the need for the investor to initiate payment every time a purchase transaction is conducted. It is a one-time process to register a bank account under this facility. An existing investor can fill up the OTM form to register a bank account and hand it over to the Investor Service Centre for processing. A new investor can submit the OTM form along with the application form for subscription. The OTM mandate requires the bank name, bank account number, account type, IFSC and MICR code to be provided to identify the account to be registered. A cancelled cheque or copy with the name and account number pre-printed on it has to accompany the application form for verification of the account details. The folio number for existing investors and the application form number for new investors have to be provided along with the email id and phone number. Investors can select the frequency at which debit can be made, monthly, quarterly, half-yearly, or 'As and when presented' and specify the fixed amount that can be debited. The mandate also allows account holders to specify the maximum amount that can be debited on a daily basis and select the category— 'As and when presented' under the frequency parameter to enable multiple SIP or other purchase debits under the folio. For example, investors can mandate an amount of Rs.5000/- that can be debited as and when presented. There is no limit on number of transactions as long as the total amount is within the daily maximum limit specified in the mandate. The period for which the mandate will be valid should also be specified in the form. The name(s) and signatures of the bank account holders have to be affixed on the form. Registering the OTM can take 3 to 4 weeks.

The OTM mandate is at a folio level. This means that the folio holder can use the OTM mandate for all purchase transactions under the folio. Mutual funds may specify the schemes and the type of purchase transactions that can be conducted through the OTM— Fresh lump sum purchase, additional purchase, SIP investments.

The OTM can be used to make the eligible purchases through physical, online, SMS and other modes of transaction offered by the mutual fund. The mandate can be cancelled by submitting the OTM form indicating cancellation.

## **Other payment mechanism for mutual fund purchases**

### ***Cheque/Demand Draft***

Application forms for fresh investment/transaction slip for additional purchase is normally accompanied by cheque/demand draft (DD) drawn in favour of the scheme in which application is to be made. In order to prevent misuse of physical payment instruments mutual funds prescribe precautions such as mentioning of the name/PAN number of the investor and details of the scheme on the payment instrument. A separate payment instrument should accompany each scheme/each plan.

Cheques are signed by the account holder, while DDs are signed by the banker. Generally, DDs are accepted only if the investor is from a location where there is no official collection centre for the application. The bank charges for the outstation DD will be borne by the AMC within specified limits.

NRI/PIO applications need to be accompanied by cheque drawn on an NRO/NRE/FCNR account (for non-repatriable investment) or NRE/FCNR account (for repatriable investment). If Indian Rupee Drafts are purchased abroad or cheques issued from NRE/FCNR account an account debit certificate from the bank issuing the draft confirming the debit and/or Foreign Inward Remittance Certificate (FIRC) by investor's banker shall also be enclosed to certify the source of funds as remitted from abroad.

The payment instrument would need to be local i.e. cheque should be drawn on a local bank account. If it is drawn on an out-station bank account, then the bank should offer the facility of 'at par' payment in the location where the application form and cheque are submitted. If such an 'at par' facility is available, 'payable at par at ..... (list of locations / all over India)' would be clearly mentioned on the face or back of the cheque. Cheques accompanying the investment application are to be signed by the investor and drawn on an account in which the first holder is an account holder.

Similarly, DD should clearly mention the place of payment as the location where the application form / transaction slip and payment instrument are being submitted.

The payment instrument should not be post-dated (except for future installments under SIP), and not stale (i.e. cheque date should not be more than 3 months older than the date on which the cheque is to be banked). Third-party cheques are not accepted except in special cases. To know about Third Party Payments, refer Box.9.1.

### **Box:9.1 Third Party Payments**

A third-party payment is defined as one made through a bank account other than that of the first holder of the folio. If the payment is made through a joint bank account, then the person mentioned as the first holder of the folio should be one of the joint holders for the payment to be considered non-third party payment.

There are some exceptions where third party payments will be accepted.

- Payment by Parents/Grand-Parents/Related Persons on behalf of a minor in consideration of natural love and affection or as gift for a value not exceeding Rs 50,000/- for each regular purchase or per SIP installment. 'Related Person' means any person investing on behalf of a minor in consideration of natural love and affection or as a gift. In such cases, persons who make payment should be KYC Compliant and sign Third Party Declaration form.
- Employer making payments on behalf of employee through payroll deductions, and custodian on behalf of FPIs are permitted third-party payments.
- Payments by the AMC to its empanelled distributors on account of commissions etc. in the form of units of the mutual fund scheme managed by the AMC either through an SIP or lump sum investments or a similar arrangement of payment of commission by a Company to its agents will also be considered accepted third party payments. AMCs are required to put checks and balances in place to verify such transactions.

A Third-Party Declaration form duly completed has to accompany the application where the payment is from this source. The beneficial investor has to be clearly identified in the form by giving the full name of the first/sole investor and using the folio number if it is an existing number or the application form number for a new investment. Compliance with the KYC norms and providing the PAN details are mandatory by the third party making the payment irrespective of the amount involved. The source of funds with which the payments are being made should be clearly established. Where the payment is being made by cheque then the name of the third party making the payment should be pre-printed on the cheque. If this is not available then a bank statement or pass book having the party's name or letter on the bank's letterhead giving details of the bank account held should be attached. Similarly, if the payment is made by a pre-funded instrument such as a demand draft then proof of the funding having come from the third-party's account has to be enclosed. If electronic modes such as RTGS/NEFT, NACH or account transfer are used then the acknowledgement copy of the instructions to the bank has to be provided. The purpose of the documentary proof is to provide AMC the evidence that the payment was made out of the bank account of the third party and should therefore have the details of the account holder clearly mentioned. Pre-funded instruments such as demand drafts issued against cash for Rs.50,000 or more will not be accepted as payment.

## **Cash Payments**

Mutual funds usually do not accept cash. Small investors, who may not be tax payers and may not have PAN/bank accounts, such as farmers, small traders/businessmen/workers are allowed cash transactions for purchase of units in mutual funds to the extent of Rs. 50,000/- per investor, per mutual fund, per financial year. This is subject to compliance with Prevention of Money Laundering Act, 2002 and SEBI Circulars on Anti Money Laundering (AML) and other applicable AML rules, regulations and guidelines. This facility is available only for resident individuals, sole proprietorships and minors investing through their guardians. They must be compliant with the KYC norms, whether or not they have a PAN. The application must be submitted in physical mode to avail of this payment option. A prescribed deposit slip for making cash investments available at the Investor Service Centre (ISC) has to be used to give details of the scheme in which the investment is being made and the amount of investment. The deposit slip along with the cash has to be deposited at the bank branches designated to accept the cash investments. The acknowledgement copy of the bank slip received from the bank along with the application form/transaction slip has to be submitted to the ISC for time stamping.

Although investment can be made in cash, repayment in form of redemptions, dividend payments etc. can be only through the banking channel. The pay-out bank details have to be provided in the application form.

Apart from the above mentioned exception for small investors, application money need to come through normal banking channels. Instruments or payment modes that are not accepted for payment include Stock-invests, Postal orders, Money orders, Cash (except as discussed above), Outstation cheques and Post-dated cheques (except for systematic investments).

### **9.8.2 Payment Mechanism for Repurchase of Units**

The investor has various options for receiving the money, due to him from the scheme on repurchase of units:

#### **Cheque**

This is a traditional approach, where the receipt of money in the investor's bank account is delayed on account of the processes involved viz. time taken by the AMC to prepare and send the cheque, time taken by postal authorities/courier to deliver the cheque, time taken by the investor to deposit the cheque in the bank, and time taken by the banking system to transfer the proceeds to the investor's bank account.

#### **Electronic Modes**

Electronic modes allow for the repurchase proceeds to be transferred electronically to the investor's bank account. This is much faster because the various processes mentioned earlier

for payment by cheque, are obviated. A Direct Credit from the mutual fund's account to that of the investor can be done provided the investor holds an account with a bank with which the mutual fund has an arrangement to make direct credits. Other electronic modes include RTGS/NEFT/NACH etc. Details such as the account number, branch address, IFSC/MICR code have to be provided to the mutual fund to enable credit to the bank accounts of investors of redemption amounts and dividends. This information is collected at the time of making the application. Electronic modes may not be available to all investors, depending upon their geographic location and/or the bank and branch with which they hold their account. In such cases cheques and demand drafts will be used to make payments to the investors.

The redemption proceeds will be paid in favour of the sole/first holder of the folio. If the proceeds are paid by cheque, then the same will be sent to the unitholders address.

For units held in dematerialized form, the redemption proceeds will be paid into the bank account registered with the DP.

It may be noted that for non-resident investors, payment is made by the AMC in rupees. In case the investment has been made on repatriable basis, and the investor wishes to transfer the money abroad, the costs associated with converting the rupees into any foreign currency would be to the account of the investor. Proceeds of investments made on repatriable basis can be credited to an NRE or FCNR account, as required by the investor. In case of redemptions by NRIs there will also be tax deducted at source as applicable.

Mutual funds provide investors the facility to register multiple bank accounts to facilitate receiving the redemption, dividends and any other pay outs from the fund. An individual investor can register up to five bank accounts and a non-individual investor, ten. The first holder of the folio must be an account holder in each of the accounts that are registered. One of the accounts is designated as the default account, and unless otherwise specified all credits are made to this account by the mutual fund. Investors can change the default bank account at any time by instructing the AMC to do so.

In case of NRI investments, if the payment for the investment was made through an NRO account, then the registered account should also be of the same type. If payment was routed through an NRE account, then the registered accounts can be an NRO or NRE account.

A redemption request may be accompanied by a request to credit the amount to an account other than the default bank account registered with the mutual fund. If this account is among the bank accounts that have already been registered with the mutual fund under the facility to register multiple bank accounts, then the credit will be made to the desired account. If the account has not been registered, then the amount will be credited to the default bank account and the request for change in the bank account will not be processed.

## Instant Access Facility

IAF facilitates credit of redemption proceeds in the bank account of the investor on the same day of the redemption request. The MFs/AMCs can offer IAF only in Liquid schemes of the mutual fund. The monetary limit under the IAF is Rs. 50,000 or 90 percent of latest value of investment in the scheme, whichever is lower. This limit is applicable per day per scheme per investor. Also, there can be repurchase transactions through the stock exchange platform or MFU platform.

### 9.9 Cut-off Time and Time Stamping

As seen earlier, the sale and re-purchase prices are a function of the applicable NAV. In order to ensure fairness to investors, SEBI has prescribed cut-off timing to determine the applicable NAV. The provisions, which are uniformly applicable for all mutual funds, are as follows:

Type of Scheme	Transaction	Cut off time	Applicable NAV
Equity oriented funds and debt funds (except liquid funds) in respect of purchases less than Rs. 2 lakhs <sup>48</sup>	Purchases and Switch ins	3.00 pm	Same day NAV if received before cut off time.
			Next business day NAV for applications received after cut off time.
Equity oriented funds and debt funds (except liquid funds) in respect of transaction equal to or more than Rs. 2 lakhs	Purchases and Switch ins	3.00 pm	Irrespective of the time of receipt of application, NAV of the business day on which the funds are available for utilisation without availing of any credit facility before the cut-off time of that day is applicable.

<sup>48</sup> Vide SEBI circular dated September 17, 2020, it was decided that with respect to purchase of units of [MF schemes](#) (except liquid and overnight schemes), closing NAV of the day shall be applicable, on which the funds are available for utilisation irrespective of the size and time of receipt of such application. Until now, investors who gave a cheque for below Rs 2,00,000 got the same day's NAV, while those putting more got the NAV of the day when the cheque was realised. This comes into effect from January 1, 2021.

Candidates are advised to read: [https://www.sebi.gov.in/legal/circulars/sep-2020/circular-on-mutual-funds\\_47574.html](https://www.sebi.gov.in/legal/circulars/sep-2020/circular-on-mutual-funds_47574.html) for more details.

Type of Scheme	Transaction	Cut off time	Applicable NAV
Liquid fund	Purchases and Switch ins	1.30 pm	<p>If application received upto the cut off on a day and funds are available for utilisation before the cut-off time, without availing any credit facility, whether intra-day or otherwise then closing NAV of the day immediately preceding the day of the receipt of application is applicable.</p>
			<p>If application received after cut off time on a day and funds are available for utilisation on the same day whether intra-day or otherwise, the closing NAV of the day immediately preceding the next business day is applicable.</p> <p>[Mutual funds shall calculate NAV for each calendar day for their liquid fund schemes and plans.]</p>
			<p>Irrespective of the time of receipt of applications, where the funds are not available for utilisation before the cut-off time, without availing any credit facility, whether intra-day or otherwise, the closing NAV of the day immediately preceding the day on which the funds are available for utilisation.</p>
Equity Oriented Funds, Debt funds (Other than Liquid funds)	Redemptions and Switch outs	3.00pm	<p>Same day NAV if received before cut off time.</p>
			<p>Next business day NAV for applications received after cut off time.</p>

Type of Scheme	Transaction	Cut off time	Applicable NAV
Liquid funds	Redemptions and Switch outs	3.00 pm	NAV of day immediately preceding the next business day, if received before cut off time.  If redemption request is received through Instant Access Facility (IAF) upto the cut off time, then the lower of: (a) NAV of previous calendar day and (b) NAV of calendar day on which application is received
			Next business day NAV for applications received after cut off time.  If redemption request is received through Instant Access Facility (IAF) after the cut off time, then the lower of: (a) NAV of calendar day on which such application is received and (b) NAV of next calendar day

The above cut-off timing is not applicable for NFOs and International Schemes.

These are explained with some examples below:

Consider the following case as an example:

Assume that in a particular week, Monday, Wednesday, Thursday and Friday are business days, whereas all the other days are non-business days. The week would look as under:

- Sunday – non-business day
- Monday – business day
- Tuesday – non-business day
- Wednesday – business day
- Thursday – business day
- Friday – business day
- Saturday – non-business day

Given the above details, following are some examples of transactions to understand what NAV would be applicable:

1. An investor submits an application on Monday to buy units of an equity mutual fund scheme for Rs. 3,00,000.

If application is made on Monday and fund gets realized on Wednesday by 2 pm, it will be Wednesday's NAV. If funds are realized or available for utilisation on Wednesday by 5 pm, then it will be Thursday's NAV.

2. An investor makes an application to purchase units of a liquid fund

If application is made on Monday and fund gets realized by 1 p.m. on Monday, it will be Sunday's NAV. If it gets realized by 3 pm on Monday, it will be Tuesday's NAV. If it gets realized by 10 am on Wednesday, it will be Tuesday's NAV.

3. An investor makes an application for redemption of units of equity fund on Monday

If the application is submitted before the cut-off time, the redemption would be processed at Monday's NAV. However, if the application is submitted after the cut-off time, the applicable NAV would be of Wednesday. (Remember: Tuesday is a non-business day).

4. Redemption from liquid fund, application submitted on Monday

If the application is submitted before the cut-off time, the redemption would be processed at Sunday's NAV. However, if the application is submitted after the cut-off time, the applicable NAV would be of Wednesday. (Remember: Tuesday is a non-business day).

### **Time Stamping**

The precision in setting cut-off timing makes sense only if there is a fool proof mechanism of capturing the time at which the sale and re-purchase applications are received. This is ensured through the following:

Mutual funds disclose Official Points of Acceptance (OPoAs) and their addresses in the SID and their website. All transaction requests need to be submitted at the OPoAs. The time stamping on the transaction requests is done at the official points of acceptance.

As a convenience, the distributor may accept the transaction request from the investor, but this would need to be sent to an OPoA at the earliest. When the cut-off timing is applied, the time when it is submitted to the OPoA is relevant—not the time when the investor submits the transaction request to the distributor.

These points of acceptance have time stamping machines with tamper-proof seal. Opening the machine for repairs or maintenance is permitted only by vendors or nominated persons

of the mutual fund. Such opening of the machine has to be properly documented and reported to the Trustees.

Applications are sequentially numbered from the first number of the machine to the last number of the machine, before a new numbering cycle is started for the machine. The daily time stamping of application does not start with serial 1.

Application for purchase of units is stamped with automatically generated location code, machine identifier, serial number, date and time; the reverse of the payment instrument has to be similarly stamped with the same number; the acknowledgement issued to the investor gets a similar stamp.

Application for re-purchase and investor's acknowledgement are stamped with the same information.

Similarly, applications for non-financial transactions like change of address, and investor's acknowledgement are stamped. However, here stamping of time is not relevant; the date stamping is pertinent.

For online transactions, the time as per the web server to which the instruction goes, is used in determining the NAV for sale/re-purchase transactions.

## **9.10 KYC Requirements for Mutual Fund Investors**

All investors, both individual and non-individual, including joint holders, NRIs, PoA holders and its issuers, and guardians in the case of minors have to be KYC compliant, irrespective of the investment value. This applies for transactions such as new/additional purchases, switch transactions, new systematic investment plan (SIP)/micro SIP registrations received from effective date, new systematic transfer plan (STP) registrations from effective date, new dividend transfer plan (DTP) registrations from effective date.

The KYC process involves establishing the identity and address of the investor as required under the Anti-Money Laundering Laws. The application for investment must be accompanied by the acknowledgement for having completed the KYC process issued by the KYC Registration Agency (KRA).

Broadly, mutual fund investors need to submit the following documents to the distributor or other capital market intermediary registered with SEBI, such as stock broker and depository participant. The information is updated in the central system of the KRA.

### **9.10.1 KYC Documents**

For the KYC process (for establishing proof of identity and address), the following documents are required:

- **Permanent Account Number (PAN) Card** with photograph is mandatory for all applicants except those who are specifically exempt from obtaining PAN. *This serves as the proof of identity.* With a view to bring about operational flexibility and in order to ease the PAN verification process, SEBI has provided that market intermediaries may verify the PAN of their clients online at the Income Tax website without insisting on the original PAN card, provided that the client has presented a document for Proof of Identity other than the PAN card.
- There are some PAN exempt mutual fund investment. See Box 9.2 for details.
- The following categories of investors are exempt from producing PAN:
  - In case of transactions undertaken on behalf of Central/State government and by officials appointed by the court.
  - Investors residing in the state of Sikkim.
  - UN entities/Multilateral agencies exempt from paying taxes/filing tax returns in India.
  - Investments (including SIPs and lump sum investments) in Mutual Fund schemes upto Rs. 50,000/- per investor per year per mutual fund.

These categories of investors however have to provide an alternate document such as the Aadhaar card, Passport, Voter's Id, Driving License or other photo-identity card which serve as the **proof of identity**.

- **Proof of Address** such as Passport, Voter's Id, Ration card, Driving License, bank account statement, utility bill and other specified documents. If address for communication and permanent address are different then documentary proofs have to be provided for both. The proof of address in the name of the spouse may be accepted.

The copies of the documents produced have to be self-attested and the originals have to be provided for verification purpose. In case, the originals are not produced for verification then the copies of the documents must be attested by persons authorized to do so. The sample of KYC forms are provided from Appendix 7 to Appendix 10.

### **Box 9.2: PAN Exempt Investments in Mutual Funds**

Providing Permanent Account Number (PAN) is compulsory for all mutual fund investments. Exception has been made for Micro-SIPs i.e. SIPs where annual investment (12 month rolling or April-March financial year) does not exceed Rs 50,000. Similarly, as discussed earlier in this chapter, small investors investing upto Rs. 50,000 per mutual fund per financial year do not need to provide PAN Card. Rs. 50,000 is a composite limit for the small investor's Micro-SIP and lump sum investments together.

Investment by individuals, minors and sole-proprietary firms within the limits specified above are exempted from the requirement of PAN card. However, the KYC norms have to be complied with a SEBI registered KRA. Investors must quote the PAN Exempt KYC Reference Number (PEKRN) issued by the KRA and submit a copy of the letter with the application form.

Instead of the PAN, the investors (including joint holders) can submit any one of the following PHOTO IDENTIFICATION documents for KYC verification:

- Voter Identity Card
- Driving License
- Government / Defence identification card
- Passport
- Photo Ration Card
- Photo Debit Card (Credit card not included because it may not be backed up by a bank account)
- Employee ID cards issued by companies registered with Registrar of Companies
- Photo Identification issued by Bank Managers of Scheduled Commercial Banks / Gazetted Officer/Elected Representatives to the Legislative Assembly / Parliament
- ID card issued to employees of Scheduled Commercial / State /District Co-operative Banks
- Senior Citizen / Freedom Fighter ID card issued by Government
- Cards issued by Universities/deemed Universities or institutes under statutes like Institute of Chartered Accountants of India, Institute of Cost Accountants of India and Institute of Company Secretaries of India
- Permanent Retirement Account Number (PRAN) card issued to National Pension System (NPS) subscribers by CRA (NSDL)
- Any other photo ID card issued by Central Government / State Governments /Municipal authorities / Government organizations like ESIC / EPFO.

The Document must be current and valid and the copy shall be self-attested by the investor/attested by the ARN holder mentioning the AMFI Registration Number (ARN).

## 9.10.2 KYC Registration Agencies

### *Centralised KYC Registration Agencies*

SEBI has instituted a centralised KYC process for the capital market, including mutual funds. This is a significant benefit for the investor. Based on completion of KYC process with one capital market intermediary, the investor can invest across the capital market. KYC Registration Agencies (KRAs) facilitate this centralised KYC process.

Once a capital market intermediary has performed an In-Person Verification (IPV) of the investor and other documentation requirements are in place, and the intermediary uploads the investor's data to the database of a KRA, the KYC is valid across the capital market. The investor can benefit from that KYC to invest in any part of the capital market (not limited to mutual funds).

SEBI circulars dated August 22, 2011, October 5, 2011 and December 26, 2013, on uniform KYC norms prescribed a standard account opening form (AOF). Part I of the form contains the basic KYC details of the investor used by all SEBI registered intermediaries and Part II of the form contains additional information specific to dealing in the stock exchanges.

Vide Notification dated November 26, 2015, the Government of India authorised the Central Registry of Securitisation and Asset Reconstruction and Security Interest of India (CERSAI) to act as and to perform the functions of the Central KYC Record Registry under the PML Rules 2005, including receiving, storing, safeguarding and retrieving the KYC records in digital form of all the clients in the financial sector.<sup>49</sup>

The KYC template finalised by CERSAI has to be used by the registered intermediaries as Part I of the AOF for individuals. The registered intermediaries shall upload the KYC data with Central KYC Records Registry (cKYCR) in respect of all individual accounts opened on or after August 1, 2016 where KYC is required to be carried out as per the circulars issued by SEBI from time to time. Some of the key functions of Central KYC Registry have been mentioned below:

- It shall be responsible for electronically storing, safeguarding and retrieving the Know Your Customer (KYC) records and making such records available online to reporting entities or Director.
- Information updated about a customer shall be disseminated on request by Central KYC Registry to any reporting entity that avail the services of the Central KYC Registry in respect of the customer.

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<sup>49</sup> Client as defined in clause (ha) sub section (1) of Section 2 of the Prevention of Money Laundering Act, 2002 dated November 2015.

- The services of the Central KYC Registry will be available on payment of prescribed fee, in advance.
- It shall process the KYC records received from a reporting entity for de-duplication and issue a unique KYC Identifier for each client to the reporting entity.

Where a customer submits a KYC identifier to a reporting entity, then such reporting entity shall download the KYC records from the Central KYC Registry by using the KYC Identifier and shall not require a customer to submit the documents again unless:

- There is a change in the information of the customer as existing in the records of Central KYC Registry.
- The current address of the client is required to be verified.
- The reporting entity considers it necessary in order to verify the identity or address of the client, or to perform enhanced due diligence or to build an appropriate risk profile of the client.

### ***KYC through e-KYC service of UIDAI***

In consultation with Unique Identification Authority of India (UIDAI) and the market participants, e-KYC service launched by UIDAI has also been accepted as a valid process for KYC verification. The information containing relevant client details and photograph made available from UIDAI as a result of e-KYC process shall be treated as sufficient proof of Identity and Address of the client. However, the client shall have to authorize the intermediary to access his data through UIDAI system.<sup>50</sup>

Entities in the securities market, as may be notified by the Central Government, shall be allowed to undertake Aadhaar Authentication under section 11A of the PMLA. These entities would be registered with UIDAI as KYC user agency (KUA) and shall allow all the SEBI registered intermediaries/mutual fund distributors to undertake Aadhaar Authentication of their clients for the purpose of KYC through them.

The SEBI registered intermediaries/mutual fund distributors, who want to undertake Aadhaar authentication services through KUAs, shall enter into an agreement with any one KUA and get themselves registered with UIDAI as sub-KUAs. The agreement in this regard shall be prescribed by UIDAI. Upon notification by the Central Government/registration with UIDAI, the KUAs and sub- KUAs shall adopt the following process for Aadhaar e-KYC of investors (resident) in the securities market. This entire process is mentioned in Appendix 11.

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<sup>50</sup> SEBI circular no. SEBI/HO/MIRSD/DOP/CIR/P/2019/123 dated November 05, 2019

### ***KYC through Intermediaries***

Where the investors choose to hold the units in demat form or for applicants who choose to invest through the stock exchange infrastructure, the KYC performed by the Depository Participant will be considered in compliance with the KYC norms.

Additional details of the investor, namely occupation, Gross Annual Income/ Networth and Politically Exposed Persons (PEP) status are also captured in the application form by mutual funds. This is mandatory information and has to be provided both by individuals and non-individuals.

Centralised KRAs have made the KYC process simpler for investors. Mutual funds, depositories, registrars and transfer agents, KYD compliant mutual fund distributors and brokers are authorised to facilitate the KYC documentation of investors.

#### **9.10.3 KYC Process**

KYC Process entails the following:

- The requisite form has to be filled-in along with supporting documents. The supporting documents (identity and address proof) are verified with the original documents. Alternatively, the investor can provide a True Copy attested by a Notary Public, Gazetted Officer or Manager of a Scheduled Commercial Bank.
- The original documents of the identity and address proof are returned to the investor after verification while the forms and supporting documents are uploaded in the server of any centralised KRA.
- The intermediaries mentioned above are also authorised to perform an In-Person Verification (IPV) of the investor, which is mandatory. The name, designation and organisation of the person conducting the IPV has to be recorded on the KYC form. An IPV performed by Scheduled Commercial Bank is also acceptable for mutual fund investments.

Once these processes are completed and the details are uploaded on the KRA's servers, the KYC process is complete. The investor does not need any further KYC for dealing in any part of the securities market (depository, stock exchange transactions, mutual fund transactions etc.).

Similarly, in the event of change of address or any other information, the mutual fund investor needs to fill the standard form and follow the prescribed process only once, with any of the intermediaries mentioned above. (Refer to Appendix 9 and Appendix 10). Based on that, the information will be updated with all the mutual funds and other capital market related parties where the investor has invested.

SEBI has eased the Know Your Client (KYC) Process by enabling Online KYC, use of Technology/ App by the registered intermediary<sup>51</sup>. The use of technological innovations which can facilitate online KYC has been allowed. This facilitates the investors to complete the KYC without the requirement of physically visiting the office of the intermediary. SEBI has enabled the usage of eSign, Digilocker and electronic signature as permitted by the Government of India under the Information Technology Act, 2000 and the Rules made thereunder.

The enablement has been done to facilitate investor to submit their Officially Valid Documents (OVDs) for the purpose of KYC to the SEBI intermediary's online / digital platform, App, through e-mail or electronic means.

#### *KYC for Minors*

Where investment is made by a minor, KYC requirements have to be complied with by the Guardian. The proof of age of the minor has to be provided.

#### *KYC for Power of Attorney holder on behalf of an investor*

In the case of investments by a Power of Attorney (PoA) holder on behalf of an investor, KYC requirements have to be complied with, by both, investor and PoA holder. A PoA holder cannot apply for KYC compliance on behalf of the issuer of the PoA.

#### *KYC for NRIs*

For NRI investors PAN is the sole identification number for KYC compliance. A copy of the passport/PIO card/OCI card and overseas address proof is mandatory.

### **9.10.4 Additional Requirements applicable for Institutional Investors**

Since institutional investors are not natural persons, authorised individuals invest on behalf of the institution. Therefore, the following additional documents are essential:

- Eligibility for the investing institution to invest. For instance, a company/trust is eligible to invest under the laws of the country, but the company's own incorporation documents (Memorandum of Association and Articles of Association or Trust Deed)

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<sup>51</sup>Candidates are advised to read: [https://www.sebi.gov.in/media/press-releases/apr-2020/sebi-eases-the-know-your-client-kyc-process-by-enabling-online-kyc-use-of-technology-app-by-the-registered-intermediary\\_46612.html](https://www.sebi.gov.in/media/press-releases/apr-2020/sebi-eases-the-know-your-client-kyc-process-by-enabling-online-kyc-use-of-technology-app-by-the-registered-intermediary_46612.html) and [https://www.sebi.gov.in/legal/circulars/apr-2020/clarification-on-know-your-client-kyc-process-and-use-of-technology-for-kyc\\_46565.html](https://www.sebi.gov.in/legal/circulars/apr-2020/clarification-on-know-your-client-kyc-process-and-use-of-technology-for-kyc_46565.html) and [https://www.sebi.gov.in/legal/circulars/apr-2020/clarification-on-know-your-client-kyc-process-and-use-of-technology-for-kyc\\_46565.html](https://www.sebi.gov.in/legal/circulars/apr-2020/clarification-on-know-your-client-kyc-process-and-use-of-technology-for-kyc_46565.html)

may not have provided for such investments. The company/trust cannot invest if its incorporation documents do not provide for investments of this type. Similarly, in some states, permission of the Charity Commissioner is necessary, before Religious and Charitable Trusts can invest.

- Authorisation for the investing institution to invest. This is typically in the form of a Board Resolution.
- Authorisation for the official to sign the documents on behalf of the investing institution. This again is provided for in the Board Resolution. In case of other non-individual investors, too the list of authorised signatories would be required. The mutual fund can allow transactions only if the transaction form/slip carries the signature of any (one or more, as required) of the authorised signatories.
- SEBI has mandated that investors other than individuals have to provide details of the 'Ultimate Beneficial Owner' (UBO) of the investments and submit documents to establish their identity of such UBOs through any of the identity proofs acceptable under the KYC norms. An UBO of a company is one who owns or is entitled to more than 25 percent of its shares or profits, more than 15 percent in case of partnerships and body of persons. In case of a trust, this includes the settler, the trustees, the beneficiaries who are entitled to 15 percent or more of the benefits. The UBO requirements are not applicable to listed companies or subsidiaries of the same.

These documentation requirements for institutional investors are in addition to the normal KYC documentation, discussed earlier.

### **Legal Information and Mandatory Declarations**

As part of the Client Due Diligence (CDD) process under Prevention of Money Laundering Act, all categories of investors of SEBI registered intermediaries, which includes mutual funds, except individual investors and a company that is listed on a stock exchange or is a majority owned subsidiary of such a company is required to provide the information to establish and verify the identity of the persons who beneficially own or control the securities account. The proof of identity of the Ultimate Beneficial Owner (UBO) such as Name/s, Address, PAN/Passport together with self-attested copy and the UBO declaration form has to be submitted to the AMC/RTA. In case there is a change in the UBO then the same should be intimated to the AMC/RTA.

### **9.10.5 Foreign Account Tax Compliance Act and Common Reporting Standards**

To comply with the requirements of Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standards (CRS) provisions, financial institutions, including mutual funds, are required to undertake due diligence process to identify foreign reportable accounts and collect such information as required under the said provisions and report the same to the US Internal Revenue Service/any other foreign government or to the Indian Tax Authorities for

onward transmission to the concerned foreign authorities. The application form requires information to be provided if the citizenship/nationality/place of birth/tax residency are places other than India for all categories of investors. The countries of tax residency and respective tax payer reference ID has to be provided. Once an investor is identified as covered under the said regulation, the entire investment value of all the folios held will be reported. The identity of the investors and their direct and indirect beneficiaries and controlling persons will be reported. If there is a change in the status of the investor after the information is first provided, then the same has to be reported to the mutual fund within 30 days.

### **9.11 Systematic Transactions**

Mutual funds provide transactional facilities that allow investors to tailor investments and structure pay-outs to suit their specific needs and goals. Systematic transactions, such as systematic investments, withdrawals and transfers, enable periodic investments and withdrawals that investors can align to the available investible surplus, need for regular funds or rebalancing the investments to manage risks. Signing up for the systematic transactions also enables these transactions to be executed without the intervention of the investor every time, thus protecting the portfolio from investor inertia.

#### **9.11.1 Systematic Investment Plan**

It is considered a good practice to invest regularly, particularly into volatile markets such as equity markets. SIP is an approach where the investor invests constant amounts at regular intervals. A benefit of such an approach, particularly in equity schemes, is that it averages the unit-holder's cost of acquisition since more units are bought for the same amount of investment when the price/markets are down and fewer units when the price/markets are up.

Suppose an investor were to invest Rs 1,000 per month for 6 months. If, in the first month, the NAV is Rs 10, the investor will be allotted  $\text{Rs } 1,000 \div \text{Rs } 10$  i.e. 100 units. In the second month, if the NAV has gone up to Rs 12, the allotment of units will go down to  $\text{Rs } 1,000 \div \text{Rs } 12$  i.e. 83.333 units. If the NAV goes down to Rs 9 in the following month, the unit-holder will be allotted a higher number of  $\text{Rs } 1,000 \div \text{Rs } 9$  i.e. 111.111 units.

Thus, the investor acquires his units at lower than the average of the NAV on the 6 transaction dates during the 6-month period – a reason why this approach is also called *Rupee Cost Averaging*. Systematic investing allows investors to buy into a volatile market over time at an average price without having to predict market movements.

It is easier for investors to generate the smaller amounts required to invest through a periodic investment plan than the large sums required to make lump sum investments. Saving for goals becomes easier when investible surpluses are periodically invested.

Mutual funds make it convenient for investors to lock into SIPs by investing through Post-Dated Cheques (PDCs), NACH or Standing Instructions (SI).

An SIP can be used to initiate a fresh purchase in a scheme and open a folio or make additional purchases in an existing folio. The initial investment to initiate an SIP purchase is typically lower than that for a lump sum purchase. An SIP can also be initiated during a New Fund Offer (NFO).

### **9.11.2 Systematic Withdrawal Plan**

Just as investors do not want to buy all their units at a market peak, they do not want to risk redeeming all their units in a market trough. Investors can therefore opt for the safer route of offering for re-purchase a constant value of units over a period of time. Suppose an investor registers to withdraw Rs. 1,000 per month for 6 months. If, in the first month, the NAV is Rs 10, the investor's unit-holding will be reduced by Rs. 1,000 ÷ Rs. 10 i.e. 100 units. In the second month, if the NAV has gone up to Rs. 12, the unit-holding will go down by fewer units viz. Rs. 1,000 ÷ Rs. 12 i.e. 83.333 units. If the NAV goes down to Rs 9 in the following month, the unit-holder will be offering for re-purchase a higher number of units viz. Rs 1,000 ÷ Rs 9 i.e. 111.111 units. Thus, the investor re-purchases his units at an average NAV during the 6-month period. The investor does not end up in the unfortunate position of exiting all the units in a market trough. Since units are being redeemed, exit loads and taxes will apply. The effect of exit loads will increase the number of units that needs to be redeemed to withdraw a fixed amount of money since it reduces the effective price for the investor. In the earlier example, if there was an exit load of 1 percent then the first tranche of withdrawal when the NAV is at Rs.10 will be for 101.0101 units since the exit load of 1 percent reduces the applicable NAV for the investor to Rs.9.90 from the Rs.10. In order to get Rs.1000 the investor therefore has to redeem 101.0101 units.

Mutual funds make it convenient for investors to manage their SWPs by registering the amount, periodicity (generally, monthly) and period for their SWP. Some schemes even offer the facility of transferring only the appreciation or the dividend. In this option, the withdrawal is not fixed but will vary depending upon the availability of appreciation in the specific investment chosen by the investor. The advantage of a variable SWP relative to a fixed amount of withdrawal is that the capital invested will not be withdrawn. Depending upon the type of SWP chosen the mutual fund will re-purchase or redeem the appropriate number of units of the unit-holder, without the formality of having to give a re-purchase instruction for each transaction. An investor may opt for SWP for several reasons:

- To minimise the risk of redeeming all the units during a market trough.
- Meet liquidity needs for regular expenses.

- Assuming the scheme is profitable, the re-purchase ensures that some of the profits are being regularly encashed by the investor.

### 9.11.3 Systematic Transfer Plan

This is a variation of SWP. While in a SWP the constant amount is paid to the investor at the pre-specified frequency, in a STP, the amount that is withdrawn from a scheme (called the source scheme) is re-invested in some other scheme (called the target scheme) of the same mutual fund. Thus, it operates as a SWP from the source scheme, and a SIP into the target scheme. Since the investor is effectively switching between schemes, it is also called “switch” if it is just one transaction or tranche. If there are multiple tranches over a fixed period on pre-defined date of an amount that is defined ahead, then it is an STP. The transfer of funds from the source scheme is equivalent to a redemption. Exit loads and taxes will apply like any other redemption transactions. The minimum investment and redemption limits specified by the mutual fund for the schemes will not apply to an STP. The mutual fund will also specify the source schemes from which the switch/transfer can be made and the target schemes into which the switch/transfer can be made. If the unit-holder were to do this SWP and SIP as separate transactions.

- The Unit-holder ends up waiting for funds during the time period that it takes to receive the re-purchase proceeds, and has idle funds, during the time it takes to re-invest in the second scheme. During this period, the market movements can be adverse for the unit-holder.
- The Unit-holder has to do two sets of paper work (Redeem and Purchase) for every period.

The STP offered by mutual funds is a cost-effective and convenient facility. It can be used by investors to make periodic investments into a volatile market such as equity, or to rebalance a portfolio, or to book profits. Investors can choose to transfer a fixed amount each period or to transfer the appreciation in a scheme.

#### Example

An investor who holds lump sum amount of Rs.10 lakhs in a short-term debt fund and registers for an STP to transfer Rs.100000 each month over 10 instalments to a diversified equity scheme of the same mutual fund. There is an exit load of 0.25 percent on redemption from the short-term debt fund up to three months from the date of allotment and no exit load thereafter.

The first 3 instalments of Rs.1,00,000 transferred will be after the exit load of 0.25 percent. The load chargeable on each instalment will be Rs.250 and the amount transferred to the equity scheme will be Rs. 99750. After the third instalment there will be no exit load and the

full amount of Rs.1,00,000 will be transferred. Any return earned on the short-term debt fund will be taxed as applicable.

#### **9.11.4 Switch**

A *switch* is a redemption from one scheme and a purchase into another combined into one transaction. For example, investors who believe that equity markets have peaked and want to book profits can switch out from an equity scheme and switch into a short-term debt fund.

#### **9.11.5 Dividend Transfer Plan**

Dividend Transfer Plan (DTP) is a facility that allows investors to invest the dividend earned in a mutual fund investment into another scheme of the same mutual fund. Investors with a low risk profile can get some benefits of diversification by transferring dividends earned from debt funds into equity funds. Similarly, dividends earned in equity funds can be transferred into debt funds to rebalance the portfolio and manage risks. Mutual funds decide the schemes, plans and options from which the dividends can be transferred and the target schemes to which they can be transferred.

The investor must hold units in the dividend option of a scheme to sign up for this facility. Once the investor registers a DTP, any existing instruction for dividend pay-out or dividend re-investment will be overridden. All the units held under the scheme, plan and option selected for DTP will be covered under the transfer. The investor has to clearly identify the source scheme, plan and option from which the transfer has to be made and the target scheme, plan and option to which the dividend should be transferred. The units in the target scheme will be held in the same folio as the source scheme. The minimum application amount specified for the target scheme will not apply to investments made under a DTP. The mutual fund may specify a minimum amount of dividend that can be transferred. The dividend is invested in the target scheme on the next business day after the record date for the dividend pay-out in the source scheme.

Mutual funds may require the DTP enrolment form to be registered a specific number of days before the record date for the dividend. The DTP mandate will stand automatically terminated when the unit holding in the source scheme becomes nil. It can also be terminated by sending a written request to the mutual fund.

### **9.12 Operational aspects of Systematic Transactions**

Mutual funds specify the schemes in which systematic transactions are offered. The fund also specifies the minimum investment for each tranche, the dates on which the transactions can be conducted and the minimum period for which the investor can sign up. From the available options, the investor can choose the amount of the periodic transaction, the frequency

(monthly, quarterly, semi-annual, annual), the period over which the transaction will be done and the dates. In case of a minor investor however, the SIP will be registered only till the date of the minor attaining majority even though the instructions may be for a period beyond the date of majority. A default SIP date, frequency, end date may be specified by the scheme which will be applied in case the investor does not make a selection. Mutual funds may also offer the facility to increase the installment amount periodically.

A new investor has to submit both the application form as well as the SIP enrollment form to register for an SIP. The information provided in both the forms have to tally. In case of an existing investor only the SIP enrollment form has to be submitted. The enrollment form requires the names, PAN and KYC compliance of all the holders of the folio and their signatures. For existing investors only, the folio number needs to be provided. The enrollment form has to be signed as per the mode of holding of the existing folio. The investment details to be provided in the form includes the scheme, plan and option selected. The SIP details to be provided are the SIP amount, frequency, SIP date and the start and end date for the SIP period. The details of the bank account that is registered for NACH/Direct Debit/Standing Instructions for the SIP should be provided in the form. Information available under the folio, such as unitholder details and mode of holding, will apply to the SIP investments also. Signature of the investor in application form/folio records and enrollment form has to be the same. In case the existing folio is operated jointly then the SIP form has to be signed by all the holders.

The enrollment form has to be submitted to the mutual fund a specified number of days before the first installment, typically 15 to 30 days. For example, assume a mutual fund requires a registration time of 30 days for an SIP enrollment. An investor submits an enrollment form on 5<sup>th</sup> September and selects 15<sup>th</sup> as the SIP date. The first installment will be 15<sup>th</sup> of October since 30 days are required for registration. The enrollment time may come down if investors already have a One-Time Mandate (OTM) registered in the folio for making payments.

The payment modes accepted for SIPs include post-dated cheques and electronic payment modes such as NACH, direct debit and standing instructions (SI). The cheque numbers, date and amount for each cheque has to be provided. An authorization to the bank to execute the electronic payment has to be signed which will be registered with the bank by the mutual fund. To avail of the NACH facility of the RBI, the applicant should have an account with a bank in a city where the facility is approved by RBI and the bank should participate in the local MICR clearing. Direct debit and Standing Instructions are facilities that the investor can use if they hold an account with a bank and in a branch that has a tie up with the mutual fund. The first installment should accompany the enrollment form. This can either be through a cheque drawn on the bank which is registered for NACH/Direct Debit/SI for the SIP, or any other bank provided a photocopy of a cheque drawn on the bank registered for the electronic payment is also enclosed with the enrollment form. Alternatively, the first installment need not be paid

by cheque if the enrollment form is attested by the bank which is registered for debiting the installments.

### **SIP Top-up Facility**

Mutual funds provide an additional facility through an SIP to enhance the disciplined savings of investors. It is called the SIP Top-Up facility. Investors have the option to increase the SIP amount at intervals chosen by them. The increase can be of a fixed amount or a percentage of the existing SIP amount. For example, assume an investor has registered for a monthly SIP of Rs.2500 for a 3-year period and has also signed up to top-up the SIP at an annual frequency by Rs.500. In the first year the SIP installment will be Rs. 2500. The second year each monthly installment will be increased by Rs. 500 to Rs. 3000 and in the third year it will go up to Rs.3500. If the investor had instead signed up for a 10 percent annual increase, then the SIP installment goes up to Rs.2750 (2500 +10 percent of 2500) in the second year and Rs.3025 (2750+ 10 percent of 2750) in year 3. The top-up facility helps investors increase their savings with time as income and investible surpluses go up. Investors have the option to either set an upper limit for the SIP with Top-up facility or the date from which SIP Top-Up amount will cease. Once it reaches the pre-defined upper limit or the pre-defined date, the Top-up facility is discontinued. However, the SIP amount along with the Top-up amount will remain constant till the end of the SIP tenure.

Investors register for the Top-up facility at the time of enrolling for the SIP. An existing SIP investor can also register for a Top-up facility. The details of the existing SIP, such as scheme/plan, frequency, duration and amount has to be correctly provided while registering for the top-up facility. Mutual funds may not offer the Top-up facility for Micro-SIPs or it may be subject to the condition that the SIP amount and the Top-Up together does not exceed Rs. 50,000 in a rolling 12-month period or financial year.

### **Renewal and Cancellation of SIP**

To renew an SIP, a renewal form has to be submitted giving details of the scheme, plan and option, SIP amount, SIP date and period.

An SIP can be cancelled by giving due notice of the same to the AMC by providing details of the SIP such as folio number, scheme name, option, bank details and mode of payment. The period of notice required will be specified by the AMC. The bank mandate, in case of electronic payment mode, also has to be cancelled. An SIP may also stand cancelled if there are insufficient funds in the bank account when payment is due.

### **Registration and Cancellation of SWP**

In case of systematic withdrawals, the investor has to register the SWP with the mutual fund and specify details such as the scheme, plan, option, amount of withdrawal, frequency and

the period of the SWP. The selections have to be made from the options provided by the mutual fund. The mutual fund may specify a minimum period before the first withdrawal before which the enrollment form has to be submitted. The credits will be made to the default bank account, or any other account as required by the investor and registered with the mutual fund. The mutual fund may specify the minimum amounts for each tranche of a systematic withdrawal transaction. Typically, this is lower than what is specified for a redemption from the scheme.

An SWP will stand cancelled when all the units are redeemed. Investors can choose to cancel SWP by giving notice in writing to the mutual fund giving full details of the mandate such as scheme name, plan, option, folio details, SWP amount, frequency and period.

### **Registering and Cancellation of STP and Switches**

In case of systematic transfers and switches, the source and target schemes have to be selected at the time of registering the STP or Switch. The schemes from and to which transfers and switches can be made are defined by the mutual fund. The minimum amount of transfer is also fixed by the mutual fund. The frequency, number of installments and the dates of the transfer are selected by the investor in the form for registering the STP. Mutual funds will require a notice period for registering and cancelling the STP.

A Switch instruction will be given by the investor using the Transaction slip. The investor has to provide the folio number, scheme, plan and option from which the switch will be made. The switch can be defined in rupees or number of units. The scheme, plan and option into which the switch has to be made should be provided. The units of the target scheme acquired under a switch or transfer will be under the same folio as the source scheme.

### **Execution of Systematic Transactions**

Each tranche of a systematic transaction will be executed at the applicable NAV on the date of the transaction. In case of transfers, each leg of the transfer (redemption and purchase) will be executed at the applicable NAV for each scheme. The investor will have to bear the loads and taxes as applicable. A systematic transaction can be cancelled at any time by giving the mutual fund notice in writing.

### **Triggers**

It is not uncommon for investors to rue missed opportunities of buying or selling because they could not give the requisite instructions in time. This is addressed through the trigger option that is offered by some mutual funds.

For instance, an investor can book profits by specifying that the units would be re-purchased if the market reaches a particular level. In that case, once the market reaches that level, the

units would be re-purchased, without the need for going through a separate re-purchase documentation. It stands to reason that if the market continues to go up after the trigger is activated, the investor loses on the further gain. A date trigger instructs the mutual fund to redeem the units specified on a particular date. Or, the investor could set a stop-loss trigger by identifying the level of the NAV or the percentage depreciation in the value of the investment at which the investment should be redeemed so that the investment is protected from a further fall in value.

Similarly, an investor can set a trigger to transfer money into an equity scheme when the market goes down, say 20 percent, or the transfer can be triggered by a fall in the NAV of the equity scheme by a defined percentage. This would help the investor conveniently increase his position in equities, when the markets decline. Typically, triggers are set on the value of indices or the investment. Investors can choose to redeem just the appreciation or the entire holding value on the activation of the trigger or a percentage of the current value of the investment. Investors will choose this depending upon the type of trigger. For example, a stop loss trigger may go with redeeming the entire investment value while an appreciation trigger may be paired with redeeming the amount of appreciation. Investors may also choose to switch to another scheme on the activation of the trigger. Mutual funds decide the type of triggers that will be offered and the schemes on which they will be offered. For each investment under a folio, a separate trigger facility request has to be made. A notice period may be specified by the mutual fund for registering and cancelling a trigger facility. A trigger is a one-time facility that extinguishes when the trigger is activated and the corresponding action is completed.

## **9.13 Non-Financial Transactions in Mutual Funds**

### **9.13.1 Nomination**

Most investors like clarity about what would happen to their unit-holding, in the unfortunate event of their demise. This clarity can be achieved by executing a Nomination Form, where the nominee's name is specified. The nomination made in a folio applies to all the investments held under the folio. Nomination can be made in favour of a maximum of three nominees. Where there are multiple nominees, the unitholder(s) must define the percentage holding for each nominee making a total of 100 percent.

If the percentages are not clearly indicated, then the nomination will be made equally among the nominees. In case of a folio held in the name of a single individual, nomination is required unless the holder specifically confirms their intent not to nominate at the time of making the application. In the case of joint holding, every unit-holder will have to sign the nomination form, irrespective of the mode of holding.

Only individual investors can make a nomination. Investments by minors cannot have a nomination. A Power of Attorney holder cannot make a nomination.

#### *Nominees*

The nominee can be an individual, including minors and NRIs, central and state governments and local authorities. If the nominee is a minor, then a guardian too can be specified. A nomination cannot be made in favour of a trust (except a religious or charitable trust), society, body corporate, partnership, Karta of an HUF or a Power of Attorney holder.

#### *Change in Nomination*

A nomination can be changed or cancelled at any time. The change or cancellation has to be made by all the unitholders who made the original nomination, irrespective of the mode of holding. When a new nomination is registered with the AMC, the earlier nomination made, if any, stands automatically superseded. The death of a nominee will cancel the nomination made, if it is a single nominee. If there are multiple nominees, in the event of the death of one or more nominees the transmission of units will be made in favour of the remaining nominee(s).

#### *Nomination in case of demat holdings of mutual fund*

For units held in dematerialized mode, the nominee made for the demat account will apply. Such nominations will be governed by the bye-laws of the depository.

#### **9.13.2 Pledge/Lien of Units**

Banks, NBFCs and other financiers often lend money against pledge of Units by the Unit-holder. This is effected through a *Pledge Form* executed by the unit-holder (*pledger*). The form has a provision for specifying the party in whose favour the units are pledged (*pledgee*). The units that are offered as security for a loan should have completed the lock-in period, if any. All the unit-holders, irrespective of the mode of holding, of the folio must sign the form requesting the marking of the lien in favour of the lender. The form should clearly state the name of the unit-holder(s) as it appears in the folio, identify the scheme, plan and option and the number of units on which the lien should be marked. A non-individual entity must enclose a board resolution and other authorization for the person pledging the units. Once units are pledged, the Unit-holder/s cannot sell or switch-out the pledged units, until the pledgee gives a written no-objection to release the pledge. As long as the lien is marked, the lender will have the authority to enforce the pledge and redeem units after providing documents necessary for the same. The minimum redemption requirement for a scheme will not apply

in these cases. The dividend pay-outs declared on units under lien may be paid to the unit-holder or the lender depending upon the agreement.

### **9.13.3 Demat Account**

*Dematerialisation* is a process whereby an investor's holding of investments in physical form (paper), is converted into a digital record. Benefit of holding investments in demat form is that investors' purchase and sale of investments gets automatically added or subtracted from their investment demat account, without having to execute cumbersome paperwork. Settlement of most transactions in the stock exchange needs to be compulsorily done in demat form.

In order to avail this facility, the investor needs to open a demat account with a depository participant. The access of demat facility for mutual fund investors has increased, with National Stock Exchange and Bombay Stock Exchange making available screen-based platforms for purchase and sale of mutual fund schemes.

Mutual funds are required to provide investors the option to hold the units in demat form. The mutual fund has to obtain an ISIN for each option of a scheme and make the information available in all the account statements sent to the investor. The application form for mostly all schemes have an option to provide the demat account details in case the investor chooses to hold the units in demat form. The demat facility is typically initiated by the mutual fund, which would tie up with a Depository (like National Securities Depository Ltd or Central Depository Services (India) Ltd). On the basis of this tie-up, investors can open a demat account with a Depository Participant and dematerialize their investment holdings i.e. convert their physical units into demat units. Usual KYC documentation is required for opening the account. However, once the KYC including IPV is performed for opening a demat account, no separate KYC is required to be done by the AMC or distributor or any other capital market intermediary. If KYC has already been done by any other capital market intermediary, then the DP will not insist on another KYC.

The option to apply for the units in dematerialized form is provided in the application form. The name of the Depository Participant with whom the investor holds the account, DP ID number and Beneficiary Account Number has to be provided. A copy of the DP statement enclosed with the application form may help the mutual fund verify the information provided in the application form. The name(s), mode of holding of the demat account and PAN of the holders are matched with the application for units and the units will be directly credited to the demat account after the realization of funds. If the data provided in the application form does not match the depository data then the application will be considered as invalid for processing under demat mode and instead the investor may be issued units in physical mode, provided the application is otherwise valid. All details such as address, bank account details, nomination for the units held in demat form is according to the information available in the

depository's records. Any changes to the said information have to be made by contacting the depository. Redemption requests for units held in demat mode has to be submitted to the depository or through the stock exchange platform.

Investors can also choose to get their existing units (as represented by the statement of account) dematerialized. On dematerialisation, the investor's unit-holding will be added to his/her demat account. As and when the investor sells the unit-holding, the relevant number of units will be reduced from the investor's demat account. The proceeds of redemptions as well as the dividend pay-outs will be credited to the bank account linked to the demat account. The investor benefits from a demat account are as follows:

- Less paperwork in buying or selling the mutual fund units, and correspondingly, accepting or giving delivery of the units.
- Direct credit of bonus and rights units that the investor is entitled to, into the investor's demat account.
- Change of address or other details need to be given only to the Depository Participant, instead of separately providing it to every company/mutual fund where the investor has invested and holds demat units.
- Consolidate all investments in mutual funds, direct equity, debentures and others under one account.

The investor also has the option to convert the demat units into physical form. This process is called *re-materialisation*.

#### **9.13.4 Change in Folio Details**

The personal information of the investor captured under the folio is liable to changes which have to be updated in the records. Some of the information, such as name, address, status and contact details, are provided during the KYC compliance process. Any changes have to be updated with the KRA using the change form. The KRA will communicate the updated information to all the mutual funds. Others, such as change in bank accounts, change in the mode of holding in operating a folio, or the nominations made in an investment, have to be updated with each mutual fund.

#### **Change in Personal Information**

The KYC Registration Agency (KRA) prescribes a change form to be used to register change, if any, in the information provided at the time of the Know Your Customer (KYC) process. These include:

- Change in Name
- Change in Status/ Nationality

- Change in PAN
- Change in permanent address or address for correspondence
- Change in Contact Details
- Change in name of spouse/father

In the Change Form the individual has to provide the name, date of birth, PAN or PERN (PAN Exempt Reference Number), and Aadhaar number, as per the original KYC records to identify themselves in the records of the KRA. A self-attested copy of the PAN, where available, has to accompany a change request. The new or changed information has to be provided in the space provided for the same in the form. Any change has to be supported by documents and the details provided in the form should match the documentary proofs provided. The documents have to be self-attested and the originals have to be produced for verification. If the originals are not available for verification, then the copies have to be attested by entities authorized to do so.

If the units are held in dematerialized form, the procedure for change in address would be as determined by the depository participant.

A **change in guardian** in a minor's folio will require the new guardian to comply with KYC and PAN requirements, provide bank account details and a no-objection certificate from the existing guardian.

The **change in the status of an investor from minor to major** will require the PAN and KYC compliance of the investor to replace that of the guardian. The signature of the investor and the new bank account details have to be updated in the records. The guardian will then cease operating the account.

### **Change in Bank Account Details**

A change in bank account details have to be directly registered with each mutual fund. Investors can register up to five bank accounts with a mutual fund for individual investors and 10 for non-individuals. One of the registered accounts will be designated as the default account into which all the dividend and redemption proceeds will be credited. Investors can instruct the mutual fund to credit the proceeds to any of the other accounts too at the time of executing a redemption transaction. The investor can add or delete accounts within the limits specified. If the default bank account is being deleted from the list of registered accounts then before that another account has to be designated as the default bank account in Part B of the Multiple Bank Registration Form. Details to be provided for adding a bank account are the name of the bank, account number and type, branch address, IFSC and MICR code. The form should be accompanied by a cancelled cheque of the said account with the name of the first holder of the mutual fund folio pre-printed on it. If the name is not pre-printed on it then a bank statement, pass book or bank certificate that gives the name,

account number and address should be enclosed. If photocopies are submitted, then the original should be produced for verifications. The form for registering the change has to be signed according to the mode of holding of the folio.

If the investor has not used the facility to register multiple bank accounts, then the Change of Bank details form can be used to change the existing bank account linked to the folio and provide details of the new bank account.

### **9.13.5 Transmission of Units**

Transmission is the process of transferring units to the person entitled to receive it in the event of the death of the unit holder. The person entitled to receive it depends upon the folio conditions of joint holding and nomination. If the first holder passes away, the second holder is substituted as first holder. In a singly held folio with nominations, the units are transferred to the nominee. If a folio is jointly held and has nominations, the right of the joint holder will take precedence. If there are no nominations in the folio, the units are transmitted to the legal successors. See Box 9.3 for understanding nomination in context of mutual fund investments.

#### **Box 9.3: Nomination in mutual fund investments**

It is important to note here that nomination is only an authorization for the mutual fund to transfer the units to the nominee in the event of demise of the unit-holder.

The nominee holds the units in trust for the legal heirs of the investor. It does not create any title or beneficial interest in the units in favour of the nominee after the death of the unit-holder. The inheritance laws applicable to the unit-holder too need to be considered by the investor if they are looking at nomination as a way of passing on their wealth to their heirs.

Before the transfer is effected, the mutual fund will insist on the KYC documentation from the nominee, death certificate of the deceased unit-holder, and an indemnity against future problems for the mutual fund arising out of the transfer.

SEBI had directed the AMCs to adopt a standard Transmission Request Form and common set of documents for transmission of units as prescribed by AMFI and to make the same available on the websites of AMCs, RTAs and AMFI.<sup>52</sup>

Pursuant to the above, AMFI, in consultation with AMFIs Standing Committee on Operations/Compliance and Risk, has reviewed and updated the existing AMFI guidelines for

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<sup>52</sup> Vide SEBI circular no. SEBI/HO/IMD/DF3/CIR/P/2019/166 dated December 24, 2019

Transmission of Units including the supporting documents and has introduced the Transmission Request Forms to be used under different situations.<sup>53</sup>

A request for transmission has to be made in the Transmission Request form and an NOC form has to be submitted. The documents that are required for a valid transmission claim will depend upon the situation.<sup>54</sup> (See Appendix 12).

## **9.14 Change in Status of Special Investor Categories**

Minors, NRIs, HUFs investing through a constituted attorney constitute a special category of individual investors. Some of these investors do not make investments directly instead investments are made by designated entities on their behalf. These categories of individual investors require additional documentation and process, due to their differential status with respect to taxation and mode of operation of investments or restrictions on certain components of investment activity.

### **9.14.1 Minor turned Major**

Once the minor become major, financial transactions are disallowed in their account. No debits or redemptions can be made in bank accounts; mutual funds folios or demat account of minors-turned-major. Minors are not eligible to sign documents, enter into contracts, or issue third party cheques. However, after a minor becomes major, they can conduct such transactions, only after their signature is attested by their banker.

**KYC:** Minors attaining majority will have to complete all the KYC process by submitting proof of identity and address. Banks and depositories may also insist on personal verification of the minor-turned-major. On becoming a major, the erstwhile minor investor has to complete the KYC details, provide updated bank account details including cancelled original cheque leaf of the new account. No further transactions shall be allowed till the status of the minor is changed to major.

**PAN Card:** The PAN issued to a minor will have to be resubmitted to the Income Tax authorities, for issuance of a new card, with the same number, but the new signature of the minor-turned-major.

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<sup>53</sup> To check the updated guidelines for Transmission of Units under various scenarios along with the standard formats of Transmission Request Forms and supporting documents please refer to <https://www.amfiindia.com/investor-corner/investor-center/procedure-to-claim.html>

<sup>54</sup> For latest updates refer to <https://www.amfiindia.com/investor-corner/investor-center/procedure-to-claim.html>

**Demat Account:** Since demat accounts of minors can be held only on single-name basis, the account opening process has to be redone for a minor-turned-major. This involves opening of a new demat account. Securities held in the old demat account with minor status are transferred to the new demat account. Depositories may waive transaction charges on such transfers.

**Mutual Fund Investments:** When the units are held on behalf of the minor, the ownership of the units, vest with the minor. The guardian may operate the minor's account only until the minor attains the age of majority. As per SEBI circular no. SEBI/HO/IMD/DF3/CIR/P/2019/166 dated December 24, 2019, upon the minor attaining the status of a major, the minor in whose name the investment was made is required to provide all the KYC details, updated bank account details including cancelled original cheque leaf of the new account. No further transactions shall be allowed till the status of the minor is changed to major.

Accordingly, when a minor turns a major, he/she needs to submit an application for change in status from Minor to Major in a prescribed form (hereinafter referred to as MAM form), along with the prescribed documents.

The guardian is then not allowed to undertake any financial or non-financial transactions from the date of the minor attaining majority. All existing standing instructions like SIP, SWP & STP, if registered for a period beyond the date on which the minor attains majority will cease to be executed from the date of the minor attaining majority.

In short, the minor's account is frozen for operation by the guardian on the day the minor attains the age of majority and no further customer-initiated transactions shall be permitted till the status is changed from minor to major. (Note: Dividend pay-out or dividend reinvestment, where applicable, shall continue to be processed. In such cases, dividend amount, net of TDS (wherever applicable), shall be credited to the unitholder's registered bank account or reinvested in the folio, as the case may be.)<sup>55</sup>

Before submitting the MAM application form for change in status from Minor to Major, the unitholder is required to –

- i. Apply for PAN and obtain a PAN card;
- ii. Complete the KYC process; and
- iii. Change his/her status in his/her existing bank account from Minor to Major OR open a new bank account immediately upon becoming a major and procure a new cheque book with his/her name pre-printed thereon.

Only after fulfilling the above steps, the applicant should submit the prescribed MAM form duly completed to the AMC/ Registrar along with the requisite supporting documents.

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<sup>55</sup>For more details refer to: [https://www.amfiindia.com/investor-corner/investor-center/Minor\\_attaining\\_Majority.html](https://www.amfiindia.com/investor-corner/investor-center/Minor_attaining_Majority.html)

Documents required for change in status from Minor to Major:

- 1) The prescribed MAM form duly filled in all respects.<sup>56</sup>
- 2) Copy of PAN Card of the applicant
- 3) KYC Acknowledgment or a duly completed KYC form.
- 4) A cancelled cheque leaf with the applicant's name pre-printed or the applicant's latest Bank Statement/Passbook.
- 5) Signature attestation by the bankers)
- 6) Nomination Form.
- 7) A fresh SIP, STP, SWP mandate in the prescribed form (in order to continue the SIP, STP, SWP, if applicable.)

**Systematic Transactions** (SIP, SWP, STP and others): Standing instructions like Systematic Investment Plans (SIP), Systematic Withdrawal Plans (SWP), Systematic Transfer Plans (STP) are registered in a minor folio only till the date of the minor attaining majority, even though the instructions may be for an extended period. When the minor is approaching the age of majority, AMCs usually send letters advising the guardian and the minor to submit the form along with prescribed documents to change the status of the account/folio to "major". All SIP, STP, SWP and any other standing instruction registered in the minor's account are suspended if the documents are not received by the date when the minor attains majority. The folio is frozen for operation by the guardian on the day the minor attains the age of majority and no transactions shall be permitted till the documents related to minor turned major are received.

#### 9.14.2 NRI to Resident Indian

If a person returns to India and forgoes the NRI status, he needs to carry out certain procedures with respect to his investments and bank accounts.

**Bank Account:** Once an NRI becomes a RI, he cannot operate his NRO/NRE/FCNR (B) accounts. He needs to inform to the bank about the change of status to resident Indian and needs to open a Resident Rupee Account. Account opening documents such as address proof, identity proof, photographs need to be submitted. A Resident Foreign Currency (RFC) account may be opened by a returning Indian to transfer balances from NRE /FCNR (B) accounts. This account

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<sup>56</sup> Note: Signature of the applicant (minor who has turned major) in the MAM form shall be duly attested in the space provided therein by the parent/guardian whose signature is registered in the records of the mutual fund against the folio of the minor unitholder or by a Notary or a Judicial Magistrate First Class (JMFC). Alternatively, the applicant's signature may be attested by the unitholder's bankers in the prescribed form as per format.

<https://www.amfiindia.com/Themes/Theme1/downloads/RequestforchangeinGuardianofMinorUnitholder.pdf>  
<https://www.amfiindia.com/Themes/Theme1/downloads/MAMForm-forchangeinstatusfromMinortoMajor.pdf>

<https://www.amfiindia.com/Themes/Theme1/downloads/Annexure-I-BankAttestationofSignature.pdf>

can hold foreign currency and continue to receive funds in foreign currency from investments abroad.

**Demat Account:** Just like bank account, the returning NRI needs to inform change of status to the designated authorised dealer branch through which the investor had made investments in the Portfolio Investment Scheme, as well as the DP with whom he has opened a demat account. A new demat account with 'Resident' status needs to be opened. All the balances held in the NRI demat account shall be transferred to the new 'Resident' demat account. After transfer, the NRI demat account will get closed.

**Mutual Fund Investments:** The NRI needs to inform the relevant AMCs about the change of status, change of address and bank details with respect to mutual fund investments. KYC change form needs to be sent to the KYC registration agency for change of status, address and bank details. An acknowledgement shall be issued by the KYC registration agency on submission of request and will carry out the necessary changes in its records. Once the investor is flagged as an NRI, TDS will be deducted at source on gains made on sale/redemption of mutual fund investments by NRIs as applicable.

#### **9.14.3 Change in Karta of HUF**

For change in 'Karta' of an HUF, a letter is required from the new Karta stating the reason for change of Karta in mutual fund records. The respective AMC may have a specific form. Name of the deceased Karta, folio number, scheme, unit details may be mentioned in the letter signed by the new Karta. KYC documents of the new Karta and the HUF need to be provided. If the HUF is already KYC compliant, the HUF KYC need not be furnished. Along with the letter and KYC documents, the following must be enclosed:

- Attested copy of death certificate
- Bank certificate stating signature and details of new Karta
- Indemnity bond signed by all co-parceners and new Karta

#### **9.15 Investor transactions – turnaround times**

SEBI's guidelines prescribe the turnaround times for investors' transactions with the mutual fund.

<b>Service provided by Mutual Funds</b>	<b>Turnaround Time</b>
NAV Calculation and disclosure	On a daily basis <sup>57</sup>
Mutual Fund Schemes (other than IPO of ELSS) to remain open for subscription	Maximum of 15 days
Mutual Fund Schemes to allot units or refund money	Within 5 business days of closure of NFOs <sup>58</sup>
Re-opening for ongoing sale/re-purchase of open ended scheme (other than ELSS)	Within 5 business days of allotment
Dispatch of Dividend warrants to investors	Within 30 days of declaration of the dividend
Dispatch of Redemption/re-purchase cheques to investors	Within 10 working days from the date of receipt of transaction request. <sup>59</sup>
Scheme-wise Annual Report or an abridged summary to all unit holders	Four months from the date of closure of the relevant accounts year <sup>60</sup>
Statement of portfolio to be sent to all unitholders	Before the expiry of 10 days from the close of each half year (i.e. 31 <sup>st</sup> Mar and 30 <sup>th</sup> Sep)
Half Yearly Disclosures (unaudited financial results) on mutual fund website	<p>Within 1 month from the close of each half year (i.e. 31<sup>st</sup> Mar and 30<sup>th</sup> Sep) [this is applicable for schemes other than debt and money market schemes]</p> <p>In order to further enhance transparency, it is now decided that the details of debt and money market securities transacted (including inter scheme transfers) in its schemes portfolio shall be disclosed on daily basis with a time lag of 15 days<sup>61</sup></p>
A Consolidated Account Statement (CAS) by post/email	On or before 10th of the succeeding month <sup>62</sup>
Unit certificate	<p>To be issued within 5 working days of the receipt of request for the certificate.</p> <p>For close ended schemes, units in demat form to be issued to unitholders within 2 working days of the receipt of request from unitholders.</p>

<sup>57</sup> This should be disclosed on the website of AMFI and the mutual fund. Mutual Funds/AMC's shall extend facility of sending latest available NAVs to unitholders through SMS, upon receiving a specific request in this regard.

<sup>58</sup> In the event of delays in refunds (in case of NFOs), investors need to be paid interest at the rate of 15 percent p.a. for the period of the delay. This interest cannot be charged to the scheme.

### Statement of Account in case of SIP/ STP / SWP

Initial transaction SIP / STP / SWP	within 10 working days
Ongoing SIP/STP/SWP	once every calendar quarter (March, June, September, December) within 10 working days of the end of the quarter.
On specific request by investor	it will be dispatched to investor within 5 working days without any cost.

Statement of Account shall also be sent to dormant investors i.e. investors who have not transacted during the previous 6 months. This can be sent along with the Portfolio Statement / Annual Return, with the latest position on number and value of Units held. If required by the investor, soft copy shall be e-mailed to investor every month.

AMCs (and also some distributors) offer various other services for investors. Some of these are as follows:

- Online access to information on investments, including consolidated view of various folios that relate to different family members.
- Sharing of information on portfolio valuation, income booked, returns earned, capital gains workings for income tax purposes etc.

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<sup>59</sup> In the event of delays in dispatching dividend warrants or redemption/repurchase cheques, the AMC has to pay the unit-holder, interest at the rate of 15 percent p.a. This expense has to be borne by the AMC i.e. it cannot be charged to the scheme.

<sup>60</sup> To be emailed to all unit-holders. Physical copy of abridged summary to be provided without any cost if requested.

<sup>61</sup> SEBI circular no. SEBI/HO/IMD/DF4/CIR/P/2020/163 dated September 1, 2020. This circular comes into effect from October 1, 2020.

<sup>62</sup> provided there is a financial transaction in the folio in the previous month. Further, where there are no transactions in a folio during any six-month period, a CAS detailing holding across all schemes of all mutual funds at the end of every such six-month period (i.e. September/March), shall be sent by post/e-mail by the 10th day of the month following that half year, to all such Unit holders.

## Chapter 9: Sample Questions

- 1. What term is used to describe the Net Asset Value (NAV) of the scheme after the dividend is paid out (Remember the NAV would have dropped to the extent of the dividend paid)?**
  - a. Ex-Dividend NAV
  - b. Cum-Dividend NAV
  - c. Lower NAV
  - d. Dividend NAV
  
- 2. At what price are the bonus units issued to the unitholder?**
  - a. The price is decided by the AMC in consultation with the trustees
  - b. The bonus units are allotted free of cost
  - c. At the prevailing NAV
  - d. At the prevailing NAV divided by the bonus ratio
  
- 3. Which of the following statements is True?**
  - a. Hindu Undivided Families (HUFs) are not allowed to invest in mutual fund schemes
  - b. Minors cannot invest in mutual fund schemes
  - c. Foreign investors can invest in Indian mutual fund schemes, provided they have completed the Know-Your-Client (KYC) formalities
  
- 4. Whose KYC needs to be completed in case of an application by a minor?**
  - a. The minor
  - b. The guardian
  - c. Any family member of the minor
  - d. No KYC is required in case of applications by minors
  
- 5. How many (maximum) bank accounts can a resident individual investor register with a mutual fund folio?**
  - a. 1
  - b. 2
  - c. 3
  - d. 5

## CHAPTER 10: RISK, RETURN AND PERFORMANCE OF FUNDS

### Learning Objectives:

After studying this chapter, you should know about:

- General and Specific risk factors
- Factors affecting mutual fund performance of different schemes
- Drivers of returns and risk in a scheme
- Measures of returns
- SEBI norms regarding return representation of returns by mutual funds in India
- Risks in fund investing with a focus on investors
- Various risk measure
- Certain Provisions with respect to Credit risk

### 10.1 General and Specific Risk Factors

Chapter 1 covered various asset categories and the risks associated with those. This chapter would go deeper in understanding the risks involved in investing with mutual funds. The risk would be categorized between standard/general risks and those specific to individual asset categories. Investment, per se, involves taking and managing various risk. In such a case, it is important to understand which risks one is exposed to and how to manage those risks. It is also important for one to decide which risks one needs to take and for what purpose.

When the investor chooses to invest through mutual funds, the fund manager manages some part of the risks, whereas some of the others are controlled due to the structure of mutual funds. And still, some risks remain to be managed by the investor separately.

The Scheme Information Document (SID) highlights two broad categories of risks, (1) standard risk factors, and (2) specific risk factors. The standard risk factors are the risks that all mutual fund investments are exposed to whereas there are certain risks specific to individual asset category. For example, credit risk or interest rate risk are associated with debt securities, whereas currency risk would be associated with investments in foreign securities, or even in shares of companies exposed to foreign currency.

The Scheme Information Document (SID) contains a list of all these risks. The SID also contains a discussion on various risk mitigation strategies. A snapshot from a Scheme Information Document is presented below:

### **10.1.1 General Risk Factors:**

- Investment in mutual fund units involves investment risks such as trading volumes, settlement risk, liquidity risk, default risk, including the possible loss of principal.
- As the price/value/interest rates of the securities in which the scheme invests fluctuates, the value of investment in the scheme may increase or decrease. In addition to the factors that affect the value of individual investments in the Scheme, the NAV of the Scheme can be expected to fluctuate with movements in the broader equity and bond markets and may be influenced by factors affecting capital and money markets in general, such as, but not limited to, changes in interest rates, currency exchange rates, changes in governmental policies, taxation, political, economic or other developments and increased volatility in the stock and bond markets.
- Past performance of the Sponsor/AMC/Mutual Fund does not guarantee future performance of the Scheme.
- The name of the Scheme does not in any manner indicate either the quality of the Scheme or its future prospects and returns.
- The Sponsors are not responsible or liable for any loss resulting from the operation of the Scheme beyond the initial contribution made by it towards setting up the Mutual Fund.

Some of the general risk factors are explained below:

#### **Liquidity Risk**

The liquidity of investments made in the Scheme may be restricted by trading volumes, settlement periods and transfer procedures. Although the investment universe constitutes securities which will have high market liquidity, there is a possibility that market liquidity could get impacted on account of company/sector/general market related events and there could be a price impact on account of portfolio rebalancing and/or liquidity demands on account of redemptions.

Different segments of the Indian financial markets have different settlement periods and such periods may be extended significantly by unforeseen circumstances. There have been times in the past, when settlements have been unable to keep pace with the volume of securities transactions, making it difficult to conduct further transactions. Delays or other problems in settlement of transactions could result in temporary periods when the assets of the Scheme are un-invested and no return is earned thereon. The inability of the Scheme to make intended securities purchases, due to settlement problems, could cause the Scheme to miss certain investment opportunities. By the same token, the inability to sell securities held in the Scheme' portfolios, due to the absence of a well-developed and liquid secondary market for

debt securities, would result at times, in potential losses to the Scheme, should there be a subsequent decline in the value of securities held in the Scheme' portfolios.

Money market securities, while fairly liquid, lack a well-developed secondary market, which may restrict the selling ability of the Scheme and may lead to the Scheme incurring losses till the security is finally sold.

The liquidity of a bond may change, depending on market conditions leading to changes in the liquidity premium attached to the price of the bond. At the time of selling the security, the security can become illiquid, leading to loss in value of the portfolio.

Even though the Government securities market is more liquid compared to other debt instruments, on occasions, there could be difficulties in transacting in the market due to extreme volatility leading to constriction in market volumes. Liquidity of the Scheme may suffer in case any relevant guideline issued by RBI undergoes any adverse changes.

### **Interest Rate Risk**

Fixed income securities such as government bonds, corporate bonds, money market instruments and derivatives run price-risk or interest-rate risk. Generally, when interest rates rise, prices of existing fixed income securities fall and when interest rates drop, such prices increase. The extent of fall or rise in the prices depends upon the coupon and maturity of the security. It also depends upon the yield level at which the security is being traded.

Derivatives carry the risk of adverse changes in the price due to change in interest rates.

### **Re-investment Risk**

The investments made by the Scheme are subject to reinvestment risk. This risk refers to the interest rate levels at which cash flows received from the securities in the Scheme are reinvested. The additional income from reinvestment is the 'interest on interest' component. The risk is that the rate at which interim cash flows can be reinvested may be lower than that originally assumed.

### **Political Risk**

Investments in mutual fund Units in India may be materially adversely impacted by Indian politics and changes in the political scenario in India either at the central, state or local level. Actions of the central government or respective state governments in the future could have a significant effect on the Indian economy, which could affect companies, general business and market conditions, prices and yields of securities in which the Scheme invest.

The occurrence of selective unrest or external tensions could adversely affect the political and economic stability of India and consequently have an impact on the securities in which the

Scheme invests. Delays or changes in the development of conducive policy frameworks could also have an impact on the securities in which the Scheme invests.

### **Economic Risk**

A slowdown in economic growth or macro-economic imbalances such as the increase in central and state level fiscal deficits may adversely affect investments in the country. The underlying growth in the economy is expected to have a direct impact on the volume of new investments in the country.

### **Foreign Currency Risk**

The Scheme may be denominated in Indian Rupees (INR) which is different from the home currency for Foreign Portfolio Investors in the mutual fund units. The INR value of investments when translated into home currency by Foreign Portfolio Investors could be lower because of the currency movements. The AMC does not manage currency risk for Foreign Portfolio Investors and it is the sole responsibility of the Foreign Portfolio Investors to manage or reduce currency risk on their own. The Sponsor/Fund/Trustees/ AMC are not liable for any loss to Foreign Investors arising from such changes in exchange rates.

Settlement Risk (Counterparty Risk) - Specific floating rate assets may also be created by swapping a fixed return into a floating rate return. In such a swap, there is the risk that the counterparty (who will pay floating rate return and receive fixed rate return) may default.

### **Risks associated with transaction in Units through stock exchange(s)**

In respect of transaction in Units of the Scheme through stock exchanges, allotment and redemption of Units on any Business Day will depend upon the order processing /settlement by BSE/NSE and their respective clearing corporations on which the Fund has no control.

#### **10.1.2 Specific Risk Factors**

##### **A) Risk related to equity and equity related securities**

Equity and equity related securities are volatile and prone to price fluctuations on a daily basis. The liquidity of investments made in the scheme can get restricted by trading volumes and settlement periods. Settlement periods may be extended significantly by unforeseen circumstances. The inability of the scheme to make intended securities purchases, due to settlement problems, could cause the Scheme to miss certain investment opportunities. Similarly, the inability to sell securities held in the scheme portfolio would result at times, in potential losses to the scheme, if there is a subsequent decline in the value of securities held in the scheme portfolio. Also, the value of the scheme investments may be affected by interest rates, currency exchange rates, changes in law/policies of the government, taxation

laws and political, economic or other developments which may have an adverse bearing on individual securities, a specific sector or all sectors.

### **Risk associated with short selling and Stock Lending**

Securities Lending is lending of securities through an approved intermediary to a borrower under an agreement for a specified period with the condition that the borrower will return equivalent securities of the same type or class at the end of the specified period along with the corporate benefits accruing on the securities borrowed. There are risks inherent in securities lending, including the risk of failure of the other party. Such failure can result in a possible loss of rights to the collateral, the inability of the approved intermediary to return the securities deposited by the lender and the possible loss of corporate benefits accruing thereon. Short-selling is the sale of shares or securities that the seller does not own at the time of trading. Instead, he borrows it from someone who already owns it. Later, the short seller buys back the stock/security he shorted and returns the stock/security to the lender to close out the loan. The inherent risks are Counterparty risk and liquidity risk of the stock/security being borrowed. The security being short sold might be illiquid or become illiquid and covering of the security might occur at a much higher price level than anticipated, leading to losses.

### **Risks associated with mid-cap and small-cap companies**

The market capitalization spectrum has been defined as follows:

- Large-Cap Stocks: 1st -100th company in terms of full market capitalization
- Mid-Cap Stocks: 101st -250th company in terms of full market capitalization
- Small-Cap Stocks: 251st company onwards in terms of full market capitalization

Investment in mid-cap and small-cap companies are based on the premise that these companies have the ability to increase their earnings at a faster pace as compared to large-cap companies and grow into larger, more valuable companies. However, as with all equity investments, there is a risk that such companies may not achieve their expected earnings results, or there could be an unexpected change in the market, both of which may adversely affect investment results.

Historically, it has been observed that as you go down the capitalization spectrum i.e. from large- cap stocks to mid-cap stocks and beyond, there are higher risks in terms of volatility and market liquidity. Scheme also invests in mid-cap and small-cap companies and hence is exposed to associated risks.

### **Risk associated with Dividend**

Dividend is due only when declared and there is no assurance that a company (even though it may have a track record of payment of dividend in the past) may continue paying dividend in future. As such, the schemes are vulnerable to instances where investments in securities may not earn dividend or where lesser dividend is declared by a company in subsequent years in which investments are made by schemes. As the profitability of companies are likely to vary and have a material bearing on their ability to declare and pay dividend, the performance of the schemes may be adversely affected due to such factors.

### **Risk associated with Derivatives**

The mutual fund schemes may invest in derivative products in accordance with and to the extent permitted under the SEBI MF Regulations and by RBI. Derivative products are specialized instruments that require investment techniques and risk analysis different from those associated with stocks and bonds. The use of a derivative requires an understanding not only of the underlying instrument but of the derivative itself. Trading in derivatives carries a high degree of risk although they are traded at a relatively small amount of margin which provides the possibility of great profit or loss in comparison with the principal investment amount. Thus, derivatives are highly leveraged instruments. Even a small price movement in the underlying security could have an impact on their value and consequently, on the NAV of the Units of the Scheme. The risks associated with the use of derivatives are different from or possibly greater than, the risks associated with investing directly in securities and other traditional investments.

Some of the risks associated with derivatives are discussed below:

- Counterparty Risk occurs when a counterparty fails to abide by its contractual obligations and therefore, the scheme is compelled to negotiate with another counter party, at the then prevailing (possibly unfavourable) market price. For exchange traded derivatives, the risk is mitigated as the exchange provides the guaranteed settlement but one takes the performance risk on the exchange.
- Market Liquidity Risk occurs where the derivatives cannot be transacted due to limited trading volumes and/or the transaction is completed with a severe price impact.
- Model Risk is the risk of mis-pricing or improper valuation of derivatives.
- Basis Risk arises due to a difference in the price movement of the derivative vis-à-vis that of the security being hedged.
- The Scheme may find it difficult or impossible to execute derivative transactions in certain circumstances. For example, when there are insufficient bids or suspension of trading due to price limit or circuit breakers, the Scheme may face a liquidity issue.

- Investments in index futures face the same risk as the investments in a portfolio of shares representing an index. The extent of loss is the same as in the underlying stocks.
- Derivative products are leveraged instruments and can provide disproportionate gains as well as disproportionate losses to the investor / unitholder. Execution of investment strategies depends upon the ability of the fund manager(s) to identify such opportunities which may not be available at all times. Identification and execution of the strategies to be pursued by the fund manager(s) involve uncertainty and decision of fund manager(s) may not always be profitable. No assurance can be given that the fund manager(s) will be able to identify or execute such strategies.
- There are certain additional risks involved with use of fixed income derivatives such as interest rate risk, and liquidity risk.

## **B. Risks related to debt funds**

### **Reinvestment Risk**

Investments in fixed income securities carry re-investment risk as interest rates prevailing on the coupon payment or maturity dates may differ from the original coupon of the bond.

### **Rating Migration Risk**

Fixed income securities are exposed to rating migration risk, which could impact the price on account of change in the credit rating. For example: One notch downgrade of a AAA rated issuer to AA+ will have an adverse impact on the price of the security and vice-versa for an upgrade of a AA+ issuer.

### **Term Structure of Interest Rates Risk**

The NAV of the Scheme' Units, to the extent that the Scheme are invested in fixed income securities, will be affected by changes in the general level of interest rates. When interest rates decline, the value of a portfolio of fixed income securities can be expected to rise. Conversely, when interest rates rise, the value of a portfolio of fixed income securities can be expected to decline.

### **Credit Risk**

Fixed income securities (debt and money market securities) are subject to the risk of an issuer's inability to meet interest and principal payments on its debt obligations. The Investment Manager will endeavour to manage credit risk through in-house credit

analysis.

Different types of securities in which the Scheme would invest as given in the SID carry different levels of credit risk. Accordingly, the Scheme' risk may increase or decrease depending upon their investment patterns. E.g. corporate bonds carry a higher amount of risk than Government securities. Further, even among corporate bonds, bonds which are rated AAA are comparatively less risky than bonds which are AA rated.

The credit risk is the risk that the counter party will default in its obligations and is generally small as in a Derivative transaction there is generally no exchange of the principal amount.

### **Risk associated with floating rate securities**

**Spread Risk:** In a floating rate security the coupon is expressed in terms of a spread or mark up over the benchmark rate. In the life of the security this spread may move adversely leading to loss in value of the portfolio. The yield of the underlying benchmark might not change, but the spread of the security over the underlying benchmark might increase leading to loss in value of the security.

**Basis Risk:** The underlying benchmark of a floating rate security or a swap might become less active or may cease to exist and thus may not be able to capture the exact interest rate movements, leading to loss of value of the portfolio.

### **Risk factors associated with repo transactions in Corporate Bonds**

The Scheme may be exposed to counter party risk in case of repo lending transactions in the event of the counterparty failing to honour the repurchase agreement. However, in repo transactions, the collateral may be sold and a loss is realized only if the sale price is less than the repo amount. The risk is further mitigated through over-collateralization (the value of the collateral being more than the repo amount).

### **Risks associated with Creation of Segregated portfolio**

Investor holding units of segregated portfolio may not be able to liquidate their holding till the time recovery of money from the issuer. Security comprises of segregated portfolio may not realise any value. Listing of units of segregated portfolio on recognised stock exchange does not necessarily guarantee their liquidity. There may not be active trading of units in the stock market. Further trading price of units on the stock market may be significantly lower than the prevailing NAV.

**Risks associated with investments in Securitized Assets:** A securitization transaction involves sale of receivables by the originator (a bank, non-banking finance company, housing finance company, or a manufacturing/service company) to a Special Purpose Vehicle (SPV), typically

set up in the form of a trust. Investors are issued rated Pass Through Certificates (PTCs), the proceeds of which are paid as consideration to the originator. In this manner, the originator, by selling his loan receivables to an SPV, receives consideration from investors much before the maturity of the underlying loans. Investors are paid from the collections of the underlying loans from borrowers. Typically, the transaction is provided with a limited amount of credit enhancement as stipulated by the rating agency for a target (rating), which provides protection to investors against defaults by the underlying borrowers.

Some of the risk factors typically analysed for any securitization transaction are as follows:

**Risks associated with asset class:** Underlying assets in securitised debt may assume different forms and the general types of receivables include commercial vehicles, auto finance, credit cards, home loans or any such receipts. Credit risks relating to these types of receivables depend upon various factors including macro-economic factors of these industries and economies. Specific factors like nature and adequacy of collateral securing these receivables, adequacy of documentation in case of auto finance and home loans and intentions and credit profile of the borrower influence the risks relating to the asset borrowings underlying the securitised debt.

**Risks associated with pool characteristics:**

**(a) Size of the loan:** This generally indicates the kind of assets financed with loans. While a pool of loan assets comprising of smaller individual loans provides diversification, if there is excessive reliance on very small ticket size, it may result in difficult and costly recoveries.

**(b) Loan to Value Ratio:** This indicates how much percentage value of the asset is financed by borrower's own equity. The lower LTV, the better it is. This ratio stems from the principle that where the borrowers own contribution of the asset cost is high, the chances of default are lower. To illustrate for a Truck costing Rs. 20 lakh, if the borrower has himself contributed Rs.10 lakh and has taken only Rs. 10 lakh as a loan, he is going to have lesser propensity to default as he would lose an asset worth Rs. 20 lakh if he defaults in repaying an installment. This is as against a borrower who may meet only Rs. 2 lakh out of his own equity for a truck costing Rs. 20 lakh. Between the two scenarios given above, the latter would have higher risk of default than the former.

**(c) Original maturity of loans and average seasoning of the pool:** Original maturity indicates the original repayment period and whether the loan tenors are in line with industry averages and borrower's repayment capacity. Average seasoning indicates whether borrowers have already displayed repayment discipline. To

illustrate, in the case of personal loans, if a pool of assets consists of those who have already repaid 80 percent of the installments without default, this certainly is a superior asset pool than one where only 10 percent of installments have been paid. In the former case, the portfolio has already demonstrated that the repayment discipline is far higher.

**(d) Default rate distribution:** This indicates how much percent of the pool and overall portfolio of the originator is current, how much is in 0-30 DPD (days past due), 30-60 DPD, 60-90 DPD and so on.<sup>63</sup> The rationale here is very obvious, as against 0-30 DPD, the 60-90 DPD is certainly a higher risk category.

### **Credit Rating and Adequacy of Credit Enhancement**

Unlike in plain vanilla instruments, in securitisation transactions, it is possible to work towards a target credit rating, which could be much higher than the originator's own credit rating. This is possible through a mechanism called "Credit enhancement". The process of "Credit enhancement" is fulfilled by filtering the underlying asset classes and applying selection criteria, which further diminishes the risks inherent for a particular asset class. The purpose of credit enhancement is to ensure timely payment to the investors, if the actual collection from the pool of receivables for a given period is short of the contractual pay-out on securitisation. Securitisation is normally non-recourse instruments and therefore, the repayment on securitisation would have to come from the underlying assets and the credit enhancement. Therefore, the rating criteria centrally focus on the quality of the underlying assets.

The Schemes predominantly invest in those securitisation issuances which have AA and above rating indicating high level of safety from credit risk point of view at the time of making an investment. However, there is no assurance by the rating agency either that the rating will remain at the same level for any given period of time or that the rating will not be lowered or withdrawn entirely by the rating agency.

- **Limited Liquidity & Price Risk:** The secondary market for securitised papers is not very liquid. There is no assurance that a deep secondary market will develop for such securities. This could limit the ability of the investor to resell them. Even if a secondary market develops and sales were to take place, these secondary transactions may be at a discount to the initial issue price due to changes in the interest rate structure.

- **Limited Recourse to Originator & Delinquency:** Securitised transactions are normally backed by pool of receivables and credit enhancement as stipulated by the rating agency, which differ from issue to issue. The Credit Enhancement stipulated represents a limited loss cover to the Investors. These Certificates represent an

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<sup>63</sup> Days Past due or DPD means, that for any given month, how many months' worth of payment is unpaid.

undivided beneficial interest in the underlying receivables and there is no obligation of either the Issuer or the seller or the originator, or the parent or any affiliate of the seller, issuer and originator. No financial recourse is available to the Certificate Holders against the Investors Representative. Delinquencies and credit losses may cause depletion of the amount available under the credit enhancement and thereby the investor pay-outs may get affected if the amount available in the credit enhancement facility is not enough to cover the shortfall. On persistent default of an obligor to repay his obligation, the servicer may repossess and sell the underlying Asset. However, many factors may affect, delay or prevent the repossession of such asset or the length of time required to realize the sale proceeds on such sales. In addition, the price at which such asset may be sold may be lower than the amount due from that Obligor.

- **Risks due to possible prepayments:** Asset securitisation is a process whereby commercial or consumer credits are packaged and sold in the form of financial instruments. Full prepayment of underlying loan contract may arise under any of the following circumstances:

- a. Obligor pays the receivable due from him at any time prior to the scheduled maturity date of that receivable; or

- b. Receivable is required to be repurchased by the seller consequent to its inability to rectify a material misrepresentation with respect to that Receivable; or

- c. The servicer recognizing a contract as a defaulted contract and hence repossessing the underlying asset and selling the same.

- d. In the event of prepayments, investors may be exposed to changes in tenor and yield.

- **Bankruptcy of the Originator or Seller:** If originator becomes subject to bankruptcy proceedings and the court in the bankruptcy proceedings concludes that the sale from originator to trust was not a sale then an Investor could experience losses or delays in the payments due. All possible care is generally taken in structuring the transaction so as to minimize the risk of the sale to Trust not being construed as a 'True Sale'. Legal opinion is normally obtained to the effect that the assignment of Receivables to Trust in trust for and for the benefit of the Investors, as envisaged herein, would constitute a true sale.

- **Bankruptcy of the Investor's Agent:** If Investor's agent becomes subject to bankruptcy proceedings and the court in the bankruptcy proceedings concludes that the recourse of Investor's Agent to the assets/receivables is not in its capacity as agent/Trustee but in its personal capacity, then an Investor could experience losses or

delays in the payments due under the agreement. All possible care is normally taken in structuring the transaction and drafting the underlying documents so as to provide that the assets/receivables if and when held by Investor's Agent is held as agent and in Trust for the Investors and shall not form part of the personal assets of Investor's Agent. Legal opinion is normally obtained to the effect that the Investors Agent's recourse to assets/ receivables is restricted in its capacity as agent and trustee and not in its personal capacity.

- **Risk of co-mingling:** The servicers normally deposit all payments received from the obligors into the collection account. However, there could be a time gap between collection by a servicer and depositing the same into the collection account especially considering that some of the collections may be in the form of cash. In this interim period, collections from the loan agreements may not be segregated from other funds of the servicer. If the servicer fails to remit such funds due to Investors, the Investors may be exposed to a potential loss. Due care is normally taken to ensure that the Servicer enjoys highest credit rating on standalone basis to minimize co-mingling risk.

#### **Risk Factors Associated with Investments in REITs and InvITs:**

REITs and InvITs are exposed to price-risk, interest rate risk, credit risk, liquidity or marketability risk, reinvestment risk. Also, there is a risk of lower than expected distributions. The distributions by the REIT or InvIT will be based on the net cash flows available for distribution. The amount of cash available for distribution principally depends upon the amount of cash that the REIT/InvITs receives as dividends or the interest and principal payments from portfolio assets.

However, there are various risk management strategies that are employed to manage the different types of risks. These are mentioned below:

#### **Managing Market Liquidity Risk**

The liquidity risk is managed by creating a portfolio which has adequate access to liquidity. The Investment Manager selects fixed income securities, which have or are expected to have high secondary market liquidity. There is good secondary market liquidity in government securities. As far as other long dated fixed income securities are concerned, the endeavour is to invest in high quality securities, for example bonds issued by public sector entities. Market Liquidity Risk will be managed actively within the portfolio liquidity limits. The first access to liquidity is through cash and fixed income securities.

#### **Managing Credit Risk**

Credit Risk associated with fixed income securities is managed by making investments in securities issued by borrowers, which have a good credit profile. The credit research process

includes a detailed in-house analysis and due diligence. Limits are assigned for each of the issuer (other than government of India); these limits are for the amount as well as maximum permissible tenor for each issuer. The credit process ensures that issuer level review is done at inception as well as periodically by taking into consideration the balance sheet and operating strength of the issuer.

### **Managing Term Structure of Interest Rates Risk**

The Investment Manager actively manages the duration based on the ensuing market conditions. As the fixed income investments of the Scheme are generally short duration in nature, the risk is expected to be small.

### **Managing Rating Migration Risk**

The endeavour is to invest in high grade/quality securities. The due diligence performed by the fixed income team before assigning credit limits and the periodic credit review and monitoring should address company-specific issues.

### **Re-investment Risk**

Re-investment Risk is prevalent for fixed income securities, but as the fixed income investments of the Scheme are generally short duration in nature, the impact can be expected to be small.

### **Market Risk related to equity and equity related securities**

The Investment Manager endeavours to invest in companies, where adequate due diligence and research has been performed by the Investment Manager. As not all these companies are very well researched by third-party research companies, the Investment Manager also relies on its own research. This involves one-to-one meetings with the management of companies, attending conferences and analyst meets and also tele-conferences. The company-wise analysis will focus, amongst others, on the historical and current financial condition of the company, potential value creation/unlocking of value and its impact on earnings growth, capital structure, business prospects, policy environment, strength of management, responsiveness to business conditions, product profile, brand equity, market share, competitive edge, research, technological know-how and transparency in corporate governance.

#### **• Risk associated with floating rate securities**

There is very low liquidity in floating rate securities, resulting in lack of price discovery. Hence, incremental investments in floating rate securities are going to be very limited.

## **Managing Risk associated with favourable taxation of equity-oriented Scheme**

This risk is mitigated as there is a regular monitoring of equity exposure of each of the equity oriented Scheme of the Fund.

### **10.2 Factors that affect mutual fund performance**

Different asset classes have different characteristics. At the same time, different fund managers may adopt different approaches and strategies, which may also impact the performance of the schemes. Having said that, fund managers take certain risks in order to outperform the respective benchmark's performance. This means that the schemes may be subject to the risks that an asset class is exposed to, as well as the risks that the fund manager may choose or avoid. The various risks as applicable to the various scheme categories have been discussed earlier in this chapter.

#### **10.2.1 Difference between market/systematic risk and company specific risk**

Various investments are exposed to a number of risk factors. For example, stock prices move up or down based on various factors that impact the business performance of the company, or the whole economy. Out of these, the risks that impact the specific company are called company specific or firm specific risks. The risks that impact the entire economy are known as systematic risks. The company specific risks are also known as unsystematic risks. For example, a labour strike in a manufacturing plant is a company specific risk, whereas rise in inflation in the economy is a systematic risk that impacts all the businesses within the country. Hence, the systematic risk is also called the market risk.

The company specific risks can be reduced through diversification across diverse set of companies. However, the systematic risks cannot be reduced through such diversification. Since the unsystematic risk can be reduced through diversification, it is also called the diversifiable risk. On the other hand, the systematic risk is known as non-diversifiable risk.

Fund managers cannot reduce the systematic risk except by staying out of the market. Thus, some fund managers may tactically move between equity and cash depending on their view on the broader market. However, SEBI regulations impose certain limits on the permissible cash allocation in various scheme categories. The fund manager would need to operate within that and to that extent, the scheme may not be able to control the systematic risk beyond a certain level. At the same time, certain fund managers do not take such cash calls and stay fully invested at all times. They do not try to reduce the systematic risk, as they believe that the investor would have chosen the scheme after understanding the risks involved in the scheme. On the other hand, the unsystematic risk is reduced through diversification.

Finance theory states that one is rewarded for taking the non-diversifiable risk only, and not for taking the diversifiable risk.

The fund managers adopt active management strategy in order to outperform the scheme's benchmark index. For that purpose, the manager would have no choice but to take certain unsystematic risks by taking a view on the individual securities.

### **Mutual fund investments are subject to market risks**

*“Mutual fund investments are subject to market risks. Please read the scheme related documents carefully before investing.”* – These lines are part of any marketing communication by mutual fund companies. This is a regulatory requirement. It is important to understand the meaning of this line, to be able to take the advantages of the mutual funds.

Let us understand this. Unlike most other products, mutual fund is a pass-through vehicle, in which all the investment risks are passed onto the investor since the investor/unit-holder is the owner of the fund. This is not the case when one invests in say a fixed deposit. Let us take the case of a company fixed deposit. An investor is promised a certain return on investment in such fixed deposits. What the company does with the money collected determines the return the company earns – in most cases, the company raise money through this route for their investment in the business or their working capital requirements. The company is supposed to pay the investor only the promised return – nothing more, nothing less. If the company is unable to earn more than what it has promised the depositors, there is a risk that the promise may not be honoured. This is known as credit risk for the depositors. This risk does not exist in case of a mutual fund, since the ownership of the fund is with the fund's investors. However, the fund may be subject to this risk as the investments made by the fund may default on their commitments.

Is it possible to manage some of the risks? Is it possible to avoid some? Well, diversification is a proven strategy that can be used as protection against credit risk. A diversified mutual fund, as the name suggests, automatically offers diversification.

However, the one risk that a mutual fund portfolio cannot do anything about is the risk of market-wide price fluctuations. If the fund invests in a market where prices fluctuate a lot, the NAV of the fund is likely to witness huge fluctuations (e.g. growth funds investing in equity market); however, if it invests in a market where prices do not fluctuate, the NAV of the fund would be quite stable (e.g. overnight funds. This shall be discussed later.

When we talk about price fluctuations, it is important to separate the market price fluctuation from fluctuation in the price of the individual securities. There are certain factors that impact the broader market and prices of most securities fluctuate at the same time – this is called market price fluctuation; whereas some factors only impact individual securities, resulting

into fluctuation in the price of an individual security. Diversification can help reduce the latter, but cannot reduce the former.

As can be seen from the above discussion, it is not the mutual fund that carries the risk, but the underlying investments where the mutual fund has invested. Mutual funds simply pass on some of the risks and reduce some others. As discussed above, the market risk cannot be reduced through diversification.

### **10.3 Drivers of Returns and Risk in a Scheme**

The portfolio is the main driver of returns in a mutual fund scheme. The asset class in which the fund invests, the segment or sectors of the market in which the fund will focus on, the styles adopted to select securities for the portfolio and the strategies adopted to manage the portfolio determines the risk and return in a mutual fund scheme. The underlying factors are different for each asset class.

#### **10.3.1 Factors Affecting Performance of Equity Schemes**

Equity as an asset class represents growth investment. The returns to an investor are primarily from appreciation in the value of the asset. The risk to the investor arises from the absence of defined and fixed returns from these investments which can be volatile from period to period. The returns from equity are linked to the earnings of the business. Not all businesses are successful and manage to earn return for its equity investors. It is therefore important to analyse the business and its prospects before investing in its equity. Moreover, investors have to continue to evaluate the business to ensure that it remains profitable and worthy of investment.

In order to generate returns superior to the benchmark, the fund manager must construct a portfolio that is different from the benchmark – either entire portfolio or a part of it, and either always, or at least some times. Two primary strategies adopted by the portfolio managers are security selection and market timing.

Security selection is an attempt to select good quality securities that are likely to perform well in the future, as well as avoid those securities where the future may be bleak. Market timing, on the other hand, is an attempt to time the entry and exit into a market or timing the purchase and sale of a security in order to capture the upside in prices and to avoid the downside.

For these purposes, two types of analysis may be used—fundamental analysis and technical analysis.

## Fundamental and Technical analysis

Fundamental analysis is a study of the business and financial statements of a firm in order to identify securities suitable for the strategy of the schemes as well as those with high potential for investment returns and where the risks are low. Fundamental analysis normally ties in well with the security selection strategy and mostly used for identifying long term investment avenues.

The discipline of **Technical Analysis** has a completely different approach. Technical Analysts believe that price behaviour of a share over a period of time throws up trends for the future direction of the price. Along with past prices, the volumes traded indicate the underlying strength of the trend and are a reflection of investor sentiment, which in turn will influence future price of the share. Technical Analysts therefore study price-volume charts (a reason for their frequently used description as “*chartists*”) of the company’s shares to decide support levels, resistance levels, break outs, and other triggers to base their buy/sell/hold recommendations for a share.

Both types of analysts swear by their discipline. It is generally agreed that longer term investment decisions are best taken through a fundamental analysis approach, while technical analysis comes in handy for shorter term speculative decisions, including intra-day trading. Even where a fundamental analysis-based decision has been taken on a stock, technical analysis might help decide when to implement the decision i.e. the timing.

Fundamental Analysis entails review of the company’s fundamentals viz. financial statements, quality of management, competitive position in its product / service market etc. The analyst sets price targets, based on financial parameters. Some of these financial parameters are listed below:

**Earnings per Share (EPS):**  $\text{Net profit after tax} \div \text{No. of equity shares outstanding}$

This tells investors how much profit the company earned for each equity share that they own.

**Price to Earnings Ratio (P/E Ratio):**  $\text{Market Price per share} \div \text{Earnings Per Share (EPS)}$

When investors buy shares of a company, they are essentially buying into its future earnings. P/E ratio indicates how much investors in the share market are prepared to pay (to become owners of the company), in relation to the company’s earnings. The forward PE ratio is normally calculated based on a projected EPS for a future period (also called *forward EPS*)

A company’s shares are seen as expensive or otherwise by comparing its PE ratio to the market PE and peer group PE ratios. A simplistic (but faulty) view is that low P/E means that a share is cheap, and therefore should be bought; the corollary being that high P/E means that a share is expensive, and therefore should be sold. In reality, the P/E may be high because the company’s prospects are indeed good, while another company’s P/E may be low because it is unlikely to replicate its past performances. The validity of this parameter will

depend upon the robustness of the future estimates of the earnings of the company. The PE ratio needs to be recalculated every time there is a change in the earnings and its estimates.

The **Price Earnings to Growth (PEG) ratio** relates the PE ratio to the growth estimated in the company's earnings. A PEG ratio of one indicates that the market has fairly valued the company's shares, given its expected growth in earnings. A ratio less than one indicates the equity shares of the company are undervalued, and a ratio greater than one indicates an overvalued share.

**Book Value per Share:**  $\text{Net Worth} \div \text{No. of equity shares outstanding}$

This is an indicator of how much each share is worth, as per the company's own books of accounts. The accounts represent a historical perspective, and are a function of various accounting policies adopted by the company.

**Price to Book Value:**  $\text{Market Price per share} \div \text{Book Value per share}$

An indicator of how much the share market is prepared to pay for each share of the company, as compared to its book value. The drawback with this is that the book value is an accounting measure and may not represent the true value of the assets of the company.

Such financial parameters are compared across companies, normally within a sector. Accordingly, recommendations are made to buy/hold/sell the shares of the company.

As in the case of P/E ratio, most financial indicators cannot be viewed as stand-alone numbers. They need to be viewed in the context of unique factors underlying each company. The fundamental analyst keeps track of various companies in a sector, and the uniqueness of each company, to ensure that various financial indicators are understood in the right perspective.

**Dividend Yield:**  $\text{Dividend per share} \div \text{Market price per share}$

This is used as a measure of the payouts received from the company, in percentage, for each rupee of investment in the share. Since dividends are not guaranteed or fixed, investors who are particular about receiving payouts look at the trend in dividend yields over a period of time. Dividend yield is considered as a parameter by conservative investors looking to identify steady and lower risk equity investments. A high dividend yield is the result of higher payout and/or lower market prices, both of which are preferred by such conservative investors.

Another way of looking at a high dividend pay-out is that the company may have lower investment prospects and therefore pays out the profits instead of re-investing it into the company.

Dividend yields tend to go down across stocks in a bull market and rise in a bear market.

## **Investment Styles – Growth and Value**

*Growth investment style* entails investing in high growth stocks i.e. stocks of companies that are likely to grow much faster than the market. Many market players are interested in accumulating such *growth stocks*. Therefore, valuation of these stocks tends to be on the higher side. Further, in the event of a market correction, these stocks tend to decline more. Such stocks typically feature high PE and PEG ratios and lower dividend yield ratio.

*Value investment style* is an approach of picking up stocks, which are priced lower than their intrinsic value, based on fundamental analysis. The belief is that the market has not appreciated some aspect of the value in a company's share – and hence it is cheap. When the market recognizes the intrinsic value, then the price would shoot up. Such stocks are also called *value stocks*. Investors need a longer investment horizon to benefit from the price appreciation in such stocks.

Value investors maintain a portfolio of such value stocks. In the stocks where their decision is proved right, they earn very high returns, which more than offset the losses on failed decisions.

It is important to note that 'high valuation' is not the equivalent of 'high share price', just as 'low valuation' is not the same as 'low share price'. Fundamental analysts look at value in the context of some aspect of the company's financials. For example, how much is the share price as compared to its earnings per share (*Price to Earnings Ratio*); or how much is the share price as compared to its book value (*Price to Book Value Ratio*).

Thus, a company's share price may be high, say Rs. 100, but still reasonably valued given its earnings; similarly, a company may be seen as over-valued, even when its share price is Rs. 5, if it is not matched by a reasonable level of earnings.

Investments of a scheme can thus be based on growth, value or a blend of the two styles. In the initial phases of a bull run, growth stocks deliver good returns. Subsequently, when the market heats up and the growth stocks get highly valued or costly, value picks end up being safer.

## **Portfolio building approach – Top down and Bottom up**

In analysing the factors that impact the earnings of company, analysts consider the *EIC framework* i.e. the economy, the industry and the company-specific factors. Economic factors include inflation, interest rates, GDP growth rates, fiscal and monetary policies of the government, balance of payment etc. Industry factors that are relevant include regulations that affect investment and growth decisions of the companies, level of competition, availability of raw materials and other inputs and cyclical nature of the industry. Company-specific factors include management and ownership structure, financial parameters, products and market shares and others.

In a *top down* approach, the portfolio manager evaluates the impact of economic factors first and narrows down on the industries that are suitable for investment. Thereafter, the companies are analysed and the good stocks within the identified sectors are selected for investment.

A *bottom-up* approach on the other hand analyses the company-specific factors first and then evaluates the industry factors and finally the macro-economic scenario and its impact on the companies that are being considered for investment. Stock selection is the key decision in this approach; sector allocation is a result of the stock selection decisions.

Both the approaches have their merit. Top down approach minimizes the chance of being stuck with large exposure to a poor sector. Bottom up approach ensures that a good stock is picked, even if it belongs to a sector that is not so hot. What is important is that the approach selected should be implemented professionally.

Therefore, it can be said that equity returns are a function of sector and stock selection. Investors can also hope for a secular growth in a diversified mix of equity stocks when the economy does well.

### **10.3.2 Factors affecting performance of Debt Schemes**

Risks associated with marketable debt securities have been covered earlier. Primarily there are two risks impacting the debt securities, viz., interest rate risk and credit risk. The yields on debt securities tend to move up as the maturity rises (interest rate risk rises), or as the credit risk is increased.

Investment in a debt security, entails a return in the form of interest (at a pre-specified frequency for a pre-specified period), and repayment of the invested amount at the end of the pre-specified period.

The pre-specified period is called *tenor*. At the end of the tenor, the securities are said to *mature*. The process of repaying the amounts due on maturity is called *redemption*. An investor may earn capital gains or incur capital losses by selling the debt security before its maturity period.

Debt securities that are to mature within a year are called money market securities.

The total return that an investor earns or is likely to earn on a debt security is called its *yield*. The yield is a combination of interest paid by the issuer and capital gain (if the sale proceeds are higher than the amount invested) or capital loss (if the sale proceeds are lower than the amount invested) relative to the price paid to buy the security.

Debt securities may be issued by Central Government, State Governments, Banks, Financial Institutions, Public Sector Undertakings (PSU), Private Companies, Municipalities, etc.

- Securities issued by the Government are called *Government Securities* or *G-Sec* or *Gilt*.
- *Treasury Bills* are short term debt instruments issued by the Reserve Bank of India on behalf of the Government of India.
- *Certificates of Deposit* are issued by Banks (for 7 days to 1 year) or Financial Institutions (for 1 to 3 years)
- *Commercial Papers* are short term securities (upto 1 year) issued by companies.
- *Bonds/Debentures* are generally issued for tenors beyond a year. Governments and public sector companies tend to issue bonds, while private sector companies issue debentures.

Since the government is unlikely to default on its obligations, Gilts are viewed as safe as there is no credit risk associated with them. The yield on Gilt is generally the lowest in the market for a given tenor. Since non-Government issuers can default, they tend to offer higher yields for the same tenor. The difference between the yield on Gilt and the yield on a non-Government Debt security is called its *credit spread*.

The possibility of a non-government issuer defaulting on a debt security i.e. its credit risk is measured by Credit Rating companies such as CRISIL, ICRA, CARE and Fitch. They assign different symbols to indicate the credit risk in a debt security. For instance, 'AAA' is CRISIL's indicator of highest safety in a debenture. Higher the credit risk, higher is likely to be the yield on the debt security.

The interest rate payable on a debt security may be specified as a fixed rate, say 6 percent. Alternatively, it may be a floating rate i.e. a rate linked to some other rate that may be prevailing in the market, say the rate that is applicable to Gilt. Interest rates on floating rate securities (also called *floaters*) are specified as a "Base + Spread". For example, 5-year G-Sec + 2 percent, this means that the interest rate that is payable on the debt security would be 2 percent above whatever is the rate prevailing in the market for Government Securities of 5-year maturity.

The returns in a debt portfolio are largely driven by interest rates and credit spreads.

### **Interest Rates**

Suppose an investor has invested in a debt security that yields a return of 8 percent. Subsequently, yields in the market for similar securities rise to 9 percent. It stands to reason that the security, which was bought at 8 percent yield, is no longer such an attractive investment. It will therefore lose value. Conversely, if the yields in the market go down, the debt security will gain value. Thus, there is an inverse relationship between yields and value of such debt securities, which offer a fixed rate of interest.

Let us look at another example:

Suppose Company X issued a debenture for a period of 5 years carrying a coupon rate of 9.5 percent p.a. The debenture carried credit rating of AAA, which denotes highest safety.

Two years later, the debenture has residual maturity of 3 years, i.e. the debenture will mature after 3 years. At this stage, the interest rate for AAA rated debentures having 3-year maturity is 8.5 percent p.a. In such a case, the Company X debenture would fetch premium in the secondary market over its face value.

A security of longer maturity would fluctuate a lot more, as compared to short tenor securities. Debt analysts' work with a related concept called *modified duration* to assess how much a debt security is likely to fluctuate in response to changes in interest rates. Higher the modified duration of a debt security, greater is the volatility in its prices in response to changes in interest rates in the market.

In a floater, when yields in the market go up, the issuer pays higher interest; lower interest is paid, when yields in the market go down. Since the interest rate itself keeps adjusting in line with the market, these floating rate debt securities tend to hold their value, despite changes in yield in the debt market.

If the portfolio manager expects interest rates to rise, then the portfolio is switched towards a higher proportion of floating rate instruments; or fixed rate instruments of shorter tenor (which have lower modified duration). On the other hand, if the expectation is that interest rates would fall, then the manager increases the exposure to longer term fixed rate debt securities (which have higher modified duration).

The calls that a fund manager takes on likely interest rate scenario are therefore a key determinant of the returns in a debt fund – unlike equity, where the calls on sectors and stocks are important.

### **Credit Spreads**

Suppose an investor has invested in the debt security of a company. Subsequently, its credit rating improves. The market will now be prepared to accept a lower credit spread. Correspondingly, the value of the debt security will increase in the market.

The investment objective of a debt will define whether the focus of the fund manager will be on earning interest income (Accrual) or on appreciation or gains in the value of the securities held. A money market or liquid fund, an Ultra short-term debt fund or a Floating rate fund will focus only on accrual or interest income. The portfolio will hold only securities with short-term maturities which have low modified duration so that there is no risk of volatility in the values of securities held. A fund that seeks to earn a combination of coupon income and gains in the value of the securities will hold a portfolio of both short-term maturities and long-term securities. Higher the proportion of long-term securities in the portfolio, greater will be the

volatility in the returns of the fund since the securities with higher duration will see a greater volatility in their values in response to changes in interest rates in the market.

Duration management is the strategy adopted by funds with the mandate to do so where the fund manager alters the duration of the portfolio in anticipation of changes in interest rate scenario. The fund manager will increase the duration of the portfolio by moving into long term maturities if interest rates are expected to go down and vice versa. The risk in the strategy arises from the possibility that the expectation on interest rate movements may not materialize.

A debt portfolio manager also explores opportunities to earn gains by anticipating changes in credit quality, and changes in credit spreads between different market benchmarks in the market place. Including securities in portfolio whose credit rating is expected to go up will translate into gains for the portfolio when the value appreciates in response to the re-rating of the security. The risk is that the default risk in the portfolio will go up if the expected re-rating does not materialize.

Depending on the investment strategy, the fund managers may take or avoid these risks. If the asset allocation for the category is tightly defined by SEBI or through the scheme document, there is not much room for the fund manager. For example, in case of overnight funds, the fund manager must invest only in overnight securities. Hence, there is no question of taking the interest rate risk. On the other hand, when the limits are not tightly defined, the fund manager may assume an active role in managing the risk, e.g. an ultra-short term debt fund may take credit risk, since the SEBI regulations only define the permitted maturity profile, which indicates how much interest rate risk the scheme can take.

Dynamic bond fund is a category where the fund manager may take a view on the interest rate movements and positions the portfolio to benefit out of it. When the view is that the rates are likely to move down, the manager may increase the maturity of the portfolio (or buy long maturity securities and sell short maturity papers), and vice versa.

### **10.3.3 Factors Affecting Performance of Gold Funds**

Gold, as an asset class does not generate any current income. This was discussed in Chapter 1. In such a case, the only way an investor in gold makes money is when one is able to sell the gold at prices higher than one's cost of purchase. The gold prices move on account of the demand-supply balance or imbalance as well as the general view on the price of the asset.

Gold is a truly international asset, whose quality can be objectively measured. The value of gold in India depends on the international price of gold (which is quoted in foreign currency), the exchange rate for converting the currency into Indian rupees, and any duties on the import of gold.

Therefore, returns in gold as an asset class depends on the following factors:

## **Global price of gold**

Gold is seen as a safe haven asset class. Therefore, whenever there is political or economic turmoil, gold prices shoot up.

Most countries hold a part of their foreign currency reserves in gold. Similarly, institutions like the International Monetary Fund have large reserves of gold. When they come to the market to sell, gold prices weaken. Purchases of gold by large countries tend to push up the price of gold.

## **Strength of the Rupee**

Economic research into inflation and foreign currency flows helps analysts anticipate the likely trend of foreign currency rates.

When the rupee becomes stronger, the same foreign currency can be bought for fewer rupees. Therefore, the same gold price (denominated in foreign currency), translates into a lower rupee value for the gold portfolio. This pushes down the returns in the gold fund. A weaker rupee, on the other hand, pushes up the rupee value of the gold portfolio, and consequently the returns in gold would be higher.

Since the gold funds are passive in nature, the fund manager does not take a view on the movement of gold prices. Such funds simply invest in gold and hence there is no risk related to the decisions taken by the fund management team.

### **10.3.4 Factors affecting performance of Real Estate funds**

Unlike gold, real estate is a local asset. It cannot be transported – and its value is driven by local factors. Some of these factors are:

#### **Economic scenario**

At times of uncertainty about the economy (like recessionary situation), people prefer to postpone real estate purchases and as a consequence, real estate prices weaken. As the economy improves, real estate prices also tend to keep pace.

#### **Infrastructure development**

Whenever infrastructure in an area improves, real estate values increase.

#### **Interest Rates**

When money is cheap and easily available, more people buy real estate. This pushes up real estate prices. Rise in interest rates therefore softens the real estate market.

The behaviour of real estate is also a function of the nature of real estate viz. residential or commercial; industrial, infrastructural, warehouse, hotel or retail.

Similarly, a lot of innovation is possible in structuring the real estate exposure. Real estate analysts are experts in assessing the future price direction of different kinds of real estate, and structuring exposure to them.

The composition of the portfolio is the most important driver of returns in a scheme. The factors that drive the return of some of the asset classes are discussed above. The factors that cause fluctuation in the returns of these asset classes, and the schemes that invest in them, are discussed in a later section on risk drivers.

Real estate investments can generate returns in two ways, viz. rental income and capital appreciation. While the former could accrue regularly, the latter is difficult to determine as the same may happen over a period of time and it is difficult to ascertain the same in the short term.

SEBI has mandated that the mutual funds employ neutral valuation agencies to determine the current valuation of the real estate investments. Currently, there are no mutual fund schemes investing in real estate.

#### **10.4 Measures of Returns**

The returns from an investment is calculated by comparing the cost paid to acquire the asset (outflow) or the starting value of the investment to what is earned from it (inflows) and computing the rate of return. The inflows can be from periodic payouts such as interest from fixed income securities and dividends from equity investments and gains or losses from a change in the value of the investment. The calculation of return for a period will take both the income earned and gains/loss into consideration, even if the gains/loss have not been realized.

##### **10.4.1 Simple Return**

Suppose you invested in a scheme at a NAV of Rs. 12. Later, you found that the NAV has grown to Rs. 15. How much is your return?

The *Simple Return* can be calculated with the following formula:

$$\frac{(\text{Later Value} \textit{ minus } \text{Initial Value}) \times 100}{\text{Initial Value}}$$

$$\frac{(\text{Rs}15 \textit{ minus } \text{Rs}12) \times 100}{\text{Rs}12}$$

i.e. **25 percent**

Thus, simple return is simply the change in the value of an investment over a period of time.

### 10.4.2 Annualized Return

Two investment options have indicated their returns since inception as 5 percent and 3 percent respectively. If the first investment was in existence for 6 months, and the second for 4 months, then the two returns are obviously not comparable. Annualisation helps us compare the returns of two different time periods.

The *Annualized Return* can be calculated as:

$$\frac{\text{Simple Return} \times 12}{\text{Period of Simple Return (in months)}}$$

Investment 1	Investment 2
$\frac{5 \text{ percent} \times 12}{6}$	$\frac{3 \text{ percent} \times 12}{4}$
i.e. 10 percent	i.e. 9 percent

### 10.4.3 Compounded Return

If the two investment options mentioned above were in existence for 6 years and 4 years respectively, then it is not possible to calculate the annualised return using the above formula as it does not consider the effect of *compounding*.

*What is compounding?* Suppose you deposited Rs. 10,000 in a cumulative bank deposit for 3 years at 10 percent interest, compounded annually.

The bank would calculate the interest in each of the 3 years as follows:

Year	Opening Balance (Rs)	Interest (10 percent on opening balance)	Closing Balance (Rs)
1	10,000	1,000	11,000
2	11,000	1,100	12,100
3	12,100	1,210	13,310

Thus, at the end of the 3 year period, your principal of Rs. 10,000 would have grown to Rs. 13,310. If, on the other hand, the bank had calculated interest on simple basis, it would have calculated interest at Rs. 1,000 for each of the 3 years, and given you Rs. 13,000.

The difference between Rs 13,310 and Rs 13,000 is the effect of compounding. Longer the period of investment holding, higher would be the difference, if compounding is not considered.

*Compounded return* can be calculated using a formula:

$$(\text{Later Value} / \text{Initial Value})^{(1/n)} - 1$$

Where: 'n' is the period in years.

Thus, if Rs. 1,000 grew to Rs. 4,000 in 2 years, Later Value= Rs 4,000; Initial Value = Rs 1,000; n = 2 years, then the compounded return is given by the formula:

$$\text{Thus, compounded return} = ((4000/1000)^{(1/2)}) - 1$$

MS Excel will calculate the answer to be 1. This is equivalent to 1 X 100 i.e. 100 percent. Thus, the investment yielded a 100 percent compounded return during the 2 years.

Logically, for a return of 100 percent, the initial value of Rs. 1,000 should have grown by 100 percent i.e. doubled to Rs. 2,000 in the first year; and further doubled to Rs. 4,000 in the second year. Thus LV had to reach a value of Rs. 4,000, which indeed was the case. It is possible to do the above calculations, by using the concerned NAVs of a scheme. Thus, to calculate the returns from a scheme over a specific period of time, then:

- NAV at the beginning of the period is Initial Value
- NAV at the end of the period is Later Value and
- Exact number of days during the period, divided by 365 is 'n'

Conceptually, these calculations give you only the return in the form of change in NAV. Another form of return for an investor in a mutual fund scheme is dividend. NAV goes down after a dividend is paid. Therefore, in the above examples, if dividend was paid, then that has not been captured in any of the three kinds of returns calculated viz. Simple, Annualised and Compounded.

The above three formulae are thus applicable only for growth schemes, or for dividend schemes that have not paid a dividend during the period for which return is being calculated.

Whenever a dividend is paid – and compounding is to be considered - the CAGR technique (or the reinvestment method, as some call it) prescribed by SEBI is used.

#### 10.4.4 Compounded Annual Growth Rate

The CAGR calculation is based on an assumption that the dividend would be re-invested in the same scheme at the ex-dividend NAV. The following example will clarify the calculation.

You invested Rs. 10,000 in a scheme at Rs. 10 per unit on June 30, 2019

On January 1, 2020, the scheme paid out a dividend of Re. 1 per unit. The ex-dividend NAV was Rs. 12.50.

On January 1, 2021, the scheme paid out another dividend of Re. 1 per unit. The ex-dividend NAV was Rs. 15.

Let us calculate the CAGR, which we know captures the impact of both dividend payments and compounding.

We know that the **initial value of investment is Rs. 10,000.**

If Rs. 10,000 was invested at Rs. 10 per unit, then you would have 1,000 units (i.e. Rs. 10000/Rs. 10).

The first dividend of Re. 1 per unit on 1,000 units would amount to Rs. 1,000. If this amount was re-invested in the same scheme at the ex-dividend NAV, then you would have 80 additional units (i.e. Rs. 1000/Rs. 12.50, where the reinvestment happens at the ex-dividend NAV of Rs. 12.50 ).

Thus, your unit-holding would have gone up from 1,000 to 1,080 units.

The second dividend of Re. 1 per unit, on the revised unit-holding of 1,080 units would amount to Rs. 1,080. If this amount were re-invested in the same scheme at the ex-dividend NAV, then you would have 72 additional units (Rs. 1,080/Rs. 15, reinvestment at the ex-dividend NAV).

Thus, your unit-holding would have gone up from 1,080 to 1,152 units. At Rs. 15 per unit, this would be valued at Rs. 17,280.

Therefore, the **later value of units is Rs. 17,280.**

The impact of dividend has been captured in the form of increase in the number of units.

You now need the time period in years, to compute the compounded returns. The period of June 30, 2019 to January 1, 2021 has 551 days. Dividing by 365, it translates to 1.51 years.

Thus, the **investment period in years (n) is 1.51 years.**

Now the compound interest formula can be applied.

$(\text{Later Value}/\text{Initial Value})^{(1/n)} - 1$

Where 'n' is the period in years.

Here, Rs. 10,000 grew to Rs. 17,280 in 1.51 years, LV = Rs. 17,280; IV = Rs. 10,000; n = 1.51 years.

$$= ((17280/10000)^{(1/1.51)})-1$$

MS Excel will calculate the answer to be 0.4365. This is equivalent to 0.4365 X 100 i.e. 43.65 percent. Thus, the investment yielded a 43.65 percent CAGR between June 30, 2019 and January 1, 2021.

### **Scheme Returns and Investor Returns**

The discussion so far focused on scheme returns. Investors might have a return profile that is different, on account of the role of loads.

In the earlier example, the CAGR was calculated with the closing NAV as Rs. 15. However, if an exit load of 1 percent was applicable, then the investor will receive only 99 percent of Rs. 15 i.e. Rs. 14.85 on re-purchase. Thus, your return as investor would be lower than the scheme returns.

Similarly, if the original investment had suffered an entry load of 2 percent, you would have bought the units at 102 percent of Rs. 10 i.e. Rs. 10.20. This would have brought down the returns. (Note: Entry load is no longer permitted).

Loads thus drag down the investor's return below the scheme return. Even taxes would pull down the investor's post-tax returns.

While calculating investor returns for a period, the same formulae can be used, with the following changes:

- Instead of the initial value of NAV (which is used for calculating scheme returns), the amount actually paid by the investor (i.e. NAV plus Entry Load, if any) would need to be used.
- Instead of the later value of NAV (which is used for calculating scheme returns), the amount actually received/receivable by the investor (i.e. NAV minus Exit Load, if any) would need to be used.

Investor returns might vary from the scheme returns also on account of choices regarding investment schedule, i.e., additional investment being made during the period or redeeming a portion of the investment. In such a case, for the same period investor's returns may be different from the published returns of the scheme.

The returns published in a mutual fund advertisement would be without factoring the entry or exit load, as may be applicable.

Holding period returns is calculated for a fixed period such as one month, three months, one year, three years or since inception. The return is calculated using CAGR if the holding period is over one year and simple absolute returns for less than one year. Holding period returns may not present an accurate picture of the returns from a fund if the initial value or the end value used for calculation was too high or low. To eliminate this impact rolling returns are calculated. Rolling returns is the average annualized return calculated for multiple consecutive holding periods in an evaluation period. For example, all consecutive one year returns in a three-year period with a daily/weekly/monthly rollover is calculated and averaged.

### **Pros and Cons of Evaluating Funds only on the Basis of Return Performance**

The primary factor that investors use for selecting a mutual fund for investment is the return that it has generated. To make the selection more robust, it is important to consider the consistency of the return performance and the performance relative to the benchmark of the scheme and its peer group funds. It is important for an actively managed fund to perform well in rising markets and fall less than the benchmark in a declining market.

However, the return number alone is not adequate to make a decision to invest in a scheme or exit from a scheme. The suitability of the scheme to an investor's needs must also consider the risk associated with the scheme. This includes evaluating factors like the volatility in returns over time. The extent of volatility indicates the riskiness of the scheme.

### **10.5 SEBI Norms regarding Representation of Returns by Mutual Funds in India**

Mutual funds are not permitted to promise any returns, unless it is an assured returns scheme. Assured returns schemes call for a guarantor who is named in the SID. The guarantor will need to write out a cheque, if the scheme is otherwise not able to pay the assured return.

Advertisement Code and guidelines for disclosing performance related information of mutual fund schemes are prescribed by SEBI. The same has been discussed earlier.

### **10.6 Risks in fund investing with a focus on investors**

Section 10.1 of this book covered the discussion on various general and specific risk factors in mutual fund schemes. The same must be seen from the point of view of the investors. It is understood that the investor is taking some risks while investing in mutual funds. However, in order to sell schemes suitable for the investor's situation, the distributor needs to understand the impact of these risks. The risks discussed in section 10.1 must be seen in light of the objective for which an investor has invested the money.

### **10.6.1 Risks in Equity Funds**

An investor would be exposed to the risk of price fluctuations in an equity fund. The risk is likely to go up when one moves from large-cap to mid-cap to small-cap schemes. In the same manner, the business risk or the risk of failure of a company's business also tends to be higher in case of small-cap companies in comparison to mid-caps, and higher in case of mid-caps in comparison to large caps. The liquidity risk is another risk that an equity fund investor must be careful of, although equity investments are suitable for long term. All these risks increase in a focused fund due to portfolio concentration.

The result of these risks could be that the investor's objective of long term growth from the equity fund may not materialize due to the possibility of lower than expected returns. At the same time, the presence of these risks also increases the return potential.

An investor should invest in equity funds in line with one's risk profile. It would also be prudent to ensure adequate liquidity in the portfolio through liquid funds so that one does not have to resort to selling equity funds, if one needs money when the stock markets are down.

### **10.6.2 Risks in Debt Funds**

Debt funds or income funds are often used for providing stability to the portfolio or for the purpose of generating regular income. A large number of investors are not exposed to fluctuations in prices of their debt instruments, especially majority of Indians who invest in non-marketable debt instruments, such as fixed deposits or small savings schemes. On the other hand, debt fund NAVs may fluctuate due to change in interest rates or due to credit migration. That means the debt fund portfolio may not be as stable as one expected.

Some investors opt for the dividend option in order to receive regular income. However, such income is not guaranteed and there have been instances in the past where some schemes have skipped paying the dividends during certain periods, due to non-availability of distributable surplus (See Section 7.3 in the book).

The liquid, ultra-short term, or low duration funds are often used for parking of money for short term. If gating provisions are applied or segregated portfolio is created, only partial liquidity may be available. Section 10.8 explains gating provisions and segregated portfolio in details

In case the segregated portfolios are not created, and some other investors exit from the scheme, the investors who stay invested would be exposed to even greater risks. This is explained in the below example:

Assume that XYZ Debt Fund investment in debentures of ABC Ltd. is to the extent of 5 percent of scheme's NAV. Sometime later the said debenture defaulted on repayment. If the segregated portfolio was not created, the debenture would continue to remain part of the portfolio. If 50 percent of the money from the scheme is withdrawn by various investors due to this credit default, the scheme would be required to sell the debentures that some buyers are ready to buy. That means the scheme would end up holding debenture of ABC Ltd. and sell some other papers. In such a case, the exposure to ABC Ltd.'s debenture on the remaining portfolio would be 10 percent. The investors, who continued to stay invested got a bigger problem.

In the recent past, there have been a few credit events that hit even the liquid funds, ultra-short-term debt funds, and low duration funds. This highlighted once again that while these scheme categories may be safe in terms of interest rate risk, these are not absolutely safe when it comes to credit risk. The critical point to understand is "low risk" does not mean "zero risk".

Currently according to the SEBI (Mutual Funds) Regulations, 1996 and SEBI circular dated December 28, 2018, every close-ended scheme and units of segregated portfolio shall be listed on recognized stock exchanges.<sup>64</sup> As per MF Regulations, there are several steps envisaged with respect to winding up of Mutual Fund schemes before the scheme ceases to exist. During this process, such units can be listed and traded on a recognized stock exchange, which may provide an exit to investors. Accordingly, the units of Mutual Fund schemes which are in the process of winding-up in terms of Regulation 39(2)(a) of MF Regulations, shall be listed on recognized stock exchange, subject to compliance with listing formalities as stipulated by the stock exchange.<sup>65</sup>

### **10.6.3 Risks in Hybrid Funds**

SEBI circular on mutual fund scheme categorization defined the asset allocation between equity and debt in case of certain categories within the hybrid funds. The distributor must be careful in evaluating and selecting the schemes.

It is widely believed that the arbitrage funds are very safe since they employ arbitrage strategies that nullify the exposure to any security or the stock markets. However, some arbitrage funds have the provision to invest in debt securities, as well as to employ strategies like "paired arbitrage", or "alpha hedging", or "merger arbitrage". In all these cases, the fund manager is taking a view on the price movement and not employing pure arbitrage. If the judgment turns out to be wrong, the investor could lose some money, or earn low returns.

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<sup>64</sup> Circular no. SEBI/HO/IMD/DF2/CIR/P/2018/160 and refer to [https://www.sebi.gov.in/legal/circulars/may-2020/circular-on-listing-of-mutual-fund-schemes-that-are-in-the-process-of-winding-up\\_46689.html](https://www.sebi.gov.in/legal/circulars/may-2020/circular-on-listing-of-mutual-fund-schemes-that-are-in-the-process-of-winding-up_46689.html) (dated May 20, 2020) for more details.

<sup>65</sup> [https://www.sebi.gov.in/legal/circulars/may-2020/circular-on-listing-of-mutual-fund-schemes-that-are-in-the-process-of-winding-up\\_46689.html](https://www.sebi.gov.in/legal/circulars/may-2020/circular-on-listing-of-mutual-fund-schemes-that-are-in-the-process-of-winding-up_46689.html)

#### 10.6.4 Risk in Gold Funds

As an international commodity, gold prices are difficult to manipulate. Therefore, there is better pricing transparency.

Further, gold does well when the other financial markets are in turmoil. Similarly, when a country goes into war, and its currency weakens, gold funds generate excellent returns.

These twin benefits make gold a very attractive risk proposition. An investor in a gold fund needs to be sure what kind of gold fund it is – Gold Sector Fund or Gold ETF.

#### 10.6.5 Risk in Real Estate Funds

Investment in real estate is subject to various kind of risks. Every real estate asset is different, therefore its valuation is highly subjective. Real estate is a less liquid asset class. The intermediation chain of real estate agents is largely unorganized in India. Transaction costs, in the form of stamp duty, registration fees, etc. are high. Regulatory risk is high in real estate, as is the risk of litigation and other encumbrances. The transparency level is low even among the real estate development and construction companies.

Many real estate groups are family-owned and family-driven, therefore there is poor corporate governance standards which also increases the risks of investing in their securities. Thus, real estate funds are quite high in risk, relative to other scheme types. Yet, they are less risky than direct investment in real estate.

### 10.7 Measures of Risk

Fluctuation in returns is used as a measure of risk. Therefore, to measure risk, generally the periodic returns (daily/weekly/fortnightly/monthly) are first worked out, and then their fluctuation is measured against the average return. The fluctuation or variation may be to the higher or lower side. Both are taken as risky. The fluctuation in returns can be assessed in relation to itself, or in relation to some other index. Accordingly, the following risk measures are commonly used.

#### 10.7.1 Variance

Suppose there are two schemes, with monthly returns as follows:

Month	Returns (%)	
	Scheme 1	Scheme 2
1	5	5
2	4	-5
3	5	10

Month	Returns (%)	
	Scheme 1	Scheme 2
4	6	5
<b>Average Return</b>	<b>5</b>	<b>3.75</b>
<b>Variance</b>	<b>0.67</b>	<b>39.58</b>

Variance measures the fluctuation in periodic returns of a scheme, as compared to its own average return.

This can be easily calculated in MS Excel using the following function:

= var(range of cells where the periodic returns are calculated)<sup>66</sup>

Variance as a measure of risk is relevant for both debt and equity schemes.

### 10.7.2 Standard Deviation

Like Variance, Standard Deviation too measures the fluctuation in periodic returns of a scheme in relation to its own average return. Mathematically, standard deviation is equal to the square root of variance.

Standard deviation is a measure of total risk in an investment. As a measure of risk it is relevant for both debt and equity schemes.

A high standard deviation indicates greater volatility in the returns and greater risk. Comparing the standard deviation of a scheme with that of the benchmark and peer group funds gives the investor a perspective of the risk in the scheme. Standard deviation along with the average return can be used to estimate the range of returns that the investment will take.

Since standard deviation is calculated using historic numbers it has limited use in predicting future performance.

The NAV of any scheme would keep fluctuating in line with changes in the valuation of securities in its portfolio. The change in NAV of the growth option of a scheme captures the scheme's return, as already discussed. The return can thus be calculated at different points of time, keeping the time period constant.

The standard deviation of the periodic returns can be calculated, using the '=stdev' function in MS Excel, as=stdev(range of cells where the periodic returns are calculated). This is exhibited below in illustration 10.1.

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<sup>66</sup> At least 30 observations are required in the series in order to compute an accurate statistical value of standard deviation.

### Illustration 10.1: Calculating standard deviation

		C10		fx		=STDEV(C5:C8)	
	A	B	C	D			
2							
3	<b>Week</b>	<b>NAV (₹)</b>	<b>Weekly Return</b>				
4	1	10.00					
5	2	10.05	0.50%				
6	3	10.02	-0.30%				
7	4	10.15	1.30%				
8	5	10.20	0.49%				
9							
10	Standard Deviation			0.65%			

*Standard deviation* is a statistical measure of how much the scheme's return varies as compared to its own past standard. It is a measure of total risk in the scheme. Higher the standard deviation, more risky the scheme is.

The standard deviation has been calculated above, based on weekly returns. 52 weeks represent a year. Therefore, the standard deviation can be annualised by multiplying the weekly number by the square root of 52 [written in excel as 'sqrt(52)'].

The annualised standard deviation would therefore be 0.65 X sqrt(52) i.e. 4.70 percent (rounded).

While working with monthly returns, the standard deviation would be multiplied by sqrt(12); in the case of daily returns, it would be multiplied by sqrt(252), because there are 252 trading days in a year, after keeping out the non-trading days (Saturdays, Sundays, holidays).

#### 10.7.3 Beta

Beta is based on the *Capital Asset Pricing Model (CAPM)*, which states that there are two kinds of risk in investing in equities – *systematic risk* and *non-systematic risk*. This has been explained in the earlier section. Since non-systematic risk can be diversified away, investors need to be compensated only for systematic risk, according to CAPM. This systematic risk is measured by its *Beta*.

Beta measures the fluctuation in periodic returns in a scheme, as compared to fluctuation in periodic returns of a diversified stock index (representing the market) over the same period.

The diversified stock index, by definition, has a Beta of 1. Companies or schemes, whose beta is more than 1, are seen as more risky than the market. Beta less than 1 is indicative of a company or scheme that is less risky than the market.

An investment with a beta of 0.8 will move 8 percent when markets move by 10 percent. This applies to increase as well as fall in values. An investment with a beta of 1.2 will move by 12 percent both on the upside and downside when markets move (up/down) by 10 percent.

Beta as a measure of risk is relevant only for equity schemes.

#### **10.7.4 Modified Duration**

Modified duration measures the sensitivity of value of a debt security to changes in interest rates. Higher the modified duration, higher is the interest sensitive risk in a debt portfolio.

A professional investor would rely on modified duration as a better measure of sensitivity to interest rate changes.

#### **10.7.5 Weighted Average Maturity**

Broadly, it can be said that the extent of fluctuation in value of the fixed rate debt security is a function of its *time to maturity (balance tenor)*. Longer the balance tenor, higher would be the fluctuation in value of the fixed rate debt security arising out of the same change in interest rates in the market.

This has led to the concept of *weighted average maturity* in debt schemes. If a scheme has 70 percent of its portfolio in a 4-year security, and balance 30 percent in a 1-year security, the weighted average maturity can be calculated to be (70 percent X 4 years) + (30 percent X 1 year) i.e. 3.1 years. The NAV of such a scheme can be expected to fluctuate more than another debt scheme with a weighted average maturity closer to 1.5 years.

While modified duration captures interest sensitivity of a security better, it can be reasoned that longer the maturity of a debt security, higher would be its interest rate sensitivity. Extending the logic, weighted average maturity of debt securities in a scheme's portfolio is indicative of the interest rate sensitivity of a scheme.

Being simpler to comprehend, weighted average maturity is widely used, especially in discussions with lay investors. However, a professional debt fund manager would rely on modified duration as a better measure of interest rate sensitivity.

#### **10.7.6 Credit Rating**

The credit rating profile indicates the credit or default risk in a scheme. Government securities do not have a credit risk. Similarly, cash and cash equivalents do not have a credit risk.

Investments in corporate issuances carry credit risk. Higher the credit rating, lower is the default risk.

Better the credit rating of an issuer, lower is the spread. Issuers with a poor credit rating need to offer higher yields to attract investors. Therefore, the spread on such securities is higher.

Credit rating too changes over time. A security that was rated 'AAA', can get downgraded to say, 'AA'. In that case, the yield expectations from the security would go up, leading to a decline in its market value. Thus, a shrewd investor who anticipates an improvement in credit rating on an instrument can benefit from the increase in its value that would follow.

### **10.8 Certain Provisions with respect to Credit risk**

In the debt markets, the credit risk arises on account of three things, viz., default, delay in payments, or rating downgrade. Any of these may result in fall in prices of the concerned debt securities. Such an event is also called a credit event. Whenever a credit event happens, it may lead to reduction in the trading volume of the respective paper. In such a case, mutual funds may come under stress, if a large part of the scheme is redeemed. Here is an example to understand this:

Assume that a scheme worth Rs. 10,000 crores hold 8 percent exposure in a single debt paper—debenture 'M'. If this paper is downgraded, the investors in the scheme may get concerned and would want to redeem their investments. Assume that roughly 20 percent of the scheme's size, i.e. Rs. 2,000 crores is redeemed. Since debenture 'M' has been downgraded, there may be no takers for the same in the debt market. In such a case, the fund manager of the scheme may be forced to sell other securities, which would mean that while the corpus of the scheme drops to Rs. 8,000 crores. Thus, the exposure of the scheme to debenture M increases to 10 percent.

Original corpus of the scheme = Rs. 10,000 crores

Exposure to debenture M = 8 percent of the portfolio = Rs. 800 crores

Reduced corpus of the scheme after 20 percent redemption = Rs. 8,000 crores

Now the scheme's exposure to debenture M = Rs. 800 crores/Rs. 8,000 crores  
= 10 percent

If some other investors panic after seeing a larger exposure to debenture M and they also redeem their investments, and if the corpus size reduces by half, the exposure to debenture M doubles from here, which means now the scheme holds debenture M worth 20 percent of the scheme's NAV. This can go on and on. The problem with this is that the scheme's exposure to the affected paper keeps going up and that exposes the scheme's investors to a greater risk of potential loss of capital.

On the other hand, there could be situations when the market-wide liquidity dries up, such that the scheme is unable to liquidate some of the positions it holds in certain securities. This may also mean that while the scheme may continue to hold a well-diversified portfolio across good quality securities, it is unable to liquidate the same and hence cannot fund the redemptions.

In order to reduce the impact of such risks, SEBI has allowed two provisions:

1. Gating or restriction on redemption in mutual funds
2. Segregated portfolios or side-pocketing

### **10.8.1 Gating or restriction on redemption in mutual funds<sup>67</sup>**

As a philosophy, restriction on redemption should apply during excess redemption requests that could arise in overall market crisis situations rather than exceptional circumstances of entity specific situations. The circumstances calling for restriction on redemption should be such that illiquidity is caused in almost all securities affecting the market at large, rather than in any issuer specific securities.

In order to protect the interest of the investors, the following requirement shall be observed before imposing restriction on redemptions:

Such restrictions may be imposed only when there are circumstances leading to a systemic crisis or event that severely constricts market liquidity or the efficient functioning of markets such as:

- a. Liquidity issues – when the market at large faces illiquidity affecting almost all securities. This means that such a measure cannot be employed during illiquidity in case of any particular security. AMCs should have sound internal liquidity management systems and tools in place for the mutual fund schemes. The restriction cannot be used as a tool to manage the liquidity of a scheme. Similarly, such restriction is not allowed in case of illiquidity of a specific security in the portfolio due to poor investment decision.
- b. Market failure or exchange closure—when markets are affected by unexpected events which impact the functioning of exchanges or the regular course of transactions. Such unexpected events could also be related to political, economic, military, monetary or other emergencies.
- c. Operational issues—when exceptional circumstances are caused by *force majeure*, unpredictable operational problems and technical failures (e.g. a black out). Such

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<sup>67</sup> SEBI circular dated May 2016 ([https://www.sebi.gov.in/legal/circulars/may-2016/restriction-on-redemption-in-mutual-funds\\_32577.html](https://www.sebi.gov.in/legal/circulars/may-2016/restriction-on-redemption-in-mutual-funds_32577.html))

cases can only be considered if they are reasonably unpredictable and occur in spite of appropriate diligence of third parties, adequate and effective disaster recovery procedures and systems.

According to SEBI regulations, such restrictions may be imposed only for a specified period not exceeding 10 working days in any 90-day period. Any imposition of restriction would require specific approval of Board of AMCs and Trustees and the same is required to be informed to SEBI immediately. When restriction on redemption is imposed, the following procedure shall be applied:

- No redemption requests upto Rs. 2 lakhs shall be subject to such restriction;
- When redemption requests are above Rs. 2 lakhs, AMCs shall redeem the first Rs. 2 lakhs without such restriction and remaining part, i.e. amounts over and above Rs. 2 lakhs shall be subject to the restriction.

The above information to investors shall be disclosed prominently and extensively in the scheme related documents regarding the possibility that their right to redeem may be restricted in such exceptional circumstances and the time limit for which it can be restricted.

#### **10.8.2 Segregated portfolio or side pocketing<sup>68</sup>**

To ensure fair treatment to all investors in case of a credit event and to deal with the liquidity risk, in December 2018, SEBI permitted creation of segregated portfolio of debt and money market instruments by mutual funds schemes. “Segregated portfolio” means a portfolio, comprising of debt or money market instrument affected by a credit event, that has been segregated in a mutual fund scheme. “Main portfolio” means the scheme portfolio excluding the segregated portfolio. Asset Management Company (AMC) were allowed to create segregated portfolio in a mutual fund scheme in case of a credit event at issuer level i.e. downgrade in credit rating by a SEBI registered Credit Rating Agency (CRA). Vide the December 28, 2018 circular, creation of segregated portfolio was made optional and at the discretion of the AMC.

In partial modification to SEBI circular issued in December 2018, SEBI permitted to create segregated portfolio of unrated debt or money market instruments by mutual fund schemes of an issuer that does not have any outstanding rated debt or money market instruments subject to the following:<sup>69</sup>

- Segregated portfolio of such unrated debt or money market instruments may be created only in case of actual default of either the interest or principal amount. As per SEBI circular

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<sup>68</sup> SEBI circular dated December 28, 2019 and SEBI circular dated November 7, 2019.

<sup>69</sup> This was notified vide SEBI Circular dated November 7, 2019.

dated December 28, 2018, credit event is considered for creation of segregated portfolio, however vide SEBI circular dated November 7, 2019, 'actual default' by the issuer of such instruments was considered for creation of segregated portfolio.

The respective AMC is required to inform AMFI immediately about the actual default by the issuer. Upon receiving such information, AMFI is required to immediately inform the same to all AMCs. Pursuant to dissemination of information by AMFI about actual default by the issuer, AMCs may segregate the portfolio of debt and money market instruments of the said issuer in terms of SEBI circular dated December 28, 2018.

SEBI has mandated that all new schemes launched after November 7, 2019 shall have the enabling provisions included in the SID for creation of segregated portfolio.<sup>70</sup>

AMCs shall have a detailed written down policy on creation of segregated portfolio and the same shall be approved by the trustees.

Once trustees approval is received by the AMC:

- Segregated portfolio shall be effective from the day of credit event.
- AMC shall issue a press release immediately regarding details about segregated portfolio.
- NAV of both segregated and main portfolio shall be disclosed from the day of the credit event.
- All existing investors shall be allotted equal number of units in the segregated portfolio as held in the main portfolio as on the day of the credit event.
- No redemption or subscription is allowed in the segregated portfolio. However, in order to facilitate exit to unitholders in segregated portfolio, AMC shall enable listing of units of segregated portfolio on the recognized stock exchange within 10 working days of creation of segregated portfolio and also enable transfer of such units on receipt of transfer requests.

Upon trustee's approval to create a segregated portfolio, the investors redeeming proceeds based on the NAV of main portfolio will continue to hold the units of segregated portfolio. However, investors subscribing to the scheme, will be allotted units only in the main portfolio based on its NAV. In case trustees do not approve the proposal of segregated portfolio, subscription and redemption application will be processed based on the NAV of the total portfolio.

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<sup>70</sup> SEBI circular dated November 7, 2019 ([https://www.sebi.gov.in/legal/circulars/nov-2019/creation-of-segregated-portfolio-in-mutual-fund-schemes\\_44889.html](https://www.sebi.gov.in/legal/circulars/nov-2019/creation-of-segregated-portfolio-in-mutual-fund-schemes_44889.html))

### **TER for Segregated Portfolio**

- 1) AMC will not charge investment and advisory fees on the segregated portfolio. However, TER (excluding the investment and advisory fees) can be charged, on a pro-rata basis only upon recovery of the investments in segregated portfolio.
- 2) The TER so levied shall not exceed the simple average of such expenses (excluding the investment and advisory fees) charged on daily basis on the main portfolio (in percent terms) during the period for which the segregated portfolio was in existence.
- 3) The legal charges related to recovery of the investments of the segregated portfolio may be charged to the segregated portfolio in proportion to the amount of recovery. However, the same shall be within the maximum TER limit as applicable to the main portfolio. The legal charges in excess of the TER limits, if any, shall be borne by the AMC.
- 4) The costs related to segregated portfolio shall in no case be charged to the main portfolio.

### **Net Asset Value of Segregated Portfolio**

The Net Asset Value (NAV) of the segregated portfolio is required to be declared on a daily basis. Adequate disclosure of the segregated portfolio shall appear in all scheme related documents, in monthly and half-yearly portfolio disclosures and in the annual report of the mutual fund and the scheme.

### **Risks Associated with Segregated Portfolio**

1. Investor holding units of segregated portfolio may not be able to liquidate their holding till the time of recovery of money from the issuer.
2. Securities comprising segregated portfolio may not realize any value.
3. Listing of units of segregated portfolio in recognized stock exchange does not necessarily guarantee their liquidity. There may not be active trading of units in the stock market. Further trading price of units on the stock market may be significantly lower than the prevailing NAV.

The following case illustrates the concept of segregated portfolios.

#### **Illustration of Segregated Portfolio:**

Portfolio Date: 30 September 2019

Downgrade event date: 30 September 2019

Downgrade Security: 8 percent XYZ Ltd. from A- to C

## Valuation marked down: 50 percent

Portfolio on the date of credit event						
Security		Rating	Type of security	Qty	Price Per Unit (INR)	Market Value (INR)
8.00 % XYZ Ltd.*	(A)	CRISIL A-	Non Convertible Debenture	25000	49.552	12,38,800
7.80% AVC Ltd.	(B)	CRISIL AAA	Non Convertible Debenture	25000	101.021	25,25,525
7.65% UYV Ltd.	(C)	CRISIL AAA	Non Convertible Debenture	21000	100.022	21,00,462
8.10% MNO Ltd.	(D)	CRISIL A-	Non Convertible Debenture	30000	99.548	29,86,440
Cash and Cash Equivalent (E)						11,50,000
Net Assets (A+B+C+D+E)						1,00,01,227
Unit Capital (no. of units)						10,000
NAV per unit (INR)						1000.1227
<b>*Downgraded security</b>						

Before marked down, the security was valued at Rs.99.105/- per unit. On the date of credit event i.e. on 30 September 2019, NCD of 8 percent XYZ Ltd will be moved to a segregated portfolio.

Main portfolio as on 30th September 2019						
Security		Rating	Type of security	Qty	Price Per Unit (INR)	Market Value (INR)
7.80% AVC Ltd.	(B)	CRISIL AAA	Non Convertible Debenture	25,000	101.021	25,25,525
7.65% UYV Ltd.	(C)	CRISIL AAA	Non Convertible Debenture	21,000	100.022	21,00,462
8.10% MNO Ltd.	(D)	CRISIL A-	Non Convertible Debenture	30,000	99.548	29,86,440
Cash and Cash Equivalent (E)						11,50,000
Net Assets (B+C+D+E)						87,62,427
Unit Capital (no. of units)						10,000
NAV per unit (INR)						876.2427

Segregated Portfolio as on 30th September 2019						
8.00 % XYZ Ltd.#	(A)	CRISIL C	Non-Convertible Debenture	25,000	49.552	12,38,800
Net Assets (A only since this comprises of only this security)						12,38,800
Unit Capital (no. of units)						10,000
NAV per unit (INR)						123.88

This security was marked down by 50 percent on the date of credit event.

<b>Total Portfolio value after creation of segregated portfolio</b>			<b>Total Value (INR lakhs)</b>
<b>Particular</b>	<b>Main Portfolio</b>	<b>Segregated Portfolio</b>	
Number of Units	10,000	10,000	
Total Value	87,62,427	1,238,800	1,00,01,227
NAV per unit (INR)	876.2427	123.88	1000.1227

### **Chapter 10: Sample Questions**

- 1. Government securities can be considered to be completely risk-free. State whether True or False.**
  - a. True
  - b. False
  
- 2. Unsystematic risk can be reduced through diversification. State whether True or False.**
  - a. True
  - b. False
  
- 3. Which of the following type of analysis tracks the price and volume data related to trading in the security?**
  - a. Quantitative analysis
  - b. Fundamental analysis
  - c. Technical analysis
  - d. Situation analysis
  
- 4. An investor invested in scheme A when the scheme's NAV was Rs. 120 per unit. The investor redeemed the investments at the NAV of Rs. 135. Calculate the simple return.**
  - a. 10.00 percent
  - b. 11.11 percent
  - c. 12.50 percent
  - d. 15.00 percent
  
- 5. Which of the following is a measure of fluctuation in periodic returns in an equity mutual fund scheme?**
  - a. Variance
  - b. Sharpe ratio
  - c. Modified duration
  - d. Jensen's Alpha

## CHAPTER 11: MUTUAL FUND SCHEME PERFORMANCE

### LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Concept of Benchmarks and Performance in case of mutual funds
- Difference between Price Returns Index versus Total Returns Index
- Basis of Choosing an appropriate performance benchmark
- Benchmarks for Equity Schemes
- Benchmark for Debt Schemes
- Benchmark for Other Schemes
- Quantitative measures of fund manager performance
- Sources to track mutual fund performance
- Sources of Scheme Performance Disclosures

### 11.1 Benchmarks and Performance

#### Benchmarks

Mutual fund schemes invest in the market for the benefit of Unit-holders. How well did a scheme perform? An approach to assess the performance is to pre-define a comparable—a benchmark—against which the scheme can be compared.

- A credible benchmark should meet the following requirements: It should be in sync with (a) the investment objective of the scheme (i.e. the securities or variables that go into the calculation of the benchmark should be representative of the kind of portfolio implicit in the scheme's investment objective); (b) asset allocation pattern; and (c) investment strategy of the scheme.
- The benchmark should be calculated by an independent agency in a transparent manner, and published regularly. Most benchmarks are constructed by stock exchanges, credit rating agencies, securities research houses or financial publications.

Choice of benchmark is simplest for an index fund. The investment objective is clear on the index that the scheme would track. That index would then be the benchmark for the scheme.

For other schemes, choice of benchmark is subjective. The benchmark for a scheme is decided by the AMC in consultation with the trustees. The Scheme Information Document has to mention the benchmark. Further, along with the past performance of the scheme, the performance of the benchmark during the same period has to be mentioned.

At a later date, the fund may choose to change the benchmark. This could be for various reasons. For instance, the investment objective of the scheme may change, or the construction of the index may change, or a better index may become available in the market. AMCs can change the benchmark in consultation with the trustees. Further, the change needs to be justified and documented. Mutual fund schemes are required to disclose the name(s) of benchmark index/indices with which the scheme performance is compared.

### **11.2 Price Return Index or Total Return Index**

Earlier, the Mutual Fund schemes were benchmarked to the Price Return variant of an Index (PRI). PRI only captures capital gains of the index constituents. With effect from February 1, 2018, the mutual fund schemes are benchmarked to the Total Return variant of an Index (TRI). The Total Return variant of an index takes into account all dividends/interest payments that are generated from the basket of constituents that make up the index in addition to the capital gains.<sup>71</sup>

Such a change was required to ensure that the performance comparison is fair. The scheme performance would be calculated after adding the dividends that the scheme has earned from the investments. Even in case of dividend option, the scheme performance is calculated using the dividend reinvestment method<sup>72</sup>. In such a case, if the scheme performance is compared with that of PRI, it would give a slight advantage to the scheme. The shift to TRI has been another one in the direction of increasing transparency of mutual funds.

In other words, this would make it appear that fewer schemes are able to beat their benchmark indices. While the reality has not changed, the presentation of the same has changed. The gap between the returns between PRI and TRI is the amount of dividend. Historically, in the Indian markets, the dividend yields at the index levels have ranged between 1.5 percent to 2.5 percent, most of the times.

### **11.3 Basis of Choosing an appropriate performance benchmark**

The selection of the benchmark for performance comparison must also be done keeping these in mind. With an objective to enable the investors to compare the performance of a scheme vis-à-vis an appropriate benchmark, SEBI has mandated: <sup>73</sup>

- Selection of a benchmark for the scheme of a mutual fund to be in alignment with the investment objective, asset allocation pattern and investment strategy of the scheme.
- The performance of the schemes of a mutual fund to be benchmarked to the Total Return variant of the Index chosen as a benchmark.

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<sup>71</sup> For details regarding computation of composite CAGR, refer to SEBI Circular No. – SEBI/HO/IMD/DF3/CIR/P/2018/04 dated January 4, 2018.

<sup>72</sup> Mutual funds use this method of reinvestment i.e. the cash from the dividend received is used to buy more shares with no fee or commission charged.

<sup>73</sup> SEBI has clarified this via the circular no. SEBI/HO/IMD/DF3/CIR/P/2018/4 dated January 4, 2018.

- Mutual funds should use a composite CAGR figure of the performance of the PRI benchmark (till the date from which TRI is available) and the TRI (subsequently) to compare the performance of their scheme in case TRI is not available for that particular period.

Thus, the scheme's benchmark must be chosen based on Scheme's investment objective, Investment strategy of the scheme, and the scheme's asset allocation pattern. All the three can be seen in the Scheme Information Document.

#### **11.4 Benchmarks for equity schemes**

The following aspects of the investment objective (scheme type, choice of investment universe, portfolio concentration, underlying exposure) drive the choice of benchmark in equity schemes.

##### ***Scheme Type***

A sector fund would invest in only the concerned sector; while there are some funds that invest in all sectors. Therefore, funds investing in different sectors need to have a diversified index as a benchmark index, like S&P BSE Sensex or Nifty 50 or S&P BSE 200 or S&P BSE 500 or Nifty 100 or Nifty 500 as a benchmark; sectoral/thematic funds select sectoral/ thematic indices such as S&P BSE Bankex, S&P BSE FMCG Index, Nifty Infrastructure Index and Nifty Energy Index.

##### ***Choice of Investment Universe***

Some equity funds investing in different sectors invest in large companies; while there are others that focus on mid-cap stocks or small cap stocks. S&P BSE Sensex and Nifty 50 indices are calculated based on 30 (in the case of Sensex) / 50 (in the case of Nifty) large companies. Thus, these indices are appropriate benchmarks for those equity funds that invest in large companies. For mid cap funds mid cap indices such as Nifty Midcap 50 or S&P BSE Midcap are considered as better benchmarks.

##### ***Choice of Portfolio Concentration***

Some equity funds investing in different sectors prefer to have fewer stocks in their portfolio. For such schemes, appropriate benchmarks are narrow indices such as S&P BSE Sensex and Nifty 50, which have fewer stocks. Schemes that propose to invest in more number of companies will prefer broader indices like S&P BSE 100/Nifty 100 (based on 100 stocks), S&P BSE 200/Nifty 200 (based on 200 stocks) and S&P BSE 500/Nifty 500 (based on 500 stocks).

## 11.5 Benchmarks for Debt Schemes

As per the SEBI guidelines, the benchmark for debt (and balanced schemes) should be developed by research and rating agencies recommended by AMFI. CRISIL, ICICI Securities and NSE have developed various such indices.

NSE's MIBOR (Mumbai Inter-Bank Offered Rate) is based on short term money market. NSE similarly has indices for the Government Securities Market. These are available for different variations such as Nifty composite G-sec index, Nifty 4-8 Year G-sec index, Nifty 10 year benchmark G-sec index etc.. BSE also has certain indices for Government securities such as the S&P BSE India Sovereign Bond Index, S&P BSE India Government Bill Index etc.

ICICI Securities' Sovereign Bond Index (I-Bex) is based on government securities. It consists of an umbrella index covering the entire market, and sub-indices catering to three contiguous maturity buckets. The three sub-indices are—Si-Bex (1 to 3 years), Mi-Bex (3 to 7 years) and Li-Bex (more than 7 years). CRISIL also has a set of indices for debt schemes (see Table 11.1)

Table 11.1: CRISIL has a set of indices for debt schemes.

Scheme Category	CRISIL Index
Overnight Fund	CRISIL Overnight Index
Liquid Fund	CRISIL Liquid Fund Index
Ultra Short Term Fund	CRISIL Ultra Short Term Debt Index
Money Market Fund	CRISIL Money Market Index
Low Duration Fund	CRISIL Low Duration Debt Index
Short Duration Fund	CRISIL AA Short Term Bond Fund Index
Medium Duration Fund	CRISIL Medium Term Debt Index
Medium to Long Duration Fund	CRISIL Medium to Long Term Debt Index
Long Duration Fund	CRISIL Long Term Debt Index
Dynamic Bond	CRISIL Composite Bond Fund Index
Corporate Bond Fund	CRISIL Short Term Corporate Bond Index, CRISIL Medium Term Corporate Bond Index, CRISIL Long Term Corporate Bond Index, CRISIL Corporate Bond Composite Index
Credit Risk Fund	CRISIL Credit Risk Index

The following aspects such as scheme type; choice of investment universe drive the choice of benchmark in debt schemes.

### ***Scheme Type***

Liquid schemes invest in securities of upto 91 days' maturity. Therefore, a short term money market benchmark such as NSE's MIBOR or CRISIL Liquid Fund Index is suitable.

Non-liquid schemes can use one of the other indices mentioned above, depending on the nature of their portfolio.

## **Choice of Investment Universe**

Gilt funds invest only in Government securities. Therefore, indices based on Government Securities are appropriate. Debt funds that invest in a wide range of Government and Non-Government securities need to choose benchmarks that are calculated based on a diverse mix of debt securities.

### **11.6 Benchmarks for Other Schemes**

#### **Hybrid Funds**

Hybrid funds invest in a mix of debt and equity. Therefore, the benchmark for a hybrid fund is a blend of an equity and debt index.

For instance, a hybrid scheme with asset allocation of about 65 percent in equity and balance in debt, can use a synthetic index that is calculated as 65 percent of S&P BSE Sensex and 35 percent of I-Bex. CRISIL has also created some blended indices for hybrid funds (see Table 11.2).

**Table 11.2: CRISIL blended indices for hybrid funds**

<b>Scheme Category</b>	<b>Index</b>	<b>Debt Index</b>	<b>Equity Index</b>
Aggressive Hybrid Fund	CRISIL Hybrid 25+75 – Aggressive Index	CRISIL Composite Bond Fund Index [25% allocation]	S&P BSE 200 (TRI) [75% allocation]
Balanced Hybrid Fund	CRISIL Hybrid 50+50 – Moderate Index	CRISIL Composite Bond Fund Index [50% allocation]	S&P BSE 200 (TRI) [50% allocation]
Conservative Hybrid Fund	CRISIL Hybrid 75+25 – Conservative Index	CRISIL Composite Bond Fund Index [75% allocation]	S&P BSE 200 (TRI) [25% allocation]

#### **Gold ETF**

Gold price would be the benchmark for such funds.

#### **Real Estate Funds**

A few real estate services companies have developed real estate indices. These have shorter histories, and are yet to earn the wider acceptance that the equity indices enjoy.

#### **International Funds**

The benchmark would depend on where the scheme proposes to invest. Thus, a scheme seeking to invest in China might have the Hang Seng Index (Chinese index) as the benchmark. S&P 500 may be appropriate for a scheme that would invest largely in the US market. A scheme that seeks to invest across a number of countries, can structure a synthetic index that would be a blend of the indices relevant to the countries where it proposes to invest.

## Standard benchmarks

For the sake of standardization, schemes need to disclose return in INR and by way of CAGR for the following benchmarks apart from the scheme benchmarks:

Scheme Type	Benchmark
Equity scheme	Sensex or Nifty
Long term debt scheme	10 year dated Gov security
Short-term debt fund	1 year T-Bill

This was proposed in order to bring standardization to the process of benchmarking as well as comparing the scheme performance with easily available indices.

### 11.7 Quantitative Measures of Fund Manager Performance

In the section on calculation of returns, the focus was on absolute returns i.e. returns earned by the scheme. Having understood the concept of benchmarks, one can also do relative comparison viz. how did a scheme perform vis-à-vis its benchmark or peer group. Such comparisons are called *relative return* comparisons.

If a comparison of relative returns indicates that a scheme earned a higher return than the benchmark, then that would be indicative of *outperformance* by the fund manager. In the reverse case, the initial premise would be that the fund manager *under-performed*. Such premises of outperformance or under-performance need to be validated through deeper performance reviews.

AMCs and trustees are expected to conduct such periodic reviews of relative returns, as per the SEBI Guidelines.

Relative returns comparison is one approach towards evaluating the performance of the fund manager of a scheme. A weakness of this approach is that it does not differentiate between two schemes that have assumed different levels of risk in pursuit of the same investment objective. Though the two schemes may share the benchmark, their risk levels are different. Evaluating performance, purely based on relative returns, may be unfair towards the fund manager who has taken lower risk but generated the same return as a peer.

An alternative approach to evaluating the performance of the fund manager is through the risk reward relationship. The underlying principle is that return ought to be commensurate with the risk taken. A fund manager, who has taken higher risk, ought to earn a better return to justify the risk taken. A fund manager who has earned a lower return may be able to justify it through the lower risk taken. Such evaluations are conducted through *Risk-adjusted Returns*.

There are various measures of risk-adjusted returns. This workbook focuses on three metrics, which are more commonly used in the market.

### **11.7.1 Sharpe Ratio**

Sharpe ratio is a very commonly used measure of risk-adjusted returns.

An investor can invest with the government and earn a risk-free rate of return ( $R_f$ ). T-Bill index is a good measure of this risk-free return.

Through investment in a scheme, a risk is taken, and a return is earned ( $R_s$ ).

The difference between the two returns i.e.  $R_s - R_f$  is called *risk premium*. It is like a premium that the investor has earned for the risk taken, as compared to government's risk-free return.

This risk premium is to be compared with the risk taken. Sharpe Ratio uses Standard Deviation as a measure of risk. It is calculated as:

$$\text{Sharpe Ratio} = (R_s \text{ minus } R_f) \div \text{Standard Deviation}$$

Thus, if risk free return is 5 percent, and a scheme with standard deviation of 0.5 percent earned a return of 7 percent, its Sharpe Ratio would be (7 percent - 5 percent)  $\div$  0.5 percent i.e. 4.

Sharpe Ratio is effectively the risk premium generated by assuming per unit of risk. Higher the Sharpe Ratio, better the scheme is considered to be.

Sharpe Ratio comparisons can be undertaken only for comparable schemes. For example, Sharpe Ratio of an equity scheme cannot be compared with the Sharpe Ratio of a debt scheme.

### **11.7.2 Treynor Ratio**

Like Sharpe Ratio, Treynor Ratio too is a risk premium per unit of risk.

Computation of risk premium is the same as was done for the Sharpe Ratio. However, for risk, Treynor Ratio uses Beta.

Treynor Ratio is thus calculated as:

$$\text{Treynor Ratio} = (R_s \text{ minus } R_f) \div \text{Beta}$$

Thus, if risk free return is 5 percent, and a scheme with Beta of 1.2 earned a return of 8 percent, its Treynor Ratio would be (8 percent - 5 percent)  $\div$  1.2 i.e. 2.5.

Higher the Treynor Ratio, better the scheme is considered to be. Since the concept of Beta is more relevant for diversified equity schemes, Treynor Ratio comparisons should ideally be restricted to such schemes.

### **11.7.3 Alpha**

Non-index schemes too would have a level of return, which is in line with its higher or lower beta as compared to the market. Let us call this the *optimal return*.

The difference between a scheme's actual return and its optimal return is its *Alpha*—a measure of the fund manager's performance. Alpha, therefore, measures the performance of the investment in comparison to a suitable market index. Positive alpha is indicative of out-performance by the fund manager; negative alpha might indicate under-performance.

Since the concept of Beta is more relevant for diversified equity schemes, Alpha should ideally be evaluated only for such schemes.<sup>74</sup>

These quantitative measures are based on historical performance, which may or may not be replicated.

Such quantitative measures are useful pointers. However, blind belief in these measures, without an understanding of the underlying factors, is dangerous. While the calculations are arithmetic—they can be done by a novice; scheme evaluation is an art—the job of an expert.

### **11.8 Tracking Error**

The Beta of the market, by definition is 1. An index fund mirrors the index. Therefore, the index fund too would have a Beta of 1, and it ought to earn the same return as the market. The difference between an index fund's return and the market return is the *tracking error*.

Tracking error is a measure of the consistency of the out-performance of the fund manager relative to the benchmark. Earlier it was used as a measure of how closely an index fund tracked the returns from the benchmark to which it was indexed. The tracking error was expected to be zero. Now, the tracking error is used to measure how consistently a fund is able to out-perform its benchmark. It is not enough if the fund is able to generate a high excess return, it must do so consistently.

Tracking error is calculated as the standard deviation of the excess returns generated by the fund. The tracking error has to be low for a consistently out-performing fund.

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<sup>74</sup> Beta is a measure of a stock's volatility in relation to the market. By definition, the market has a beta of 1.0, and individual stocks are ranked according to how much they deviate from the market. A stock that swings more than the market over time has a beta above 1.0. If a stock moves less than the market, the stock's beta is less than 1.0. High-beta stocks are supposed to be riskier but provide a potential for higher returns; low-beta stocks pose less risk but also lower returns. (Source: Investopedia.com)

## 11.9 Scheme Performance Disclosure

SEBI has mandated disclosure of performance data by all the asset management companies (AMCs). These disclosures can be accessed through certain scheme documents and website of the fund house.

The Scheme Information Document (SID) of each scheme needs to be updated once every year, accordingly, the scheme performance numbers have to be updated as a part of this exercise. That is where the fund fact sheet plays a vital role which is published on a monthly basis by all the fund houses. Factsheet is not a statutory requirement.

There are various portals that also could be used to access the scheme performance data. Many of these portals also carry various other scheme related performance measures. Mutual funds also make available product literature that can be used by distributors and investors to evaluate schemes. This information is made available in physical and online forms. The information and data found in such literature is updated and current, and typically includes information about suitability, returns and portfolio description. These are explained below.

**Suitability:** A snapshot of the suitability of the product can be assessed from the product labels that have to be provided with any product literature. It identifies the objective of the scheme as wealth creation, regular income generation or providing liquidity, and also the asset class in which the scheme will invest to achieve the objective. The suitable investment holding period is also indicated. The riskometer identifies the risk to the capital invested and helps match the investor's risk taking ability to that of the scheme.

**Returns:** The cumulative returns that the scheme has generated over different holding periods helps assess if the fund is able to generate returns to meet the investment objectives. The comparison of the returns with that of the scheme's benchmark helps assess the ability of the portfolio manager to out-perform the markets. The discreet annual returns help in assessing the consistency of the fund's performance over different market scenarios.

**Portfolio Description:** The description of the way the portfolio will be managed in terms of how assets will be allocated and securities selected will help investors assess the suitability of the scheme to investors. In case of equity funds the extent of diversification across sectors and securities and the strategy adopted to select and manage securities based on the market capitalisation (large vs. mid vs. small) and valuation (growth vs. value) among others, will determine the risk and returns of the scheme. In case of debt funds, the tenor and credit quality of the securities as well as strategies adopted will determine the risk and return. In case of hybrid funds the allocation to different asset classes and the way each is managed will indicate the risk and return.

## Fund Factsheets

Apart from information about the schemes themselves, AMCs may also provide periodic updates on markets and the economy. These are typically part of the factsheets or may be issued as separate notes.

The fund factsheets are an official source of information of the fund's objective, performance, portfolio and basic investment requirements issued by the fund house each month. The factsheet is also used by the fund manager to communicate their views on the economy and the markets to the investors and other observers such as research analysts, rating agencies and media.

It is not mandatory for fund houses to publish factsheets. But most fund houses do so as a way to reach out to the existing and new investors.

The information disclosed in the factsheets and other product literature is subject to the advertising guidelines of SEBI.

The purpose of these updates is to help investors understand the performance of their schemes and to make plans for their investments based on expectations for different asset classes. Typically, these notes provide information on market and economic data. Some important points are analysed in the factsheet (see Table 11.3).

**Table 11.3: Metrics of Analysis in Factsheet**

<b>Metrics of Analysis</b>	<b>Purpose</b>
Level of market indices and yields	To assess the performance of the schemes
Corporate results (during earning seasons), Earning upgrades and downgrades, Analysis of profit margins and revenues, Industry-wise analysis of earnings and demand forecasts.	To reflect the tone for equity markets.
Government spending	Government spending is generally positive for economic growth. But a high fiscal deficit can have negative impact on interest levels and economic activity. It translates into higher borrowings by the government and pushes up the interest costs in the market. It also limits the ability of the government to provide fiscal impetus to the economy.
Inflation Level	To analyse effect on demand as well as costs of production and profitability of companies. If inflation goes beyond levels of comfort then there may be monetary action taken to cool it,

<b>Metrics of Analysis</b>	<b>Purpose</b>
	such as reducing availability of money and credit. This will affect demand and the ability of companies to grow.
Changes in the level of interest rates	To provide clue to changes in consumption and the demand for goods and services. Interest rate levels also affect the ability of companies to expand and grow.
Activity of domestic and foreign portfolio investors	Reflects expectations from Indian markets.
GDP Numbers	To track economic cycle and growth in economy
Economic and interest rate data from overseas economies	To evaluate the likely impact on demand for India's exports as well as fund flows into and out of Indian markets. Lower interest rates in international markets will bring funds flow to emerging markets in search for better yields
Commodity prices and prices of other inputs such as raw materials and labour	To track the impact on profitability of companies. Prices of oil affect the currency levels and thereby exports and imports.

**Scheme performance available on AMFI website:**

AMFI website ([www.amfiindia.com](http://www.amfiindia.com)) carries the performance data of all the mutual fund schemes.<sup>75</sup> This is an exhaustive resource and one can access the same for various different periods, and fund categories. A sample screen shot of the report is shown below:

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<sup>75</sup> <https://www.amfiindia.com/research-information/other-data/mf-scheme-performance-details>

**Box 11.1 Scheme performance data on AMFI website.<sup>76</sup>**

Scheme Name	Benchmark	Latest NAV (₹)		1-Year Return (%)			Daily AUM (Cr.)
		Regular	Direct	Regular	Direct	Benchmark	
Aditya Birla Sun Life Frontline Equity	NIFTY 50 Total Return	223.1200	237.2400	8.60	9.39	13.13	20,565.28
Axis Bluechip Fund	NIFTY 50 Total Return	31.4100	34.0100	24.49	26.06	13.13	8,467.46
Baroda Large Cap	NIFTY 100 Total Return Index	14.8000	15.5100	12.98	13.71	12.38	31.48
BNP Paribas Large Cap Fund	NIFTY 50 Total Return	95.6200	103.0700	20.98	22.43	13.13	795.15
Canara Robeco Bluechip Equity Fund	S&P BSE 100 Total Return Index	26.0600	27.8500	16.70	18.31	11.72	250.33
DSP Top 100 Equity	S&P BSE 100 Total Return Index	215.5110	224.9910	16.65	17.44	11.72	2,566.38

Investors, who wish to access the raw data of NAVs, dividends etc. in a systematic manner – and distributors who wish to integrate such information into their investor-management systems and processes can subscribe to the data from different vendors. Based on the subscription, data updates can be easily downloaded every day through the internet. There are some agencies that are active in this field.<sup>77</sup>

<sup>76</sup> **Note:** This is just a sample, the intent is not to recommend any specific scheme

<sup>77</sup> For example: [www.morningstar.in](http://www.morningstar.in), <https://www.valueresearchonline.com/> etc. The listing of websites is only a piece of information for the reader. Users need to convince themselves before subscribing to, or using any of this information. Neither SEBI nor NISM nor the author certifies the data or information or tools that these agencies offer.

## Chapter 11: Sample Questions

1. **'Once it is finalized, a mutual fund scheme's benchmark cannot be changed at a later date.'** State whether the statement is True or False.
  - a. True
  - b. False
  
2. **Which amongst the following is a measure of risk-adjusted returns of mutual fund scheme?**
  - a. Standard deviation
  - b. Beta
  - c. Variance
  - d. Sharpe ratio
  
3. **Which of the following cannot be considered for the purpose of selecting a scheme's benchmark?**
  - a. Mutual fund scheme's investment objective
  - b. Investment strategy of the MF scheme
  - c. Scheme's asset allocation pattern
  - d. Scheme's past returns
  
4. \_\_\_\_\_ **takes into account all dividends generated from the basket of constituents that make up the index in addition to the capital gains.**
  - a. Total return index
  - b. Price return index
  - c. Dividend return index
  
5. **Which is the most appropriate measure of evaluating how closely an index fund is tracking its benchmark?**
  - a. Treynor ratio
  - b. Tracking error
  - c. Total Expense Ratio (TER)
  - d. Assets Under Management (AUM)

## CHAPTER 12: MUTUAL FUND SCHEME SELECTION

### Learning Objectives:

After studying this chapter, you should know about scheme selection based on:

- Scheme Selection based on Investor's need, preferences and risk-profile
- Risk level in mutual fund schemes
- Scheme Selection based on Investment Strategy of Mutual Fund
- Fund performance, fund portfolio, fund age, fund size, portfolio turnover and scheme expenses.
- Selection of Mutual Fund scheme offered by different AMCs or within the scheme category
- Selecting options in mutual fund schemes
- Do's and Don'ts while selecting mutual fund schemes

### 12.1 Scheme Selection based on Investor needs, preferences and risk-profile

#### Investor Need

The selection of a mutual fund scheme for an investor will depend upon the need that the investor has from the investment. The investor may need long term appreciation in the value of his investment, or the investor may need periodic income from the investment, or the investor may need periodic income from the investment, or the investor may be looking for an avenue to park funds and need an investment with high liquidity. Therefore, understanding mutual fund schemes should eventually help one to build a robust investment portfolio that helps to achieve the investor's investment objectives. It is in this context that this chapter would look at various approaches for building a portfolio of mutual fund schemes.

At the outset, a portfolio of investments (or a portfolio of mutual funds) is a means to an end –a vehicle to achieve some objective. The objective could be a financial goal like reaching a certain level of wealth in a specified period of time; or it could be funding a major expense related to an important life event like education of one's children or funding one's retirement. The sight of the goal must never be missed.

Therefore, the first step is to set one's financial goals. The second step is to understand the investor's situation and assess the risk appetite.

## **Risk Profile of the investor**

The investor's risk appetite is a function of three things—the need to take risks, the ability to take risks, and the willingness to take risks. Thus, an understanding of the risk profile and the investment risks associated with various mutual fund schemes would be essential for deciding the asset allocation in an investor's portfolio. This was discussed in detail in Chapter 1.

## **Asset allocation**

The investor's need from the investment will determine the asset class that is most suitable for the investor. Along with the need from the investment, the investor's ability to take risk and the investor's investment horizon is equally important to select the appropriate asset class. An investor may be seeking growth and may be willing to take the risk, but unless there is an adequately long investment horizon, equity may not be suitable for investment. This is because equity markets tend to be volatile in the short-term. Over the long-term, the volatility gets smoothed out and the investments see an upward trend. An investor may have a long-term investment horizon but may be unwilling to take the risks associated with equity investing. Such an investor may prefer the lower returns from debt than the higher returns with higher risk from equity.

An investor looking for growth will find equity the best suited to meet their needs. The need for income will be best met by a debt scheme.

The investor's asset allocation is a decision regarding how much money should be allocated to which scheme category (asset class). This decision can be taken only after assessing the investor's risk profile and analysing investor's goals and situation. These aspects were discussed in Chapter 1.

## **Age of the investor**

One of the common factors that many people use to evaluate the investor's risk profile is the investor's age. It is popularly believed that younger investors have the potential for taking higher risks compared to old people. However, this may not be correct as different investors have different financial goals at different age levels. In fact, investors in the same age group may also have different goals. Their financial situations may also differ. At the same time, many of the financial goals may pertain to the whole families and not just an individual. In such cases, it may not be prudent to categorize investors on the basis of age alone.

## **Investment time horizon**

As against the investor's age, one may consider the time horizon to the respective financial goal for which one is investing. Longer the horizon to the goal, the ability to take risk is higher, whereas one may avoid risks when the goal is in the near future. An investor may need

liquidity in the portfolio for various reasons, even when the investments are meant for long periods of time.

### **Core and satellite portfolio**

At this stage it is also good to consider the role that the scheme will play in the investor's portfolio. Ideally the portfolio should be divided into core and satellite portfolios. The core portfolio will be invested according to the long term needs and goals of the investor. The satellite portfolio will be invested to take advantage of expected short-term market movements. For example, a diversified equity fund, large cap, mid-cap funds, among others may form part of the core portfolio since they generate long-term returns in broad alignment with the markets. Sector funds on the other hand do well cyclically, and investors will consider investing in them when the economic factors are positive for a particular sector. Similarly, long term gilt funds will do well when interest rates are expected to decline. The exposure to gold funds can be increased when inflation is high or when there are political, economic and fiscal uncertainties. These are all tactical investments and are held for the period when the conditions are suitable. The division between core and satellite portfolios will depend upon each investor's profile. Conservative investors may like a very small proportion of their overall portfolio to be managed tactically. A moderate investor may be comfortable with an 80 percent allocation to core investments and a 20 percent exposure to satellite or tactical portfolio. An investor comfortable with taking higher risk may have an even higher exposure to tactical investments.<sup>78</sup>

In addition to the above, it is essential to understand the risk-return levels in various categories of mutual fund schemes (section 12. 2). Further, the selection of a mutual fund scheme is done through analysis of fund performance, fund portfolio, age and other parameters (section 12.3).

### **12.2 Risk levels in mutual fund schemes<sup>79</sup>**

In order to evaluate and select various mutual fund schemes, it is important to take a look at the risk-return profile of the various scheme categories. The mutual fund scheme categorization was covered in Chapter 2. The following discussion covers the risk-return characteristics of different types of mutual fund schemes.

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<sup>78</sup> These are only indicative allocations shown in order to understand the point, and in no way these should be taken as recommendations.

<sup>79</sup> In this discussion, certain categories are not covered since it is difficult to comment without looking at the total risk. In fact, the interest rate risk and credit risk are also discussed separately. One would be required to carefully evaluate the schemes on both these risks.

### **Illustration 12.1.1: Risk-Return Hierarchy of mutual funds**

Liquid funds – Debt funds – Hybrid funds – Equity funds

In illustration 12.1.1, as one moves from liquid funds to debt funds to hybrid funds to equity funds, the potential returns as well as the investment risks increases. Broadly, one can say that moving from left to right, the risk as well as potential return would go up.

### **Illustration 12.1.2 Risk-Return Hierarchy of debt funds**

Overnight funds – Liquid funds – Ultra short duration funds – Low duration funds – Short duration funds – Medium duration funds – Medium to long duration funds – Long duration funds

The risk-return profile of debt funds may be seen in light of two separate risks—credit risk and interest rate risk. While comparing the schemes on credit risk, the assumption would be to assume that the schemes are taking similar interest rate risk. Similarly, while comparing the schemes on interest rate risk, it would be prudent to assume that credit risk is similar.

Illustration 12.1.2 shows that as we move from left to right, the potential returns as well as the interest rate risk increases. The assumption here is that the credit risk is more or less similar in each of the categories.

### **Illustration 12.1.3: Hierarchy of Credit risk in debt funds**

Gilt fund – Banking and PSU fund – Corporate bond fund – Credit risk fund

Illustration 12.1.3 shows that as we move from left to right, the potential returns as well as the credit rate risk move up. This can be seen in illustration 12.1.3. The assumption here is that the interest rate risk is more or less similar in each of the categories.

### **Illustration 12.1.4: Risk-Return Hierarchy of equity mutual funds**

Small cap funds – Mid-cap funds – Multi cap funds – Large and mid-cap funds – Large cap funds

Smaller companies are riskier than their larger counterparts, and hence small cap funds carry higher risk than mid cap funds, which in turn are riskier than the large cap funds. Illustration 12.1.4 shows that as we move from left to right, the risk decreases and potential return increases.

In a similar manner, a concentrated portfolio is riskier than a more diversified one. That means a sector fund or a thematic fund would be riskier than the diversified funds. Having

said that, the risks of concentration in a sector fund investing only in large cap stocks within the sector cannot be compared with a diversified small cap fund, since both are exposed to very different risks. While the former takes risk of concentration, the latter is exposed to the risk of the size of companies the scheme has invested in.

#### **Illustration 12.1.5: Risk-Return Hierarchy of Diversified to Concentrated funds**

Diversified funds – Focused funds – Thematic funds – Sector funds

A focused fund is riskier than a diversified fund. Here too, one must carefully evaluate the other risks the scheme would be exposed to. Broadly, one may say that the risk goes up as one moves from diversified funds to focused funds to thematic funds to sector funds. Illustration 12.1.5 shows that the risk and potential return increases as one moves from left to right. However, it may be noted that different sector funds may have different risk profiles.

#### **Illustration 12.1.6 Risk Return Hierarchy of hybrid funds**

Arbitrage fund – Equity savings fund – Conservative hybrid fund – Dynamic asset allocation fund – Multi asset allocation fund – Balanced hybrid fund – Aggressive hybrid fund

The SEBI circular on categorisation of mutual fund schemes, specifies different categories of hybrid funds, viz., conservative hybrid fund, balanced hybrid fund or aggressive hybrid fund, dynamic asset allocation fund (or balanced advantage fund), multi asset allocation fund, arbitrage fund and equity savings fund. Illustration 12.1.6 shows that the risk and potential return rise as one moves from left to right.

The risk levels in different categories of mutual fund schemes can be understood with the help of product labelling of Mutual Funds. In 2013, SEBI had introduced product labelling of mutual funds to address the issue of mis-selling and to provide investors an easy understanding of the kind of product/scheme they are investing in and its suitability to them.

All the mutual funds were required to 'Label' their schemes on the parameters such as:

- a) Nature of scheme [to create wealth or provide regular income in an indicative time horizon (short/ medium/ long term)]
- b) A brief about the investment objective (in a single line sentence) followed by kind of product in which investor is investing (Equity/Debt).
- c) Level of risk, depicted by colour code boxes as:
  - i. Blue – principal at low risk
  - ii. Yellow – principal at medium risk
  - iii. Brown – principal at high risk

*[The colour code was required to be described in text beside the colour code boxes]*

d) A disclaimer that investors should consult their financial advisers if they are not clear about the suitability of the product.<sup>80</sup>

Later in April 2015, SEBI reviewed the system of product labelling in mutual funds. It was notified that the level of risk in mutual fund schemes shall be increased from three to five as under:<sup>81</sup>

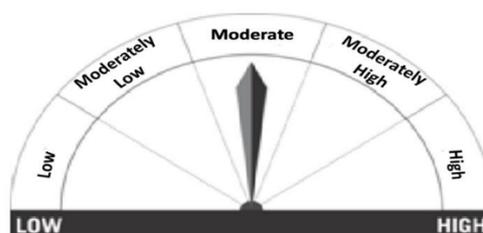
- i. Low - principal at low risk
- ii. Moderately Low - principal at moderately low risk
- iii. Moderate - principal at moderate risk
- iv. Moderately High -- principal at moderately high risk
- v. High - principal at high risk

The way of presenting the risk levels by mutual funds was also modified. The depiction of risk using colour codes was replaced by pictorial-meter named "Riskometer" which categorises the risk in the scheme at one of five levels of risk, as shown in the Table 12.1. There is also written statement of the risk to the principal below the 'Riskometer'.

**Table 12.1: Five types of risk depicted in Riskometer**

Level of Risk	Definition	Example of the Type of Mutual Fund
Low	Principal at low risk	Overnight Fund/Liquid Fund
Moderately Low	Principal at moderately low risk	Fixed Maturity Plans/Capital Protection Oriented Scheme
Moderate	Principal at moderate risk	Conservative Hybrid Plans
Moderately High	Principal at moderately high risk	Index Fund/Exchange Traded Fund/Equity Dividend Yield Fund/ Solution oriented schemes
High	Principal of high risk	Sector Fund/Thematic Fund

For enumeration, a scheme having moderate risk would be depicted with the following riskometer:



Principal at moderate risk

<sup>80</sup> SEBI circular no. CIR/IMD/DF/5/2013 dated March 18, 2013

<sup>81</sup> SEBI circular no. CIR/IMD/DF/4/2015 dated April 30, 2015

While the riskometer is an attempt to simplifying the presentation of levels of risk, it may be referred as the first step in the analysis of scheme categories, however, it should not be the only factor for taking an investment decision. The same may apply to the discussion on risk profiles of various schemes that preceded the discussion on riskometer. Each category would have some risks that are common to the category, and various schemes may take different risks, even within the same category. An investor would be advised to do a careful research oneself. In case one is unable to do so, one must consider taking help of a mutual fund distributor or a registered investment adviser.<sup>82</sup>

### **12.3 Scheme Selection based on investment strategy of mutual funds**

For the purpose of selection of mutual fund schemes, the investment objective, the investment strategy and the portfolio characteristics are important factors. As seen earlier, each mutual fund scheme starts with an investment objective. The investment strategy of the schemes is devised in order to achieve the investment objective. The portfolio is constructed in line with the investment strategy. Thus, there is a relation between the three. At the same time, someone evaluating would need to evaluate each one, since there could be multiple strategies in order to achieve the same broad investment objective, and different fund managers may construct different portfolios even within the same investment strategy.

Investors must select the product category based on the strategy and style adopted. Each of them have a different risk and return characteristics. An investor who wants to invest in low risk equity will consider an index fund or a value fund. On the other hand, an investor willing to take additional risk for better returns will choose a growth fund. An investor in debt who wants better returns will consider a mutual fund generating regular income or a long-term gilt fund, if they have a view that interest rates will decline.

The below discussion looks at the investor's selection of different kinds of mutual fund schemes based on portfolio characteristics, investment strategies and investment objectives.

#### ***Active Fund v/s Passive Funds***

Passive funds are suitable for investors looking for exposure to an asset class without the risks associated with fund manager selection and strategies. Index funds are passive funds and they are not traded on exchanges. They are expected to offer a return in line with the market because they invest in a portfolio that mimics a market index in the securities it invests in and in the weightages allotted to each security in the portfolio. There is no selection risk in index funds because the fund manager has no role in creating the portfolio. For this reason, the costs that an index fund is allowed to charge is also lower since there are no research or other fund management expenses. Exchange Traded Funds (traded on exchanges) are also passive

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<sup>82</sup> Investors should consult their financial advisers if they are not clear about the suitability of the product. A line to this effect was part of the circular on product labelling issued in 2013. [SEBI circular no. CIR/IMD/DF/5/2013 dated March 18, 2013].

funds that generate returns in line with the index or benchmark. There are no investment strategies used to generate higher returns other than what the index does.

An investor in an active fund is bearing a higher cost for the fund management, and a higher risk to earn returns better than the benchmark. The returns ought to be higher i.e. the scheme should beat the benchmark, to make the investor believe that choice of active scheme was right. This, in no way, means that the higher return is guaranteed. Hence, the quantum of risk is higher in such investments.

Investors who are more interested in the more modest objective of having an equity growth component in their portfolio, rather than the more aggressive objective of beating the equity market benchmark, would be better off investing in an index fund. This again does not mean that the NAV of an index fund will not decline in value. If the benchmark index goes down, then the NAV of the index fund too will go down. However, as suggested earlier, if the investor has a long enough horizon, then his investment will do well, in line with the overall market.

### **Open-ended funds v/s close-ended funds**

The big difference between the open-ended funds and close-ended funds may not be about the investment objective, or strategy, but about an operational feature i.e. the exit option.

The significant benefit that open-ended funds offer is liquidity viz. the option of getting back the current value of the unit-holding from the scheme.

In the case of an open-ended scheme, the unit will be bought back by the scheme at the NAV less exit load. In order to provide liquidity facility to investors, open-ended schemes maintain a part of their portfolio in liquid assets. The liquid assets component in the portfolio of an equity fund can dilute the returns that would otherwise have been earned in the equity market.

Open-end schemes are also subject to the risk of large fluctuations in net assets, on account of heavy sales or re-purchases. This can put pressure on the fund manager in maintaining the investment portfolio.

A close-ended scheme offers liquidity through its listing on a stock exchange. However, mutual fund units are not that actively traded in the market. A holder of units in a close-ended scheme will need a counterparty in the stock exchange in order to be able to sell his units and recover its value.

The price of units of a closed-end scheme in the stock exchange may be lower than the NAV. There is no limit to this discount. Typically, towards the maturity of the scheme, the market price converges towards the NAV. A closed-ended equity fund allows the fund manager to target better returns by investing in stocks of companies that may realize its potential in some time, or in relatively illiquid stocks with prospects of good returns without the pressure of

investor redemptions. Investors may invest in such schemes for the higher returns that such a strategy may provide. However, they do not have the facility of exiting the scheme if they find that the scheme's performance is not as expected. Moreover, investors need to match the maturity of the scheme with when they may require the funds invested since exiting prior to maturity by selling on the stock exchange is not a viable option.

Investors may choose the close-ended funds only if they can keep the money locked-in such schemes. Anyone, who prefers liquidity option, may want to consider investing in open-ended funds.

### ***The difference between Diversified (Multi-cap, Large-cap, Mid-cap, Large and Mid-cap) Funds, Sector Funds and Thematic Funds***

The critical difference between diversified funds and sector funds is that the multi-sector exposure in a diversified fund makes it less risky. Further, in an actively managed diversified fund, the fund manager performs the role of ensuring higher exposure to the better performing sectors.

Among the equity funds, some schemes may have a portfolio concentrated in a few stocks. Such scheme category is known as "Focused funds". These schemes carry higher risk than a diversified fund, due to higher concentration among smaller number of stocks. However, these are less risky than a sector fund.

The sector funds invest in stocks belonging to just one sector of the economy, in order to take advantages within the said sector. The examples of such funds are: Pharma fund, or banking fund.

Sector funds are risky because of the concentration in one sector. If the sector underperforms then the scheme's returns is likely to be poor. Such funds require the investor to have the skill to understand and interpret the factors that signal that a sector is ready for investment or exit. The returns earned will depend upon entering before the up-cycle in the sector starts and exiting before the downturn begins. Timing is the key to investing in such funds. The higher risk, monitoring and timing involved in such funds make them suitable for the satellite portfolio of the investor.

As someone has aptly put, "Diversification is a protection against ignorance." In other words, if one is not sure, diversification is always a good idea.

Having said that, one may use the sector funds to increase allocation in certain sectors. This is similar to the core and satellite strategy discussed earlier. In this case, a diversified portfolio may be the core portfolio, whereas the sector funds may be used tactically as the satellite portion.

Some investors are more comfortable identifying promising investment themes (for example, infrastructure), rather than specific sectors (like cement, steel etc.). Such investors can decide

on investment themes they would like to buy. Thematic funds invest in stocks across a specific themes, and to that extent they fall between the diversified fund that can invest across the market and sector funds that invest only within one sector. The examples of such funds are MNC funds, PSU funds, Infrastructure funds, etc.

### ***Large-cap v/s Mid-cap v/s Small Cap Funds***

Equity mutual fund schemes are also categorized on the basis of the market capitalization of the companies the scheme invests in. The portfolio characteristics are evident from the scheme category names, e.g., large cap funds invest in large cap stocks, whereas large and mid-cap funds invest both in large cap stocks and mid-cap stocks.

Large-cap stocks are of established companies that have stable revenues and profitability and the financial strength to withstand competition and economic downturn. Unlike such companies, mid and small caps represent companies that are in the initial stages of growth. When the economy is doing well, such companies see a tremendous growth in revenues and profitability, making them extremely attractive investment options. When industry scenario is difficult many mid-cap/small cap companies fall by the way side during economic turmoil, because they lack the resources to survive. As the economy recovers, and investors start investing in the market, the valuations in front-line stocks turn expensive. At this stage, the mid-cap/small cap funds offer attractive investment opportunities. Over a long period of time, some of the mid-cap and small-cap companies will become large companies, whose stocks get re-rated in the market. The healthy returns on such stocks can boost the returns on mid-cap and small-cap portfolios.

Mid and small cap stocks require careful evaluation and selection. It can therefore be risky to invest a large portion of the investor's portfolio in mid-cap/small cap funds.

Multi cap funds spread the investments across the market capitalization spectrum in order to try and benefit from the opportunities across the market, even while keeping the risk lower than mid-cap and small-cap funds. Similarly, large and mid-cap funds are riskier than large cap funds, but less risky than mid-cap funds.

The investor's need to generate high returns, as well as the risk taking ability and time horizon are important factors to determine the allocation between the respective scheme categories.

One may consider investing in a multi cap fund and leave the allocation within various market capitalization in the hands of the fund manager. Alternatively, one may pick up schemes from large cap, mid-cap, and small-cap separately and manage the portfolio allocation in one's own way.

### ***Growth or Value funds***

Equity fund managers adopt various different styles of selection of stocks. The most popular among these are the growth style and the value style.

Funds that follow the growth strategy seek to identify companies that are expected to grow at rates higher than the average economic growth rate. Stocks of such companies tend to do well in a bull phase in the markets. But in a market downturn the price of such stocks tend to fall much more too, making them riskier.

Value strategy seeks to identify stocks that are available at a price that is seen as cheap relative to the value that could be unlocked in the future. Over time, if the fund has been able to select the right stocks and the stock is recognized in the market, the value appreciates.

A growth fund outperforms in a bull market, while the value orientations helps a value fund outperform in a falling market. Depending on the risk-profile of the investor, both these type of funds can find a place in the core portfolio of the investor in suitable proportions. Investments in value funds yield benefits over longer holding periods.

### ***International Equity funds***

When an Indian investor invests in equities abroad, he is essentially taking two exposures:

- An exposure on the international equity market.
- An exposure to the exchange rate of the rupee. If the investor invests in the US, and the US Dollar becomes stronger during the period of his investment, he benefits; if the US Dollar weakens (i.e. Rupee becomes stronger), he loses or the portfolio returns will be lower.

Taking this kind of exposure is possible and convenient through the International equity funds, which invest in stocks of companies listed in stock exchanges located outside of India.

Investors might consider investing abroad, for any of the following reasons:

- overall returns (international equity plus exchange rate movement) will be attractive.
- an asset allocation call for diversifying investments to reduce the risk.
- such schemes provide a way to benefit from a particular opportunity and therefore are best suited to be part of the satellite portfolio of the investor, or a very small exposure in the core portfolio to benefit from the diversification benefits.

### ***Fixed Maturity Plans***

These are close-ended debt funds. Fixed Maturity Plan is ideal when the investor's investment horizon is in sync with the maturity of the scheme, and the investor is looking for a more predictable return than any conventional debt scheme, and a return that is generally superior to what is available in a fixed deposit. The credit risk of the portfolio must be considered. Investment in FMPs cannot be redeemed before the maturity of the scheme, except through the stock exchanges. Thus, keeping the liquidity aspect in mind, it is important for an investor to understand the extent of credit risk that one may want to take.

An investor, who is likely to require the funds anytime, would be better off investing in a normal open-ended debt fund.

### ***Short Duration Fund***

Short Duration Funds invest in securities with maturities between 1 year and 3 years. As such they earn returns in line with the market yields. Some funds may take a small exposure to longer term securities to benefit from a gain in value if interest rates are expected to decline.

If it is expected that interest rates in the market would increase it is safer to increase allocation to short duration funds. As the rates rise, the short-term bonds would mature, allowing the fund manager to deploy the proceeds at higher rates. These funds feature low volatility and can form part of the core portfolio of an investor with low risk-taking ability. The liquidity in the schemes makes them suitable for parking funds for the short-term.

### ***Liquid Funds***

An investor seeking the lowest risk ought to go for a liquid scheme. However, the returns in such instruments are low. The comparable for a liquid scheme in the case of retail investors is a savings bank account. These schemes are suitable for investors looking for a product to park their funds for very short periods (upto 91 days). The schemes are highly liquid and there is negligible volatility, which protects the value of the money parked. Using these schemes for longer periods is not advised since the investor will be needlessly losing out on returns.

Ultra-short term debt funds hold securities with slightly longer tenor than liquid funds, but play the same role in an investor's portfolio. The funds have the feature of low volatility and high liquidity.

### ***Floater Funds***

Floater funds, invest in floating rate instruments. Since floating rate debt securities tend to hold their investment, even if interest rates fluctuate, the NAV of floaters tend to be steady.

The strategy adopted by the debt fund to generate returns may define the suitability for the investor's needs. Certain debt funds focus on earning interest income. The returns from such schemes are likely to be steady and are expected to have low volatility.

However, some funds may be willing to lower the quality of the securities held to earn higher interest income and prospective investors need to be comfortable with this strategy.

Other funds may focus on earning total returns from both coupon income and appreciation in the value of the securities. The fund manager manages the duration of the portfolio depending upon the expectation of interest rate movements. When interest rates are expected to go down, the modified duration of the portfolio is increased so that there are greater gains to the value of the portfolio. The returns from such schemes are likely to be

more volatile. There is also the risk of the fund manager's call on interest rate direction being wrong, leading to loss in values. Investors must select the fund strategy that they are comfortable with.

### **Hybrid Schemes**

An investor desirous of having a mix of debt and equity exposures has two options—invest in a mix of equity schemes and debt schemes or investing in any of the hybrid schemes as discussed in Chapter 2 such as conservative hybrid fund, balanced hybrid fund, aggressive hybrid fund etc.

The first option obviously implies more decisions on scheme selection that the investor would need to take. But the benefit is that the investor has a wide array of scheme options, within both equity and debt scheme categories. Further, the investor would be in a position to work towards a mix of debt and equity that is most appropriate for him.

Investing in a hybrid scheme makes things simpler for the investor, because fewer scheme selection decisions need to be taken. However, the investor would need to go by the debt-equity mix in the investment portfolio of the schemes.

The equity component in a hybrid fund provides the appreciation in value, while the regular returns from the debt component provide the stability to the returns.

Such funds are suitable for investors who want equity exposure but with lower risk. Evaluate the type and extent of equity exposure that the fund takes as a norm to assess the risk in the fund.

Apart from the asset allocation between equity and debt, one must also evaluate the risk taken in the equity component and debt component separately. (Refer the discussion earlier in the chapter). The word “conservative” in the name of conservative hybrid funds category only refers to the equity allocation. Hence, investors should evaluate how the equity portion of the fund is managed i.e. whether the fund invests in large, mid or small cap stocks, if the stocks represent diverse sectors and so on. Based on this the investor can decide on the suitability of the investment. At the same time, one must also check the credit quality of the debt portfolio as well as the duration risk the scheme is exposed to.

Investors need to be cautious of the risk of a variant of hybrid schemes that are structured as dynamic asset allocation schemes.

Further, balanced schemes may be taxed as a non-equity-oriented scheme or an equity scheme depending on the scheme's investment portfolio.

### **Gold Funds**

Investors need to differentiate between Gold ETF and Gold Sector Funds. The latter are schemes that invest in shares of gold mining and other gold processing companies. The performance of these gold sector funds is linked to the profitability of these gold companies – unlike Gold ETFs whose performance would track the price of gold. When gold metal price increases, gold mining companies with large reserves of gold can appreciate a lot more than the gold metal. Conversely, they can also fall more when gold metal prices decline. The prices of shares of gold mining and other such companies will be also driven by factors other than purely the price of gold. For example, if there are concerns about a company's management the share prices may see a decline irrespective of the price of gold. On the other hand, ETF NAVs closely track the price of gold since it reflects the value of gold held in custody for the units issued. It makes it a more efficient way to take exposure to gold. Investors therefore need to understand the structure of the gold schemes more closely, before investing.

#### **12.4 Selection of Mutual Fund scheme offered by different AMCs or within the scheme category**

Different AMCs have different approaches, styles and value systems in doing business. An investor has to be comfortable with the AMC, before investing in any of its schemes.

##### **Matching fund's portfolio with its investment objective**

An investor buying into a scheme is essentially buying into its portfolio. Most AMCs share the portfolio of all their schemes on their website on a monthly basis. Investors should evaluate whether the fund's portfolio reflects its investment objective, and that the fund managers follow the strategy and style that the scheme intends to follow according to its SID. Experienced researchers can also identify how true the fund manager is, to the promised investment style.

For example, a large proportion of fully-valued front-line stocks in the portfolio of a 'value fund' is indicative of the fund manager not being true to the promised investment style. A 'short-term debt fund' that takes significant exposure to long-term debt instruments to generate better returns may be taking on more risk than what the investors are comfortable with. A 'hybrid fund' that takes aggressive equity positions, e.g. higher allocation to small cap stocks, or a concentrated portfolio; or takes aggressive positions in debt securities, e.g. investing in securities with high credit risk, or longer maturity for better returns may be exposing the investors to higher risk than what they signed up for. Similarly, if a liquid fund or ultrashort term debt fund takes high credit risk, the investor may or may not be comfortable with the same. Investors in non-gilt debt schemes should track the credit quality of the portfolio – and watch out for sector concentration in the portfolio, even if the securities have a high credit rating.

## **Fund Manager**

Long-term watchers of mutual fund performance also develop views on AMCs/Fund Managers that are more prescient in identifying changes in market trends. They believe that it is the portfolio manager that makes a huge difference to the scheme's performance.

## ***Fund Performance***

The fund's performance is a primary criterion in its selection from amongst other schemes. The returns that the fund has generated relative to its benchmark are evaluated over a period of time. The fund should ideally have consistently outperformed the benchmark. Typically, not only should it have out-performed in a bull market, but in a falling market it should have been able to protect the downside. In case of equity funds, the performance should be seen for longer periods, at least last 5 years. While for long-term debt funds at least 3 years performance need to be considered, for short-term debts funds, shorter performance period is suitable. The fund's performance against the peer group should also be considered to make the right selection.

The mutual fund provides the cumulative performance of the scheme (i.e. in terms of CAGR), the benchmark and the additional benchmark, depending upon the type of scheme, for the last 1 year, 3 years, 5 years and since inception.

For shorter term debt funds like Liquid funds, the return data is made available for shorter periods such as 7 days, 15 days and 1 month also which are more relevant given the likely holding period of investors in such schemes.

The cumulative returns data helps evaluate how the fund performed for various holding periods. These returns help evaluate the consistency with which the mutual fund was able to generate returns over different periods and market situations. While looking at historical returns, it would be important to note the following:

- Check the scheme's performance relative to the scheme's benchmark
- Compare the scheme's performance with the peer group
- Do both the above comparisons over multiple periods of time, e.g. over rolling periods. One may also consider comparing the scheme performance over various bull and bear market cycles.

### ***Fund Portfolio***

The fund's portfolio has to be evaluated to determine the risk and return in the scheme. In case of equity funds, the level of diversification across sector and stocks, the market segment in which the fund invests, the extent of cash held and the conviction showed in terms of the length of holding in stocks and churn in the portfolio, the strategy adopted for selecting securities for the portfolio and managing it, have to be considered. In case of debt funds, the average maturity and duration of the portfolio, the credit risk profile, the contribution of interest and capital gains to the total returns of the fund, liquid holding in the portfolio, need to be evaluated before making an investment decision.

### ***Fund Age***

A fund with a long history has a track record that can be studied. A new fund managed by a portfolio manager with a lack-lustre track-record is definitely avoidable. A new fund that offers a new investment opportunity should be evaluated for its suitability.

Fund age is especially important for categories of schemes, where there are more investment options, and divergence in performance of schemes within the same category tends to be more. For example, with the SEBI circular on scheme categorization, there may not be large differences in performance across large cap funds, however, there could be major differences in performance across multi-cap funds, since the investment universe is much larger in the latter.

### ***Fund Size***

The size of funds needs to be seen in the context of the proposed investment universe. For an equity fund that intends to invest in large cap stocks, a large fund size may be an advantage, while for a sector fund or a mid-cap fund with limited investment options, a large fund size may be a disadvantage. A large fund size will allow better diversification and economies of scale. A small sized fund on the other hand is more flexible and better able to take advantage of market opportunities.

### ***Portfolio Turnover***

Purchase and sale of securities entails broking costs for the scheme. Frequent churning of the portfolio would not only add to the broking costs, but also be indicative of unsteady investment management.

Portfolio Turnover Ratio is calculated as Value of Purchase and Sale of Securities during a period divided by the average size of net assets of the scheme during the period. Thus, if the sale and purchase transactions for a year amounted to Rs. 10,000 crore, and the average size of net assets is Rs. 5,000 crore, then the portfolio turnover ratio is  $\text{Rs. } 10,000 \text{ crore} \div \text{Rs. } 5,000$

crore i.e. 2 or 200 percent. This means that investments are held in the portfolio, on an average for 12 months  $\div$  2 i.e. 6 months.

The portfolio turnover needs to be viewed in the light of the investment style. Six month holding period may be too short for a value investment style, but perfectly acceptable for a scheme that wants to benefit from shifts in momentum. A short holding period may indicate that the fund manager is looking for tactical investments to take advantage of short-term market opportunities rather than identifying and investing in fundamentally strong companies for the long-term.

### ***Scheme Running Expenses***

Any cost is a drag on investor's returns. Investors need to be particularly careful about the cost structure of debt schemes, because in the normal course, debt returns can be much lower than equity schemes. Similarly, since index funds follow a passive investment strategy, a high cost structure is questionable in such schemes.

Risk, return and risk-adjusted returns as parameters to evaluate schemes were discussed earlier in this chapter. These form the basis for mutual fund research agencies to assign a rank to the performance of each scheme within a scheme category (ranking). (See Box 12.1) Some of these analyses cluster the schemes within a category into groups, based on well-defined performance traits (rating).

### **Box 12.1: Evaluation of mutual fund schemes by Research Agencies**

Every research agency has its distinctive methodology for ranking/rating, which are detailed on their websites. Investors should understand the broad parameters, before taking decisions based on the ranking/rating of any agency.

Some research agencies follow a star system for the rating. Thus, a 5-star scheme is better than a 4-star scheme; 4-star scheme is better than 3-star, and so on and so forth. However, in such a case, it is important to understand the rating methodology, and to also check whether the rating agency claims of ratings are an assessment of the past performance or indicative of the future performance of the scheme. In almost all cases, the rating assigned to a scheme is the former, i.e. assessment of the past performance, and has no predictive ability.

Quarterly performance ranking of schemes over a period of time shows that the best ranking fund in a quarter is not necessarily the best ranking fund in the next quarter. Therefore, seeking to be invested in the best fund in every category in every quarter is neither an ideal objective, nor a feasible target proposition. Indeed, the costs associated with switching between schemes are likely to severely impact the investors' returns.

The investor may therefore aim to stay invested in schemes that are in the top "few" in their category on a consistent basis. The "few" could mean 3 to 5, in categories that have few schemes; or the top 10-15percent, in categories where there are more schemes. Investors need to bear in mind that these rankings and categories are based on historical performance, which may or may not be repeated in future.

The investor also needs to remember that beyond performance of the scheme, taxes and exit loads make a big difference to the investor's return.

## **12.5 Selecting options in mutual fund schemes**

The underlying returns in a scheme, arising out of its portfolio and cost economics, is what is available for investors in its various options viz. Dividend payout, dividend re-investment and growth options.

*Dividend payout option* has the benefit of money flow to the investor; growth option has the benefit of letting the money grow in the fund on gross basis (i.e. without annual taxation).

*Re-purchase transactions* are treated as a sale of units by the investor. Therefore, there can be an element of capital gain (or capital loss), if the re-purchase price is higher (or lower) than the cost of acquiring those units. Some investors may like to book such a capital gain (or capital loss) to set it off against some other capital loss (or capital gain), where such set off is permitted. The broad set-off rules, including the differential treatment of long term and short term, were discussed earlier.

The dividend pay-out option seems attractive for investors wanting a regular income. It should however be kept in mind that even in a mutual fund scheme with a monthly dividend option, dividend declaration is a function of distributable surplus. If there is no surplus to distribute, dividend cannot be declared. Therefore, the investor is not assured of dividend in the scheme even when there is a monthly dividend option. It is for this reason, that the need for regular income is better met through a SWP for the requisite amount. Sale of units under an SWP may have STT implication (equity schemes) and capital gains tax implication (equity and debt schemes).

Dividend income is subject to tax as per the applicable tax slab of the respective investor. The tax on dividend reduces the returns for the investor. Thus, dividend option is not preferable, except in case of tax-exempt investors. As seen earlier, SWP can take care of any need for a regular income. The capital gains tax impact however, would need to be checked.

Thus, taxation and liquidity needs are a factor in deciding between the options. The advisor needs to understand the investor's situation before advising.

## **12.6 Do's and Don'ts while selecting mutual fund schemes**

While selecting the mutual fund schemes, there are few things that a mutual fund distributor must keep in mind. Some of them are listed below:

### **Ensuring suitability**

SEBI regulation on Fraudulent and Unfair Trade Practices also apply to sale of mutual fund units. In order to comply with this regulation, the distributor is required to ensure the scheme's suitability to the investor's needs and situation.

### **Sticking to investor's asset allocation**

As discussed earlier in the chapter, the asset allocation for the investor is based on the investor's situation and goals. Therefore, it is a prudent approach to keep the asset allocation at the core of selection of schemes sold to the investor.

### **Chasing past performance**

The mutual fund advertisements use the disclaimer: "Past performance may or may not be sustained in future". There is a reason for that. As experience has shown time and again, the top performers during one period may not necessarily remain as a top performer forever or near the other top performers and vice versa. In such a case, simply buying into a scheme due to good returns in the recent past may not be a wise approach.

### **Understanding the investment objective and investment strategy of the scheme**

In order to evaluate various mutual fund schemes, it is important to consider the scheme's investment objective and strategy. Both of these can help one understand what to expect from the scheme

### **Keeping an eye on the taxes and loads**

Both taxes and loads reduce investment returns. Therefore, it is important for the distributor to consider these two aspects during repurchases/redemptions. This means that when there is a need to withdraw money from a scheme, the distributor must assess the implications of capital gains tax and exit loads.

Likewise, one must also compare the taxation aspects in case of dividend and growth options periodically to evaluate the impact of tax on returns.

### **Developing a consistent methodology for scheme selection**

It would help a mutual fund distributor to have a consistent approach in scheme selection. It is also important to keep this methodology in writing so that one stays on course.

## Chapter 12-Sample Questions

1. Which of the following scheme categories would be considered the least risky in terms of credit risk?
  - a. Credit risk fund
  - b. Corporate bond fund
  - c. Dynamic bond
  - d. Gilt fund
  
2. For an investor to get a quick sense of the level of risk involved in a mutual fund scheme, SEBI suggested a simplified framework known as \_\_\_\_\_.
  - a. Risk-o-meter
  - b. Risk factors
  - c. Fact sheet
  - d. Investor's risk profile
  
3. Passive funds are safe, as the NAV of such funds do not go down even when the respective markets fall. State whether this is True or False.
  - a. True
  - b. False
  
4. Which among the following schemes would have lower risk of concentration?
  - a. Multi-cap fund
  - b. Focused fund
  - c. Thematic fund
  - d. Sector fund
  
5. \_\_\_\_\_ are close-ended debt funds.
  - a. Fixed maturity plans (FMPs)
  - b. Overnight funds
  - c. Dynamic debt funds
  - d. Arbitrage funds

**Appendix 1: Fifth Schedule of Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 [Regulations 18(22), 25(16), 68(h)]**

**CODE OF CONDUCT**

1. Mutual funds schemes should not be organised, operated, managed or the portfolio of securities selected, in the interest of sponsors, directors of asset management companies, members of Board of trustees or directors of trustee company, associated persons 239[as] in the interest of special class of unitholders other than in the interest of all classes of unitholders of the scheme.
2. Trustees and asset management companies must ensure the dissemination to all unitholders of adequate, accurate, explicit and timely information fairly presented in a simple language about the investment policies, investment objectives, financial position and general affairs of the scheme.
3. Trustees and asset management companies should avoid excessive concentration of business with broking firms, affiliates and also excessive holding of units in a scheme among a few investors.
4. Trustees and asset management companies must avoid conflicts of interest in managing the affairs of the schemes and keep the interest of all unitholders paramount in all matters.
5. Trustees and asset management companies must ensure scheme-wise segregation of [bank accounts] and securities accounts.
6. Trustees and asset management companies shall carry out the business and invest in accordance with the investment objectives stated in the scheme related documents and take investment decision solely in the interest of unitholders.
7. Trustees and asset management companies must not use any unethical means to sell, market or induce any investor to buy their schemes.
8. Trustees and the asset management company shall maintain high standards of integrity and fairness in all their dealings and in the conduct of their business.
9. Trustees and the asset management company shall render at all times high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgment.
10. The asset management company shall not make any exaggerated statement, whether oral or written, either about their qualifications or capability to render investment management services or their achievements.
11. (a) The sponsor of the mutual fund, the trustees or the asset management company or any of their employees shall not render, directly or indirectly any investment advice about any security in the publicly accessible media, whether real-time or non-real-time, unless a disclosure of his interest including long or short position in the said security has been made, while rendering such advice. (b) In case an employee of the sponsor, the trustees or the

asset management company is rendering such advice, he shall also disclose the interest of his dependent family members and the employer including their long or short position in the said security, while rendering such advice.

## **Appendix 2: AMFI Code of Ethics**

### **1.0 INTEGRITY**

1.1 Members and their key personnel, in the conduct of their business shall observe high standards of integrity and fairness in all dealings with investors, issuers, market intermediaries, other members and regulatory and other government authorities.

1.2 Mutual Fund Schemes shall be organized, operated, managed and their portfolios of securities selected, in the interest of all classes of unit holders and not in the interest of:

- sponsors
- directors of Members
- members of Board of Trustees or directors of the Trustee company
- brokers and other market intermediaries
- associates of the Members
- a special class selected from out of unitholders

### **2.0 DUE DILIGENCE**

2.1 Members in the conduct of their Asset Management business shall at all times

- render high standards of service.
- exercise due diligence.
- exercise independent professional judgment.

2.2 Members shall have and employ effectively adequate resources and procedures which are needed for the conduct of Asset Management activities.

### **3.0 DISCLOSURES**

3.1 Members shall ensure timely dissemination to all unitholders of adequate, accurate, and explicit information presented in a simple language about the investment objectives, investment policies, financial position and general affairs of the scheme.

3.2 Members shall disclose to unitholders investment pattern, portfolio details, ratios of expenses to net assets and total income and portfolio turnover wherever applicable in respect of schemes on annual basis.

3.3 Members shall in respect of transactions of purchase and sale of securities entered into with any of their associates or any significant unitholder.

- submit to the Board of Trustees details of such transactions, justifying its fairness to the scheme.

- disclose to the unitholders details of the transaction in brief through annual and half yearly reports.

3.4 All transactions of purchase and sale of securities by key personnel who are directly involved in investment operations shall be disclosed to the compliance officer of the member at least on half yearly basis and subsequently reported to the Board of Trustees if found having conflict of interest with the transactions of the fund.

#### **4.0 PROFESSIONAL SELLING PRACTICES**

4.1 Members shall not use any unethical means to sell, market or induce any investor to buy their products and schemes

4.2 Members shall not make any exaggerated statement regarding performance of any product or scheme.

4.3 Members shall endeavour to ensure that at all times

- investors are provided with true and adequate information without any misleading or exaggerated claims to investors about their capability to render certain services or their achievements in regard to services rendered to other clients,
- investors are made aware of attendant risks in members' schemes before any investment decision is made by the investors,
- copies of prospectus, memoranda and related literature is made available to investors on request,
- adequate steps are taken for fair allotment of mutual fund units and refund of application moneys without delay and within the prescribed time limits and,
- complaints from investors are fairly and expeditiously dealt with.

4.4 Members in all their communications to investors and selling agents shall

- not present a mutual fund scheme as if it were a new share issue
- not create unrealistic expectations
- not guarantee returns except as stated in the SID, and in such case, the Members shall ensure that adequate resources will be made available and maintained to meet the guaranteed returns.
- convey in clear terms the market risk and the investment risks of any scheme being offered by the Members.
- not induce investors by offering benefits which are extraneous to the scheme.

- not misrepresent either by stating information in a manner calculated to mislead or by omitting to state information which is material to making an informed investment decision.

## **5.0 INVESTMENT PRACTICES**

5.1 Members shall manage all the schemes in accordance with the fundamental investment objectives and investment policies stated in the SID and take investment decisions solely in the interest of the unit-holders.

5.2 Members shall not knowingly buy or sell securities for any of their schemes from or to

- any director, officer, or employee of the member
- any trustee or any director, officer, or employee of the Trustee Company

## **6.0 OPERATIONS**

6.1 Members shall avoid conflicts of interest in managing the affairs of the schemes and shall keep the interest of all unit-holder's paramount in all matters relating to the scheme.

6.2 Members or any of their directors, officers or employees shall not indulge in front running (buying or selling of any securities ahead of transaction of the fund, with access to information regarding the transaction which is not public and which is material to making an investment decision, so as to derive unfair advantage).

6.3 Members or any of their directors, officers or employees shall not indulge in self-dealing (using their position to engage in transactions with the fund by which they benefit unfairly at the expense of the fund and the unit-holders).

6.4 Members shall not engage in any act, practice or course of business in connection with the purchase or sale, directly or indirectly, of any security held or to be acquired by any scheme managed by the Members, and in purchase, sale and redemption of units of schemes managed by the Members, which is fraudulent, deceptive or manipulative.

6.5 Members shall not, in respect of any securities, be party to-

- creating a false market,
- price rigging or manipulation
- passing of price sensitive information to brokers, Members of stock exchanges and other players in the capital markets or take action which is unethical or unfair to investors.

6.6 Employees, officers and directors of the Members shall not work as agents/ brokers for selling of the schemes of the Members, except in their capacity as employees of the Member or the Trustee Company.

6.7 Members shall not make any change in the fundamental attributes of a scheme, without the prior approval of unitholders except when such change is consequent on changes in the regulations.

6.8 Members shall avoid excessive concentration of business with any broking firm, and excessive holding of units in a scheme by few persons or entities.

## **7.0 REPORTING PRACTICES**

7.1 Members shall follow comparable and standardized valuation policies in accordance with the SEBI Mutual Fund Regulations.

7.2 Members shall follow uniform performance reporting on the basis of total return.

7.3 Members shall ensure scheme-wise segregation of cash and securities accounts.

## **8.0 UNFAIR COMPETITION**

Members shall not make any statement or become privy to any act, practice or competition, which is likely to be harmful to the interests of other Members or is likely to place other Members in a disadvantageous position in relation to a market player or investors, while competing for investible funds.

## **9.0 OBSERVANCE OF STATUTES, RULES AND REGULATIONS**

Members shall abide by the letter and spirit of the provisions of the Statutes, Rules and Regulations which may be applicable and relevant to the activities carried on by the Members.

## **10.0 ENFORCEMENT**

Members shall:

- widely disseminate the AMFI Code to all persons and entities covered by it
- make observance of the Code a condition of employment
- make violation of the provisions of the code, a ground for revocation of contractual arrangement without redress and a cause for disciplinary action
- require that each officer and employee of the Member sign a statement that he/she has received and read a copy of the Code
- establish internal controls and compliance mechanisms, including assigning supervisory responsibility
- designate one person with primary responsibility for exercising compliance with power to fully investigate all possible violations and report to competent authority
- file regular reports to the Trustees on a half yearly and annual basis regarding observance of the Code and special reports as circumstances require
- maintain records of all activities and transactions for at least three years, which records shall be subject to review by the Trustees
- dedicate adequate resources to carrying out the provisions of the Code

## 11.0 DEFINITIONS

When used in this code, unless the context otherwise requires

(a) AMFI

“AMFI” means the Association of Mutual Funds in India

(b) Associate

“Associate” means and includes an ‘associate’ as defined in regulation 2(c) of SEBI (Mutual Fund) Regulations 1996.

(c) Fundamental investment policies

The “fundamental investment policies” of a scheme managed by a member means the investment objectives, policies, and terms of the scheme, that are considered fundamental attributes of the scheme and on the basis of which unitholders have invested in the scheme.

(d) Member

A “member” means the member of the Association of Mutual Funds in India.

(e) SEBI

“SEBI” means Securities and Exchange Board of India.

(f) Significant Unit holder

A “Significant Unit holder” means any entity holding 5 percent or more of the total corpus of any scheme managed by the member and includes all entities directly or indirectly controlled by such a unit holder.

(g) Trustee

A “trustee” means a member of the Board of Trustees or a director of the Trustee Company.

(h) Trustee Company

A “Trustee Company” is a company incorporated as a Trustee Company and set up for the purpose of managing a mutual fund.

### **Appendix 3: AMFI's Code of Conduct for Intermediaries of Mutual Funds**

3.1 Consider investor's interest as paramount and take necessary steps to ensure that the investor's interest is protected in all circumstances.

3.2 Adhere to SEBI Mutual Fund Regulations and guidelines issued from time to time related to distributors, selling, distribution and advertising practices. Be fully conversant with the key provisions of the Scheme Information Document (SID), Statement of Additional Information (SAI) and Key Information Memorandum (KIM) as well as the operational requirements of various schemes.

3.3 Comply with SEBI guidelines/requirements issued from time to time in preparation of sales, promotional or any other literature about any schemes. Performance disclosures should also comply with the requirements specified by SEBI. Provide full and latest information of schemes to investors in the form of SAI, SID, addenda, performance reports, fact sheets, portfolio disclosures and brochures; and recommend schemes appropriate for the investor's risk profile and needs.

3.4 Highlight risk factors of each scheme, desist from misrepresentation and exaggeration and urge investors to go through SAI/SID/KIM before deciding to make investments.

3.5 Disclose to the investors all material information including all the commissions (in the form of trail or any other mode) received for the different competing schemes of various Mutual Funds from amongst which the scheme is being recommended to the investors.

3.6 Abstain from indicating or assuring returns in any type of scheme, unless the SID is explicit in this regard.

3.7 Maintain necessary infrastructure to support the AMCs in maintaining high service standards to investors, and ensure that critical operations such as forwarding forms and cheques to AMCs/registrars and despatch of statement of account and redemption cheques to investors are done within the time frame prescribed in the SID/SAI and SEBI Mutual Fund Regulations.

3.8 Do not collude with investors in faulty business practices such as bouncing of cheques, wrong claiming of dividend/redemption cheques, splitting of applications in the schemes to circumvent regulations for any benefit, etc.

3.9 Do not undertake commission driven malpractices such as:

- a. recommending inappropriate products solely because the intermediary is getting higher commissions there from.
- b. encouraging over transacting and churning of Mutual Fund investments to earn higher commissions.
- c. splitting of applications to earn higher transaction charges / commissions.

3.10 Abstain from making negative statements about any AMC or scheme and ensure that comparisons, if any, are made with similar and comparable products along with complete facts.

3.11 Intermediaries shall keep themselves abreast with the developments relating to the Mutual Fund Industry as also changes in the scheme information and information on mutual fund / AMC like changes in fundamental attributes, changes in controlling interest, loads, liquidity provisions, and other material aspects and deal with the investors appropriately having regard to the up to date information.

3.12 Maintain confidentiality of all investor details, deals and transactions.

3.13 Intermediaries shall keep investor's interest and suitability to their financial needs as paramount and that extra commission or incentive should never form the basis for recommending a scheme to the investor.

3.14 Intermediaries shall not rebate commission back to investors and abstain from attracting investors through temptation of rebate/gifts etc.

3.15 To protect the investors from potential fraudulent activities, intermediary should take reasonable steps to ensure that the investor's address and contact details filled in the mutual fund application form are investor's own details, and not of any third party. Where the required information is not available in the application form, intermediary should make reasonable efforts to obtain accurate and updated information from the investor. Intermediaries should abstain from filling wrong / incorrect information or information of their own or of their employees, officials or agents as the investor's address and contact details in the application form, even if requested by the investor to do so. Intermediary should abstain from tampering in any way with the application form submitted by the investor, including inserting, deleting or modifying any information in the application form provided by the investor.

3.16 Intermediaries including the sales personnel of intermediaries engaged in sales / marketing shall obtain NISM certification and register themselves with AMFI and obtain an Employee Unique Identification Number (EUIN) from AMFI apart from AMFI Registration Number (ARN). The Intermediaries shall ensure that the employees quote the EUIN in the Application Form for investments. The NISM certification and AMFI registration shall be renewed on timely basis. Employees in other functional areas should also be encouraged to obtain the same certification.

3.17 Intermediaries shall comply with the Know Your Distributor (KYD) norms issued by AMFI.

3.18 Co-operate with and provide support to AMCs, AMFI, competent regulatory authorities, Due Diligence Agencies (as applicable) in relation to the activities of the intermediary or any regulatory requirement and matters connected thereto.

3.19 Provide all documents of its investors in terms of the Anti-Money Laundering / Combating Financing of Terrorism requirements, including KYC documents / Power of Attorney / investor's agreement(s), etc. with Intermediaries as may be required by AMCs from time to time.

3.20 Be diligent in attesting / certifying investor documents and performing In Person Verification (IPV) of investors for the KYC process in accordance with the guidelines prescribed by AMFI / KYC Registration Agency (KRA) from time to time.

3.21 Adhere to AMFI guidelines and Code of Conduct issued from time to time related to distributors, selling, distribution and advertising practices.

3.22 Intimate the AMC and AMFI any changes in the intermediary's status, constitution, address, contact details or any other information provided at the time of obtaining AMFI Registration.

3.23 Observe high standards of ethics, integrity and fairness in all its dealings with all parties – investors, Mutual Funds/ AMCs, Registrars & Transfer Agents and other intermediaries. Render at all times high standards of service, exercise due diligence, and ensure proper care.

3.24 Intermediaries satisfying the criteria specified by SEBI for due diligence exercise, shall maintain the requisite documentation in respect of the "Advisory" or "Execution Only" services provided by them to the investors.

3.25 Intermediaries shall refund to AMCs, either by set off against future commissions or payment, all incentives of any nature, including commissions received, that are subject to claw-back as per SEBI regulations or the terms and conditions issued by respective AMC.

3.26 In respect of purchases (including switch-in's) into any fund w.e.f January 1, 2013, in the event of any switches from Regular Plan (Broker Plan) to Direct Plan, all upfront commissions paid to distributors shall be liable to complete and / or proportionate claw-back.

3.27 Do not indulge in fraudulent or unfair trade practices of any kind while selling units of Schemes of any mutual fund. Selling of units of schemes of any mutual fund by any intermediary directly or indirectly by making false or misleading statement, concealing or omitting material facts of the scheme, concealing the associated risk factors of the schemes or not taking reasonable care to ensure suitability of the scheme to the investor will be construed as fraudulent / unfair trade practice.

## Appendix 4: Format of Scheme Information Document (SID)<sup>83</sup>

### FRONT COVER PAGE

#### SCHEME INFORMATION DOCUMENT

##### NAME OF THE SCHEME

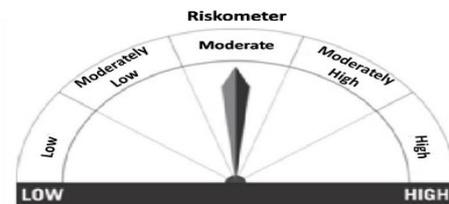
(Type of Scheme - Open /Closed / Interval/Equity/ Balanced/ Income/ Debt/ Liquid/ETF etc.)

Offer of Units of Rs. -- each for cash (subject to applicable load) during the  
New Fund Offer and Continuous offer for Units at NAV based prices

**This product is suitable for investors  
who are seeking\*:**

- .....
- .....

*\* Investors should consult their financial  
advisers if in doubt about whether the  
product is suitable for them.*



Investors understand that their principal will be at moderate risk

**New Fund Offer Opens on:** \_\_\_\_\_

**New Fund Offer Closes on:** \_\_\_\_\_

**Scheme re-opens on:** \_\_\_\_\_

Name of Mutual Fund :  
Name of Asset Management Company :  
Name of Trustee Company :  
Addresses, Website of the entities :

**The particulars of the Scheme have been prepared in accordance with the Securities and Exchange Board of India (Mutual Funds) Regulations 1996, (herein after referred to as SEBI (MF) Regulations) as amended till date, and filed with SEBI, along with a Due Diligence Certificate from the AMC. The units being offered for public subscription have not been approved or recommended by SEBI nor has SEBI certified the accuracy or adequacy of the Scheme Information Document.**

The Scheme Information Document sets forth concisely the information about the scheme that a prospective investor ought to know before investing. Before investing, investors should also ascertain

<sup>83</sup> The wordings in italics are explanatory commentary/instructions.

about any further changes to this Scheme Information Document after the date of this Document from the Mutual Fund/Investor Service Centres/Website/Distributors or Brokers.

The investors are advised to refer to the Statement of Additional Information (SAI) for details of \_\_\_\_\_ Mutual Fund, Tax and Legal issues and general information on www.\_\_\_\_\_.  
(Website address).

**SAI is incorporated by reference (is legally a part of the Scheme Information Document). For a free copy of the current SAI, please contact your nearest Investor Service Centre or log on to our website.**

**The Scheme Information Document should be read in conjunction with the SAI and not in isolation.**

This Scheme Information Document is dated \_\_\_\_\_.

Note: The wording in italics is explanatory commentary/instructions.

*Instructions:*

*i. A Mutual Fund is free to add any other disclosure, which in the opinion of the Trustees of the Mutual Fund (Trustees) or the Asset Management Company (AMC) is material for the investor, provided that such information is not presented in an incomplete, inaccurate or misleading manner. Care should be taken to ensure that inclusion of such information does not, by virtue of its nature, or manner of presentation, obscure or impede understanding of any information that is required to be included under the Scheme Information Document.*

*ii. Since investors who rely on the Scheme Information Document may not be sophisticated in legal or financial matters, care should therefore be taken to present the information in the Scheme Information Document in simple language and in a clear, concise and easily understandable manner.*

*iii. The scheme shall not have a name or title which may be deceptive or misleading. Scheme's name should be consistent with its statement of investment policy.*

*iv. The type of the scheme would mean whether the scheme is a growth scheme, income scheme, balanced scheme etc. and whether the scheme is open-ended, close-ended, an interval fund etc.*

## TABLE OF CONTENTS

**HIGHLIGHTS/SUMMARY OF THE SCHEME** - This section shall include the following:

- Name of the Scheme
- Category of the scheme
- Type of Scheme
- Investment objective
- Liquidity
- Benchmark
- Transparency/NAV Disclosure

- Loads
- Minimum Application Amount
- Minimum Additional Purchase Amount
- Minimum Redemption Amount
- Scheme Plans & Options
- Dividend Policy
- Dematerialisation
- Transaction Charges

*(Highlights/summary of the scheme, irrespective of whether they appear on the Cover Page or not, shall make a specific disclosure in case of assured return schemes regarding the guarantee given either by the AMC or by the Sponsor to distribute income at the assured rate, and to redeem the capital invested, to the unit holder. This statement shall be in bold, legible fonts.)*

## I. INTRODUCTION

### A. RISK FACTORS

#### Standard Risk Factors

- Investment in Mutual Fund Units involves investment risks such as trading volumes, settlement risk, liquidity risk, default risk including the possible loss of principal.
- As the price / value / interest rates of the securities in which the scheme invests fluctuates, the value of your investment in the scheme may go up or down *(Mutual Funds may also provide factors affecting capital market in general and not limited to the aforesaid)*
- Past performance of the Sponsor/AMC/Mutual Fund does not guarantee future performance of the scheme.
- The name of the scheme does not in any manner indicate either the quality of the scheme or its future prospects and returns.
- The sponsor is not responsible or liable for any loss resulting from the operation of the scheme beyond the initial contribution of \_\_\_\_\_ made by it towards setting up the Fund.
- The present scheme is the first scheme being launched under its management. *(Applicable, if the AMC has no previous experience in managing a Mutual Fund)*
- The present scheme is not a guaranteed or assured return scheme *(applicable to all schemes except assured return schemes)*

#### Scheme Specific Risk Factors

- **Schemes investing in Equities** - Describe briefly risks associated with investment in equity
- **Schemes investing in Bonds** – Describe briefly risks associated with fixed income products like Credit Risk, Prepayment Risk, Liquidity Risk etc.
- **Risks associated with Investing in Foreign Securities** - *(if the scheme invests in these instruments)*

- **Risks associated with Investing in Derivatives** - *(if the scheme invests in these instruments)*
- **Risks associated with Investing in Securitised Debt** - *(if the scheme invests in these instruments)*
- **Risks associated with Short Selling and Securities Lending** - *(if the scheme intends to participate in short selling and securities lending).*
- **Risks associated with investing in money market instruments** - *(if the scheme invests in these instruments).*
- **Risk Associated with investing Securitised Debt:** *(if the scheme invests in these instruments).*
- **Risk Associated with Fixed Income Securities:** *(if the scheme invests in these instruments).*
- **Risk associated with Imperfect Hedging using Interest Rate Futures:** *(if the scheme invests in these instruments).*
- **Risks Factors associated with transaction in Units through stock exchange(s):** *(if the scheme invests in these instruments).*

## B. REQUIREMENT OF MINIMUM INVESTORS IN THE SCHEME

*(Applicability for an open-ended scheme)*

The Scheme/Plan shall have a minimum of 20 investors and no single investor shall account for more than 25 percent of the corpus of the Scheme/Plan(s). However, if such limit is breached during the NFO of the Scheme, the Fund will endeavour to ensure that within a period of three months or the end of the succeeding calendar quarter from the close of the NFO of the Scheme, whichever is earlier, the Scheme complies with these two conditions. In case the Scheme / Plan(s) does not have a minimum of 20 investors in the stipulated period, the provisions of Regulation 39(2)(c) of the SEBI (MF) Regulations would become applicable automatically without any reference from SEBI and accordingly the Scheme / Plan(s) shall be wound up and the units would be redeemed at applicable NAV. The two conditions mentioned above shall also be complied within each subsequent calendar quarter thereafter, on an average basis, as specified by SEBI. If there is a breach of the 25 percent limit by any investor over the quarter, a rebalancing period of one month would be allowed and thereafter the investor who is in breach of the rule shall be given 15 days' notice to redeem his exposure over the 25 percent limit. Failure on the part of the said investor to redeem his exposure over the 25 percent limit within the aforesaid 15 days would lead to automatic redemption by the Mutual Fund on the applicable Net Asset Value on the 15th day of the notice period. The Fund shall adhere to the requirements prescribed by SEBI from time to time in this regard.

*Applicability for a close-ended scheme/interval scheme*

The Scheme(s) and individual Plan(s) under the Scheme(s) shall have a minimum of 20 investors and no single investor shall account for more than 25 percent of the corpus of the Scheme(s)/Plan(s). These conditions will be complied with immediately after the close of the NFO itself i.e. at the time of allotment. In case of non-fulfilment with the condition of minimum 20 investors, the Scheme(s)/Plan(s) shall be wound up in accordance with Regulation 39 (2) (c) of SEBI (MF) Regulations automatically without any reference from SEBI. In case of non-fulfilment with the condition of 25 percent holding by a single investor on the date of allotment, the application to the extent of exposure in excess of the stipulated 25 percent limit would be liable to be rejected and the allotment would be effective only to the extent of 25 percent of the corpus collected. Consequently, such exposure over 25 percent limits will lead to refund within 6 weeks of the date of closure of the New Fund Offer.

*For interval scheme the aforesaid provision will be applicable at the end of NFO and specified transaction period.*

**C. SPECIAL CONSIDERATIONS, if any**

**D. DEFINITIONS** - *All terms used in the Scheme Information Document shall be defined in this Section.*

*Instructions:*

- i. Language and terminology used in the Scheme Information Document shall be as provided in the Regulations. Any new term if used shall be clearly defined.*
- ii. All terms shall be used uniformly throughout the text of the Scheme Information Document e.g. the terms 'sale price' and 'repurchase price' shall be used uniformly to indicate 'offer price' and 'bid price' of units.*
- iii. The term 'scheme' shall be used uniformly to indicate the different schemes of a Mutual Fund.*

**E. DUE DILIGENCE BY THE ASSET MANAGEMENT COMPANY**

The Asset Management Company shall confirm that a Due Diligence Certificate duly signed by the Compliance Officer/Chief Executive Officer / Managing Director / Whole time Director/Executive Director of the Asset Management Company has been submitted to SEBI, which reads as follows:

It is confirmed that:

- (i) the draft Scheme Information Document forwarded to SEBI is in accordance with the SEBI (Mutual Funds) Regulations, 1996 and the guidelines and directives issued by SEBI from time to time.
- (ii) all legal requirements connected with the launching of the scheme as also the guidelines, instructions, etc., issued by the Government and any other competent authority in this behalf, have been duly complied with.
- (iii) the disclosures made in the Scheme Information Document are true, fair and adequate to enable the investors to make a well informed decision regarding investment in the proposed scheme.
- (iv) the intermediaries named in the Scheme Information Document and Statement of Additional Information are registered with SEBI and their registration is valid, as on date.

## II. INFORMATION ABOUT THE SCHEME

### A. TYPE OF THE SCHEME

*(open/close/interval, Equity/Debt/Income/Liquid/Balanced/ETF etc.)*

### B. WHAT IS THE INVESTMENT OBJECTIVE OF THE SCHEME?

*The scheme's investment objective and policies (including the types of securities in which it will invest) shall be clearly and concisely stated in the Scheme Information Document so that they may be readily understood by the unit holder/investor.*

### C. HOW WILL THE SCHEME ALLOCATE ITS ASSETS?

*This includes asset allocation table giving the broad classification of assets and indicative exposure level in percentage terms specifying the risk profile. If the scheme's name implies that it will invest primarily in a particular type of security, or in a certain industry or industries, the scheme shall have an investment policy that requires that, under normal circumstances, at least 65 percent of the value of its total assets be invested in the indicated type of security or industry. The asset allocation should be consistent with the investment objective of the scheme.*

Instruments	Indicative allocations (percent of total assets)		Risk Profile
	Maximum	Minimum	High/Medium/Low

*Percentage of investment in foreign securities, derivatives, stock lending, securitized debt etc. to be indicated.*

#### **D. WHERE WILL THE SCHEME INVEST?**

*This includes a brief narration on the types of instruments in which the scheme will invest and the concerned regulations and limits applicable shall also be mentioned.*

*Investment in overseas securities shall be made in accordance with the requirements stipulated by SEBI and RBI from time to time.*

*Brief narration on the various derivative products specifying (i) the instruments to be used (ii) the applicable limits.*

#### **E. WHAT ARE THE INVESTMENT STRATEGIES?**

*Information about investment approach and risk control should be included in simple terms. In case the scheme proposes to invest in derivatives, disclosures on the various strategies to be adopted by the fund manager shall be made.*

*In case of assured return schemes, the Scheme Information Document shall disclose:*

- *how many schemes have assured returns, their number and corpus size;*
- *the justification as to how the net worth and liquidity position of the guarantor would be adequate to meet the shortfall in these schemes;*
- *details of the schemes which did not pay assured returns in the past and how the shortfall was met.*

*Further, Portfolio turnover policy, particularly for equity oriented schemes shall also be disclosed. In discussing the investment strategies, the scheme shall briefly discuss in the Scheme Information Document the probable effect of such strategies on the rate of the total portfolio turnover of the scheme, if such effects are significant and also other consequences which will result from the higher portfolio turnover rate e.g. higher brokerage and transaction cost.*

#### **F: FUNDAMENTAL ATTRIBUTES**

Following are the Fundamental Attributes of the scheme, in terms of Regulation 18 (15A) of the SEBI (MF) Regulations:

##### **(i) Type of a scheme**

- Open ended/Close ended/Interval scheme
- Sectoral Fund/Equity Fund/Balance Fund/Income Fund/Index Fund/Any other type of Fund

##### **(ii) Investment Objective**

- Main Objective - Growth/Income/Both.
- Investment pattern - The tentative Equity/Debt/Money Market portfolio break-up with minimum and maximum asset allocation, while retaining the option to alter the asset allocation for a short term period on defensive considerations.

(iii) Terms of Issue

- Liquidity provisions such as listing, repurchase, redemption.
- Aggregate fees and expenses charged to the scheme.
- Any safety net or guarantee provided.

In accordance with Regulation 18(15A) of the SEBI (MF) Regulations, the Trustees shall ensure that no change in the fundamental attributes of the Scheme(s) and the Plan(s) / Option(s) thereunder or the trust or fee and expenses payable or any other change which would modify the Scheme(s) and the Plan(s) / Option(s) thereunder and affect the interests of Unitholders is carried out unless:

- A written communication about the proposed change is sent to each Unit-holder and an advertisement is given in one English daily newspaper having nationwide circulation as well as in a newspaper published in the language of the region where the Head Office of the mutual fund is situated; and
- The Unitholders are given an option for a period of 30 days to exit at the prevailing Net Asset Value without any exit load.

*Instruction: It shall be ensured that the advertisement is published and written communication is dispatched appropriately in advance of the commencement of 30 days period.*

**G. HOW WILL THE SCHEME BENCHMARK ITS PERFORMANCE?**

*The name and the justification (specific to the scheme objective) for the use of benchmark index with which the performance of the scheme can be compared with.*

**H. WHO MANAGES THE SCHEME?**

*Name, age, qualification and experience of the fund manager to the scheme to be disclosed. The experience of the fund manager should include last 10 years of experience and also the name of other schemes under his /her management.*

## I. WHAT ARE THE INVESTMENT RESTRICTIONS?

All the investment restrictions as contained in the Seventh Schedule to SEBI (Mutual Funds) Regulations, 1996 and applicable to the scheme should be incorporated. Further in case the fund follows any internal norms vis-à-vis limiting exposure to a particular scrip or sector, etc. apart from the aforementioned investment restrictions the same needs to be disclosed.

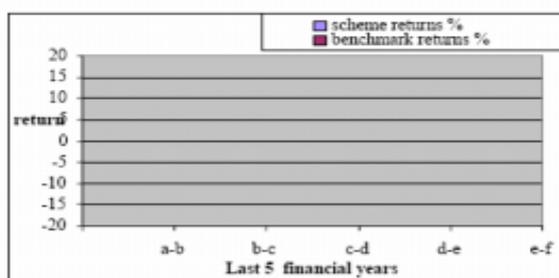
In case of equity schemes disclose only equity related investment restriction though the scheme would be investing a portion of the assets in bonds for liquidity or for other purposes. In case of fixed income/debt schemes disclose only the investment restriction applicable to bonds. In case of balanced schemes all investment restrictions are to be disclosed.

## J. HOW HAS THE SCHEME PERFORMED?

Scheme performance track record:

<p><i>In case of a new scheme, this is not applicable hence give the statement- "This scheme is a new scheme and does not have any performance track record".</i></p> <p><i>Or</i></p> <p><i>In case of a scheme in existence, the return figures shall be given for that scheme only, as per the scheme which is in existence for more than 1 year, the returns given will be Compounded Annualised Returns and for scheme which is in existence for less than 1 year, the returns would be absolute returns since inception. Absolute returns for each financial year for the last 5 years shall be represented by means of a bar diagram as per the adjacent format.</i></p>	<b>Compounded Annualised Return</b>	<b>Scheme Return %</b>	<b>Benchmark Return %</b>
	Return for the last 1 year		
	Return for the last 3 year		
	Return for the last 5 year		
	Return since inception		

Absolute Returns for each financial year for the last 5 years



## K. ADDITIONAL DISCLOSURES

(i) SCHEME PORTFOLIO HOLDINGS

(ii) INVESTMENT DETAILS

## III. UNITS AND OFFER

This section provides details you need to know for investing in the scheme.

### A. NEW FUND OFFER (NFO)

<b>New Fund Offer Period</b> This is the period during which a new scheme sells its units to the investors.	NFO opens on: NFO closes on: Date of inception/allotment
<b>New Fund Offer Price:</b> This is the price per unit that the investors have to pay to invest during the NFO.	
<b>Minimum Amount for Application/Switch in the NFO</b>	
<b>Minimum Target amount</b>  This is the minimum amount required to operate the scheme and if this is not collected during the NFO period, then all the investors would be refunded the amount invested without any return. However, if AMC fails to refund the amount within 6 weeks, interest as specified by SEBI (currently 15 percent p.a.) will be paid to the investors from the expiry of six weeks from the date of closure of the subscription period.	Rs. _____
<b>Maximum Amount to be raised (if any)</b> <i>This is the maximum amount which can be collected during the NFO period, as decided by the AMC.</i>	Rs. _____
<b>Plans / Options offered</b>	Plans: Direct , Regular Options: Dividend, Growth, Bonus etc.
<b>Dividend Policy</b>	
<b>Allotment</b>	<i>Mention, the procedure for allotment and dispatch of account statements/unit certificates. Indicate the time period.</i>

<b>Refund</b>	If application is rejected, full amount will be refunded within 6 weeks of closure of NFO. If refunded later than 6 weeks, interest @ 15 percent p.a. for delay period will be paid and charged to the AMC.
<b>Who can invest</b>  This is an indicative list and you are requested to consult your financial advisor to ascertain whether the scheme is suitable to your risk profile.	<i>Mention category of applicants, who are eligible to invest in the scheme. The AMC may also want to mention if there are any specific categories who are prohibited from investing in the scheme.</i>
<b>Who cannot invest</b>	
<b>Where can you submit the filled up applications.</b>	<i>Provide name, address and contact no. Of Registrar and Transfer Agent (R&amp;T), email id of R&amp;T, website address of R&amp;T, official points of acceptance, collecting banker details etc. on back cover page.</i>
<b>How to Apply</b>	Please refer to the SAI and Application form for the instructions.
<b>Listing</b>	<i>Mention, if applicable, the name of the Stock Exchange and the time frame by which the listing will be done.</i>
<b>Special Products / facilities available during the NFO</b>	<i>Briefly describe the facilities/products available. Facilities like: Systematic Investment Plan Systematic Transfer Plan Systematic Withdrawal Plan</i>
<b>The policy regarding reissue of repurchased units, including the maximum extent, the manner of reissue, the entity (the scheme or the AMC) involved in the same.</b>	
<b>Restrictions, if any, on the right to freely retain or dispose of units being offered.</b>	
<b>Cash Investments in mutual Funds</b>	
<b>Creation of Segregated Portfolio</b>	In case of a credit event at issuer level and to deal with liquidity risk, the AMC may create a segregated portfolio of debt and

	<p>money market instruments under the Scheme in compliance with the SEBI Circular No. SEBI/HO/IMD/DF2/CIR/P/2018/160 dated December 28, 2018, And SEBI Circular No. SEBI/HO/IMD/DF2/CIR/P/2019/12 dated November 07, 2019 as amended from time to time.</p>
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## B. ONGOING OFFER DETAILS

<p><b>Ongoing Offer Period</b></p> <p>This is the date from which the scheme will reopen for subscriptions/redemptions after the closure of the NFO period.</p>	<p>W.e.f ____ (date) or within ____ days of the date of Closure of the NFO.</p>
<p><b>Ongoing price for subscription/purchase)/ switch-in (from other schemes/plans of the mutual fund) by investors.</b></p> <p>This is the price you need to pay for purchase/switch-in.</p> <p><i>Example: If the applicable NAV is Rs. 10, entry load is 2 percent then sales price will be: Rs. 10* (1+0.02) = Rs. 10.20</i></p>	<p>At the applicable NAV subject to prevailing entry load</p>
<p><b>Ongoing price for redemption (sale) /switch outs (to other schemes/plans of the Mutual Fund) by investors.</b></p> <p>This is the price you will receive for redemptions/switch outs.</p> <p><i>Example: If the applicable NAV is Rs. 10, exit load is 2 percent then redemption price will be: Rs. 10* (1-0.02) = Rs. 9.80</i></p>	<p>At the applicable NAV, subject to prevailing exit load.</p>
<p><b>Cut off timing for subscriptions/ redemptions/ switches</b></p> <p>This is the time before which your application (complete in all respects) should reach the official points of acceptance.</p>	

<p><b>Where can the applications for purchase/redemption switches be submitted?</b></p>	<p><i>Provide the details of official points of acceptance, collecting banker details etc. on back cover page.</i></p>
<p><b>Minimum amount for purchase/redemption/switches</b></p>	
<p><b>Minimum balance to be maintained and consequences of non-maintenance.</b></p>	
<p><b>Special Products available</b></p>	<p><i>Systematic Investment Plan Systematic Transfer Plan Systematic Withdrawal Plan</i></p>
<p><b>Accounts Statements</b></p>	<p>For normal transactions (other than SIP/STP) during ongoing sales and repurchase:</p> <ul style="list-style-type: none"> <li>• The AMC shall issue to the investor whose application (other than SIP/STP) has been accepted, an account statement specifying the number of units allotted (state the service standard for the same)</li> <li>• For those unitholders who have provided an e-mail address, the AMC will send the account statement by e-mail.</li> <li>• The unitholder may request for a physical account statement by writing/calling the AMC/ISC/R&amp;T. (state procedure).</li> </ul> <p>For SIP / STP transactions:</p> <ul style="list-style-type: none"> <li>• Account Statement for SIP and STP will be despatched once every quarter ending March, June, September and December within 10 working days of the end of the respective quarter.</li> <li>• A soft copy of the Account Statement shall be mailed to the investors under SIP/STP to their e-mail address on a monthly basis, if so mandated.</li> <li>• However, the first Account Statement under SIP/STP shall be issued within 10 working days of the initial investment/transfer.</li> <li>• In case of specific request received from investors, Mutual Funds shall provide the account statement (SIP/STP) to the investors within 5 working days from the receipt of such request without any charges. Investors within 5 working</li> </ul>

	<p>days from the receipt of such request without any charges.</p> <p>Annual Account Statement:</p> <ul style="list-style-type: none"> <li>• The Mutual Funds shall provide the Account Statement to the Unitholders who have not transacted during the last six months prior to the date of generation of account statements. The Account Statement shall reflect the latest closing balance and value of the Units prior to the date of generation of the account statement.</li> <li>• The account statements in such cases may be generated and issued along with the Portfolio Statement or Annual Report of the Scheme.</li> <li>• Alternately, soft copy of the account statements shall be mailed to the investors' e-mail address, instead of physical statement, if so mandated.</li> </ul>
<b>Dividend</b>	The dividend warrants shall be dispatched to the unitholders within 30 days of the date of declaration of the dividend.
<b>Redemption</b>	The redemption or repurchase proceeds shall be dispatched to the unitholders within 10 working days from the date of redemption or repurchase.
<b>Delay in payment of redemption / repurchase proceeds</b>	The Asset Management Company shall be liable to pay interest to the unitholders at such rate as may be specified by SEBI for the period of such delay (presently @ 15 percent per annum).

### C. PERIODIC DISCLOSURES

<p><b>Net Asset Value</b></p> <p>This is the value per unit of the scheme on a particular day. You can ascertain the value of your investments by multiplying the NAV with your unit balance.</p>	<p><i>The Mutual Fund shall declare the Net asset value of the scheme on every business day on AMFI's website <a href="http://www.amfiindia.com">www.amfiindia.com</a> by (time limit for uploading NAV as per applicable guidelines) and also on their website.</i></p> <p><i>In case of open ended schemes, the NAV shall be calculated for all business days and released to the Press. In case of closed ended schemes, the NAV shall be calculated at least once a week</i></p>
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	<i>In case of Fund of Fund and investments in foreign securities, the applicable NAV disclosure policy may be indicated.</i>	
<b>Monthly/Half yearly Disclosures: Portfolio</b> This is a list of securities where the corpus of the scheme is currently invested. The market value of these investments is also stated in portfolio disclosures. <sup>84</sup>	<i>The mutual fund shall publish a complete statement of the scheme portfolio and unaudited financial results within one month from the close of each half year (i.e. Mar 31<sup>st</sup> and Sep 30<sup>th</sup>) by way of an advertisement atleast, in one national English daily and one regional newspaper where the head office of the mutual fund is located.</i>	
<b>Half yearly Financial Results</b>	<i>The mutual fund and AMC shall before the expiry of one month from the close of each half year, (Mar 31<sup>st</sup> and Sep 30<sup>th</sup>) publishes unaudited financial results in one national English daily newspaper and in a regional newspaper published in the language of the region where the head office of the mutual fund is situated.</i>	
<b>Annual Report</b>	<i>Scheme wise annual report or an abridged summary thereof shall be mailed to unitholders within six months from the date of closure of the relevant accounts year i.e. 31<sup>st</sup> March each year.</i>	
<b>Associate Transactions</b>	Please refer to Statement of Additional Information (SAI).	
<b>Taxation</b>  The information is provided for general information only. However, in view of the individual nature of the implications, each investor is advised to consult his or her own tax advisors / authorized dealers with respect to the specific amount of tax and other implications arising out of his or her participation in the schemes. (mention the tax rates as per the applicable tax laws)		
	<b>Retail Investors</b>	<b>Domestic Companies</b>
	Capital Gains: Long Term Short Term	

<sup>84</sup> SEBI has mandated mutual funds to disclose details of debt and money market securities transacted in their schemes portfolio, including inter-scheme transfers, on a daily basis with a time lag of 15 days in a prescribed format.

	Equity scheme will also attract securities transaction tax (STT) at applicable rates.
	<b>For further details on taxation please refer to the clause on Taxation in the SAI</b>
<b>Investor services</b>	<i>Name, address and telephone number and e-mail of the contact person/grievances officer who would take care of investor queries and complaints.</i>

#### **D. COMPUTATION OF NAV**

*Describe briefly the policies of the Mutual Fund with regard computation of NAV of the scheme in accordance with SEBI (Mutual Funds) Regulations, 1996.*

*Rounding off policy for NAV as per the applicable guidelines shall be disclosed.*

*Policy on computation of NAV in case of investment in foreign securities shall be disclosed.*

#### **IV. FEES AND EXPENSES**

This section outlines the expenses that will be charged to the schemes.

##### **A. NEW FUND OFFER (NFO) EXPENSES**

Details of source for meeting these expenses may be disclosed.

*These expenses are incurred for the purpose of various activities related to the NFO like sales and distribution fees paid marketing and advertising, registrar expenses, printing and stationary, bank charges, etc.*

## B. ANNUAL SCHEME RECURRING EXPENSES

*These are the fees and expenses for operating the scheme. These expenses include Investment Management and Advisory Fee charged by the AMC, Registrar and Transfer Agents' fee, marketing and selling costs etc. as given in the table below:*

*The AMC has estimated that upto \_\_\_\_\_ percent of the weekly average net assets of the scheme will be charged to the scheme as expenses (Give slab wise break up depending on the assets under management. Give plan/option wise break up if the expense structures are different). For the actual current expenses being charged, the investor should refer to the website of the mutual fund.*

Particulars	Percent of Net Assets	
	Retail Plan (the name of the plan as applicable)	Institutional Plan (the name of the plan as applicable)
Investment Management & Advisory Fee		
Custodial Fees		
Registrar & Transfer Agent Fees including cost related to providing accounts statement, dividend/redemption cheques/warrants etc.		
Marketing & Selling Expenses including Agents Commission and statutory advertisement		
Brokerage & Transaction Cost pertaining to the distribution of units		
Audit Fees / Fees and expenses of trustees		
Costs related to investor communications		
Costs of fund transfer from location to location		
Other Expenses*		
Total Recurring Expenses		

(\* To be specified as permitted under the Regulation 52 of SEBI (MF) Regulations)

These estimates have been made in good faith as per the information available to the Investment Manager based on past experience and are subject to change inter-se. Types of expenses charged shall be as per the SEBI (MF) Regulations. *(The regulatory limits on Annual Recurring Expenses and Investment Management & Advisory fees in terms of Regulation 52 shall be disclosed).*

*The mutual fund would update the current expense ratios on the website at least three working days prior to the effective date of the change. Additionally, AMCs shall provide the exact weblink of the heads under which TER is disclosed in their website*

### C. LOAD STRUCTURE

*Load is an amount which is paid by the investor to subscribe to the units or to redeem the units from the scheme. This amount is used by the AMC to pay commissions to the distributor and to take care of other marketing and selling expenses. Load amounts are variable and are subject to change from time to time. For the current applicable structure, please refer to the website of the AMC (www.-----) or may call at (toll free no.) or your distributor.*

Type of Load	Load chargeable (as percentage of NAV)
Entry	
Exit *	

*\* The load may be applicable on other types of transactions such as Dividend Reinvestment, Switch in/out, SIP/SWP/STP (which shall be disclosed in the table above as applicable)*

Load exemptions, if any:

Bonus units and units issued on reinvestment of dividends shall not be subject to entry and exit load.

All loads including Contingent Deferred Sales Charge (CDSC) for the Scheme shall be maintained in a separate account and may be utilised towards meeting the selling and distribution expenses. Any surplus in this account may be credited to the scheme, whenever felt appropriate by the AMC.

The investor is requested to check the prevailing load structure of the scheme before investing.

For any change in load structure AMC will issue an addendum and display it on the website/Investor Service Centres.

*Note: Wherever quantitative discounts are involved the following shall be disclosed – The Mutual Fund may charge the load within the stipulated limit of 7 percent and without any discrimination to any specific group of unit holders. However, any change at a later stage shall not affect the existing unit holders adversely.*

#### **D. WAIVER OF LOAD FOR DIRECT APPLICATIONS/TRANSACTIONS**

*Disclose detailed procedure for direct applications as per the applicable SEBI guidelines in order to provide the waiver of load to the investors.*

#### **E. TRANSACTION CHARGES**

#### **V. RIGHTS OF UNITHOLDERS**

Please refer to SAI for details.

#### **VI. PENALTIES, PENDING LITIGATION OR PROCEEDINGS, FINDINGS OF INSPECTIONS OR INVESTIGATIONS FOR WHICH ACTION MAY HAVE BEEN TAKEN OR IS IN THE PROCESS OF BEING TAKEN BY ANY REGULATORY AUTHORITY**

*This section shall contain the details of penalties, pending litigation, and action taken by SEBI and other regulatory and Govt. Agencies.*

*All disclosures regarding penalties and action(s) taken against foreign Sponsor(s) may be limited to the jurisdiction of the country where the principal activities (in terms of income / revenue) of the Sponsor(s) are carried out or where the headquarters of the Sponsor(s) is situated. Further, only top 10 monetary penalties during the last three years shall be disclosed.*

*In case of Indian Sponsor(s), details of all monetary penalties imposed and/or action taken during the last three years or pending with any financial regulatory body or governmental authority, against Sponsor(s) and/ or the AMC and/ or the Board of Trustees /Trustee Company; for irregularities or for violations in the financial services sector, or for defaults with respect to shareholders or debenture holders and depositors, or for economic offences, or for violation of*

<p><i>securities law. Details of settlement, if any, arrived at with the aforesaid authorities during the last three years shall also be disclosed.</i></p>	
<p><i>Details of all enforcement actions taken by SEBI in the last three years and/ or pending with SEBI for the violation of SEBI Act, 1992 and Rules and Regulations framed there under including debarment and/ or suspension and/ or cancellation and/ or imposition of monetary penalty/adjudication/enquiry proceedings, if any, to which the Sponsor(s) and/ or the AMC and/ or the Board of Trustees /Trustee Company and/ or any of the directors and/ or key personnel (especially the fund managers) of the AMC and Trustee Company were/ are a party. The details of the violation shall also be disclosed.</i></p>	
<p><i>Any pending material civil or criminal litigation incidental to the business of the Mutual Fund to which the Sponsor(s) and/ or the AMC and/ or the Board of Trustees /Trustee Company and/ or any of the directors and/ or key personnel are a party should also be disclosed separately.</i></p>	
<p><i>Any deficiency in the systems and operations of the Sponsor(s) and/ or the AMC and/ or the Board of Trustees/Trustee Company which SEBI has specifically advised to be disclosed in the SID, or which has been notified by any other regulatory agency, shall be disclosed.</i></p>	

## Appendix 5: Format of Statement of Additional Information (SAI)<sup>85</sup>

This Statement of Additional Information (SAI) contains details of \_\_\_\_\_ Mutual Fund, its constitution, and certain tax, legal and general information. It is incorporated by reference (is legally a part of the Scheme Information Document).

Name of the Mutual Fund	
Name of the Asset Management Company	
Name of the Trustee Company	
Address and Website of the above entities	

Please retain this SAI for future reference. Before investing, investor should also ascertain about any further changes in this SAI after the date of SAI from \_\_\_\_\_ InvestorServiceCenters("ISCs")/website/distributors or brokers.

This SAI is dated \_\_\_\_\_.

### TABLE OF CONTENTS:

#### I. INFORMATION ABOUT SPONSOR, AMC AND TRUSTEE COMPANIES

##### A. Constitution of the Mutual Fund

ABC (the "Mutual Fund") has been constituted as a trust on \_\_\_\_\_ in accordance with the provisions of the Indian Trusts Act, 1882 (2 of 1882) with XYZ, as the Sponsor and DEF as the Trustee. The Trust Deed has been registered under the Indian Registration Act, 1908. The Mutual Fund was registered with SEBI on \_\_\_\_\_ under Registration Code MF-

##### B. Sponsor

ABC Mutual Fund is sponsored by XYZ. The Sponsor is the Settler of the Mutual Fund Trust. The Sponsor has entrusted a sum of Rs. \_\_\_\_\_ to the Trustee as the initial contribution towards the corpus of the Mutual Fund.

Financial Performance of the Sponsor (past three years):

Particular	Year 1	Year 2	Year 3
Net Worth			
Total Income			
Profit After Tax			

<sup>85</sup> The wordings in italics is explanatory commentary/instructions.

Particular	Year 1	Year 2	Year 3
Assets under Management (if applicable)			

### C. The Trustee

DEF (the "Trustee"), through its Board of Directors, shall discharge its obligations as trustee of the ABC Mutual Fund. The Trustee ensures that the transactions entered into by the AMC are in accordance with the SEBI Regulations and will also review the activities carried on by the AMC.

Details of Trustee Directors:

Name	Age/Qualification	Brief Experience
PQR	45/CA	PQR is a fellow member of the Institute of Chartered Accountant and is in practice from 1978. He is a Senior Partner with a firm of Chartered Accountants in India. He is also a director on the Board of various companies and trustee of charitable institutions

*State the responsibilities and duties of the Trustee as well as the specific and general due diligence.*

### D. Asset Management Company

STP Ltd. is a private limited company incorporated under the Companies Act, 1956 on, having its Registered Office at \_\_\_\_\_.

STP Ltd. has been appointed as the Asset Management Company of the ----- Mutual Fund by the Trustee vide Investment Management Agreement (IMA) dated, and executed between DEF and STP.

Shareholding Pattern of the AMC:

Shareholder	Type of Holding	No. of Shares Held	% of Shareholding

Details of AMC Directors:

Name	Age/Qualification	Brief Experience

UVT	45/CA	UVT is a fellow member of the Institute of Chartered Accountant and is in practice from 1978. He is a Senior Partner with a firm of Chartered Accountants in India. He is also a director on the Board of various companies and trustee of charitable institutions

#### Duties and obligations of AMC

*State the Duties and obligation of the AMC as specified in the SEBI Mutual Fund Regulations on [www.sebi.gov.in](http://www.sebi.gov.in).*

#### Information on Key Personnel:

Name/Designation	Age/Qualification	Brief Experience
CEO		
CIO		
Operations Head		
Compliance Officer		
Sales Head		
Risk Manager		
Investor Relations Officer		

*(The AMC may decide on the key personnel it wants to mention in the SAI in addition to the persons mentioned above.)*

All the key personnel are based at the Registered Office of AMC in \_\_\_\_\_.

Procedure and Recording of Investment Decisions:

#### E. Service providers

##### **Custodian**

Name, Address and SEBI Registration Number of the Custodian for the scheme

### Transfer agent

Name and principal business address of the Registrars, Transfer Agents and the dividend paying agent. A statement to the effect that the Board of the Trustees and the AMC have ensured that the Registrar has adequate capacity to discharge responsibilities with regard to processing of applications and dispatching unit certificates to unitholders within the time limit prescribed in the Regulations and also has sufficient capacity to handle investor complaints. Also state the SEBI Registration Number of Registrars, Transfer Agents.

### Statutory auditor

Name and Address of the statutory auditor for Mutual Fund

### Legal counsel

Name and Address of the Legal Counsel

### Fund Accountant

Name and Address of the fund accountant

### Collecting Bankers

Name, Address and SEBI Registration Number

**F. Condensed financial information (CFI) for all the schemes launched by MF during the last three fiscal years (excluding redeemed schemes) in the format given below:**

HISTORICAL PER UNIT STATISTICS	SCHEME NAME		
	YR. 1	YR. 2	YR. 3
NAV at the beginning of the year (as on April 1)			
Dividends*			
Annualised return** NAV at the end of the year(as onMarch31)			
Net assets end of period (Rs. Crs)			
Ratio of recurring expenses to net assets Net Assets end of period(Rs.Crs.)			

\*Excluding dividend details of liquid scheme.

\*\*Only for growth option. Explanation to be given for not providing annualised return for options other than growth option. Absolute returns to be provided for schemes less than one year.

## II. HOW TO APPLY?

*Describe briefly the manner in which the units of the scheme being offered under the scheme information document may be purchased by the prospective investor. The descriptions should emphasise the procedures to be followed. Also provide the details of KYC requirement for unit holders.*

## III. RIGHTS OF UNITHOLDERS OF THE SCHEME

1. Unitholders of the Scheme have a proportionate right in the beneficial ownership of the assets of the Scheme.
2. When the Mutual Fund declares a dividend under the Scheme, the dividend warrants shall be despatched within 30 days of the declaration of the dividend. Account Statement reflecting the new or additional subscription as well as Redemption/Switch of Units shall be despatched to the Unitholder within 10 business days of the Specified Redemption Date. Provided if a Unitholder so desires, the Mutual Fund shall issue a Unit certificate (non-transferable) within 30 days of the receipt of request for the certificate.
3. The Mutual Fund shall dispatch Redemption proceeds within 10 Business Days of receiving the Redemption request.
4. The Trustee is bound to make such disclosures to the Unitholders as are essential in order to keep the unitholders informed about any information known to the Trustee which may have a material adverse bearing on their investments.
5. The appointment of the AMC for the Mutual Fund can be terminated by majority of the Directors of the Trustee Board or by 75 percent of the Unitholders of the Scheme.
6. 75 percent of the Unitholders of a Scheme can pass a resolution to wind-up a Scheme.
7. The Trustee shall obtain the consent of the Unitholders:
  - whenever required to do so by SEBI, in the interest of the Unitholders.
  - whenever required to do so if a requisition is made by three-fourths of the unitholders of the Scheme.
  - when the Trustee decides to windup the Scheme or prematurely redeem the Units.
8. The Trustee shall ensure that no change in the fundamental attributes of any Scheme or the trust or fees and expenses payable or any other change which would modify the Scheme and affects the interest of Unitholders, shall be carried out unless:
  - (i) a written communication about the proposed change is sent to each Unit holder and an advertisement is given in one English daily newspaper having nationwide circulation as well as in a newspaper published in the language of the region where the Head Office of the Mutual Fund is situated; and
  - (ii) the Unitholders are given an option to exit at the prevailing Net Asset Value without any Exit Load.
9. In specific circumstances, where the approval of unitholders is sought on any matter, the same shall be obtained by way of a postal ballot or such other means as may be approved by SEBI.

#### IV. INVESTMENT VALUATION NORMS FOR SECURITIES AND OTHER ASSETS

*This section shall disclose the Valuation of Assets and properties of the scheme in accordance with Eighth Schedule of Regulation 47 of SEBI (Mutual Funds) Regulations, 1996 and applicable guidelines.*

*Real Estate Mutual Fund Schemes shall disclose Valuation of Assets and properties of the scheme in accordance with Schedule IXB of Regulation 49 (F) (1) of SEBI (Mutual Funds) Regulations, 1996 and applicable guidelines.*

##### A. Equity and Equity Related Securities:

<b>Asset Class</b>	<b>Traded / Not Traded / Thinly Traded/ Listed / Unlisted</b>	<b>Valuation Methodology</b>

##### B. Fixed Income and Related Securities:

<b>Asset Class</b>	<b>Traded / Not Traded / Thinly Traded/ Listed / Unlisted</b>	<b>Valuation Methodology</b>

##### C. Mutual Fund Units, ETFs And Gold

<b>Asset Class</b>	<b>Traded / Not Traded / Thinly Traded/ Listed / Unlisted</b>	<b>Valuation Methodology</b>

##### D. Inter Scheme Transfer

<b>Asset Class</b>	<b>Traded / Not Traded / Thinly Traded/ Listed / Unlisted</b>	<b>Valuation Methodology</b>

#### V. TAX & LEGAL & GENERAL INFORMATION

##### A. Taxation on investing in Mutual Funds

*This section shall disclose the applicable tax provisions for Mutual Fund and for investments in Mutual Fund scheme.*

1. Tax Benefits/Consequences to the Mutual Fund
2. Tax Benefits / Consequences to Unit holders

## B. Legal Information

*This section may include information on Nomination Facility, KYC Requirements, Requirements of Prevention of Money Laundering Act, Transfer and transmission of units, Duration of the scheme/Winding up, Procedure and manner of winding up etc.*

## C. General Information

*In addition to the following, this section may include information on Underwriting, Securities Lending and Borrowing by the Mutual Funds etc.:*

### **Inter-Scheme Transfer of Investments:**

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. *Explanation:* "spot basis" shall have same meaning as specified by stock exchange for spot transactions.
- (b) the securities so transferred shall be in conformity with the investment objective of the scheme to which such transfer has been made.
- (c) Transfers of unquoted securities will be as per the policy laid down by the Trustee from time to time

### **Associate Transactions**

*The following disclosures, summarising historical information pertaining to the last three fiscal years of the schemes of the Mutual Fund under the management of the Asset Management Company reflecting associate transactions and the manner in which such transactions affected the performance of schemes of the Mutual Fund should be made. The disclosures shall include any underwriting obligations undertaken by the schemes of the Mutual Fund with respect to issues of associate companies, devolvement if any, of such commitments, subscription by the schemes in issues lead managed by associate companies, total business given to associate brokers and the percentage of brokerage commission paid to them and any distribution of units performed by associate companies.*

*This section shall also disclose:*

- (a) the policy for investing in group companies of the sponsor of a Mutual Fund that is followed/to be followed by the Mutual Fund, including the aggregate market value of investments in group companies of the Sponsor and asset Management Company by all the schemes of the Mutual Fund and its percentage of the aggregate net asset value of the Mutual Fund,*
- (b) in case any scheme of the Mutual Fund has invested more than 25 percent of its net assets in group companies, this shall be disclosed.*
- (c) names of associates of the Sponsor or the Asset Management Company with which the Mutual Fund proposes to have dealings, transactions and those whose services may be used for marketing and distributing the scheme and the commissions that may be paid to them.*

### **Documents Available for Inspection**

The following documents will be available for inspection at the office of the Mutual Fund at \_\_\_\_\_ during business hours on day (excluding Saturdays, Sundays and public holidays):

- Memorandum and Articles of Association of the AMC
- Investment Management Agreement
- Trust Deed and amendments thereto, if any
- Mutual Fund Registration Certificate
- Agreement between the Mutual Fund and the Custodian
- Agreement with Registrar and Share Transfer Agents
- Consent of Auditors to act in the said capacity
- Consent of Legal Advisors to act in the said capacity
- Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 and amendments from time to time thereto.
- Indian Trusts Act, 1882.

### **Investor Grievances Redressal Mechanism**

*Describe briefly the investors' complaints history for the last three fiscal years of existing schemes and the redressal mechanism thereof. The SAI should include data updated every two months on the number of complaints received, redressed and pending with the Mutual Fund.*

***Stock Lending by the Mutual Fund***

***Borrowing by the Mutual Fund***

***Amount set-off***

***Unclaimed Redemption/Dividend Amount***

***Underwriting by the Mutual Fund***

**Notwithstanding anything contained in this Statement of Additional Information, the provisions of the SEBI (Mutual Funds) Regulations, 1996 and the guidelines thereunder shall be applicable.**

***Instruction:*** A Mutual Fund is free to add any other disclosure, which in the opinion of the Trustees of the Mutual Fund (Trustees) or the Asset Management Company (AMC) is material, provided that such information is not presented in an incomplete, inaccurate or misleading manner. Care should be taken to ensure that inclusion of such information does not, by virtue of its nature, or manner of presentation, obscure or impede understanding of any information that is required to be included under the Scheme Information Document and Statement of Additional Information.

## Appendix 6: Format of Key Information Memorandum

Name of AMC & MF

(Type of scheme)

### KEY INFORMATION MEMORANDUM

----- Scheme

( ----- )

The Mutual Fund shall specify the scheme's suitability to investors:

\* Investors should consult their financial advisers if in doubt about whether the product is suitable for them.

***Mutual funds shall disclose the product labelling of the scheme depending upon the level of risk in the mutual fund scheme***



**Offer for Units of Rs. -- Per Unit for cash during the  
New fund Offer Period and at NAV based prices upon re-opening**

**New Fund Offer Opens on:**

**New Fund Offer Closes on:**

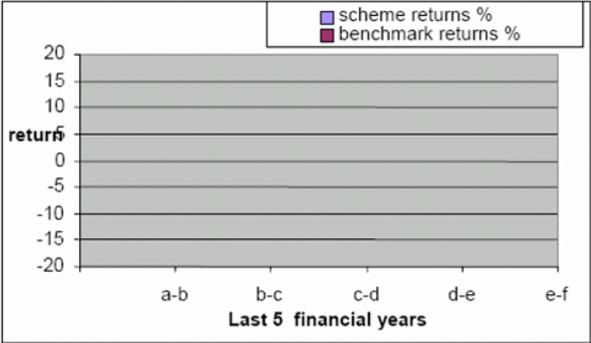
**Scheme Re-opens for continuous sale and repurchase on:**

This Key Information Memorandum (KIM) sets forth the information, which a prospective investor ought to know before investing. For further details of the scheme/Mutual Fund, due diligence certificate by the AMC, Key Personnel, investors' rights & services, risk factors, penalties & pending litigations etc. investors should, before investment, refer to the Scheme Information Document and Statement of Additional Information available free of cost at any of the Investor Service Centres or distributors or from the website [www. -----](http://www.-----).

The Scheme particulars have been prepared in accordance with Securities and Exchange Board of India (Mutual Funds) Regulations 1996, as amended till date, and filed with Securities and Exchange Board of India (SEBI). The units being offered for public subscription have not been approved or disapproved by SEBI, nor has SEBI certified the accuracy or adequacy of this KIM.

This KIM is dated \_\_\_\_\_.

<b>Name of Mutual Fund</b>			
<b>Name of Asset Management Company</b>			
<b>Addresses, Website of the entities</b>			
<b>Name of the Scheme</b>			
<b>Type of Scheme</b>			
<b>Investment Objective</b>			
<b>Asset Allocation Pattern of the scheme</b>	Types of Instruments	Normal Allocation ( percent of Net Assets)	
<b>Risk Profile of the Scheme</b>	Mutual Fund Units involve investment risks including the possible loss of principal. Please read the SID carefully for details on risk factors before investment. Scheme specific Risk Factors are summarized below:		
<b>Risk Mitigation Factors</b>			
<b>Investment Strategy</b>			
<b>How the scheme is different from the existing open ended schemes of the Mutual fund?</b>			
<b>Plans and Options</b>			
<b>Applicable NAV (after the scheme opens for repurchase and sale)</b>			
<b>Minimum Application Amount/ Number of Units</b>	Purchase	Additional Purchase	Repurchase
<b>Despatch of Repurchase (Redemption) Request</b>	Within 10 working days of the receipt of the redemption request at the authorised centre of the ----- Fund.		
<b>Benchmark Index</b>			
<b>Dividend Policy</b>			
<b>Name of the Fund Manager</b>			
<b>Name of the Trustee Company</b>			
<b>Performance of the scheme :</b>  [In case of a new scheme, the statement should be given "This scheme does not have any performance	Compounded Annualised Returns	Scheme Returns percent	Benchmark Returns percent
	Returns for the last 1 year		
	Returns for the last 3 years		

<p>track record”] Or [In case of a scheme in existence, the return figures shall be given for that scheme only, for a scheme which is in existence for more than 1 year, the returns given will be Compounded Annualised.</p> <p>Returns for scheme which is in existence for less than 1 year, the returns would be absolute returns since inception. Absolute returns for each financial year for the last 5 years shall be represented by means of a bar diagram as per the adjacent format.]</p>	Returns for the last 5 years	
	Returns since inception	
	<p>Absolute Returns for each financial year for the last 5 yearsDT</p> 	
<b>Additional Scheme Related Disclosures</b>		
<b>Portfolio Disclosures</b>		
<b>Expenses of the Scheme</b>	<b>New Fund Offer Period</b>	<b>Continuous Offer</b>
<b>(i) Load Structure</b>	<p>Entry load :</p> <p>Exit load :</p> <p>CDSC (if any):</p>	<p>Entry load :</p> <p>Exit load :</p> <p>CDSC (if any):</p>
<b>(ii) Recurring expenses</b>	<p>First Rs. 100 crores of the average weekly net assets :</p> <p>Next Rs. 300 crores of the average weekly net assets :</p> <p>Next Rs. 300 crores of the average weekly net assets :</p> <p>Balance :</p>	<p>Actual expenses for the previous financial year: ---- (Not Applicable in case of a new scheme)</p>
<b>Transaction Charges</b>		
<b>Waiver of Load for Direct Applications</b>	The applicable procedure should be given in brief.	

<b>Tax treatment for the Investors (Unitholders)</b>	Investor will be advised to refer to the details in the Statement of Additional Information and also independently refer to his tax advisor.	
<b>Daily Net Asset Value (NAV) Publication</b>	The NAV will be declared on all ----- days on the respective AMC's and AMFI websites. NAV can also be viewed on <a href="http://www.____">www.____</a> and <a href="http://www.amfiindia.com">www.amfiindia.com</a> [You can also telephone us at ----- (optional)].	
<b>For Investor Grievances please contact</b>	Name and Address of Registrar	Name, address, telephone number, fax number, e-mail id -----
<b>Non-acceptance of Third Party Cheques</b>		
<b>Unitholders' Information</b>	Give the frequency and the policy of the fund house for the providing the Accounts Statement, Annual Financial results and Half yearly portfolio to the investors.	
<b>Liquidity</b>		
<b>Application supported by blocked amount (ASBA) facility</b>		
<b>Disclosure as per SEBI circular</b>		

**Date:**

**N.B. Data and information shall be up-to-date but in no case older than 30 days from the date of KIM**

# Appendix 7: KYC Form for Individual

CKYC & KRA KYC FORM									
<p><b>Know Your Client (KYC)</b>  <b>Application Form (For Individuals only)</b>                      (Please fill the form in English and in BLOCK Letters)                      Fields marked with "*" are mandatory fields</p>	<p style="text-align: right;">  </p> <p>Application Type* <input type="checkbox"/> New  <input type="checkbox"/> Update KYC Number* <input style="width: 100px;" type="text"/></p> <p>KYC Type* <input type="checkbox"/> Normal (PAN is mandatory) <input type="checkbox"/> PAN Exempt Investors (Refer instruction K)</p>								
<p><input type="checkbox"/> <b>1. Identity Details</b> (Please refer instruction A at the end)</p>									
<p>PAN <input style="width: 100px;" type="text"/> Please enclose a duly attested copy of your PAN Card</p>									
<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <th style="width: 10%;">Prefix</th> <th style="width: 30%;">First Name</th> <th style="width: 30%;">Middle Name</th> <th style="width: 30%;">Last Name</th> </tr> <tr> <td><input style="width: 100%;" type="text"/></td> <td><input style="width: 100%;" type="text"/></td> <td><input style="width: 100%;" type="text"/></td> <td><input style="width: 100%;" type="text"/></td> </tr> </table>		Prefix	First Name	Middle Name	Last Name	<input style="width: 100%;" type="text"/>			
Prefix	First Name	Middle Name	Last Name						
<input style="width: 100%;" type="text"/>	<input style="width: 100%;" type="text"/>	<input style="width: 100%;" type="text"/>	<input style="width: 100%;" type="text"/>						
<p>Name* (same as ID proof) <input style="width: 100%;" type="text"/></p> <p>Maiden Name (If any*) <input style="width: 100%;" type="text"/></p> <p>Father / Spouse Name* <input style="width: 100%;" type="text"/></p> <p>Mother Name <input style="width: 100%;" type="text"/></p> <p>Date of Birth* <input style="width: 100%;" type="text"/></p> <p>Gender* <input type="checkbox"/> M- Male <input type="checkbox"/> F- Female <input type="checkbox"/> T-Transgender</p> <p>Marital Status* <input type="checkbox"/> Married <input type="checkbox"/> Unmarried <input type="checkbox"/> Others</p> <p>Citizenship* <input type="checkbox"/> IN- Indian <input type="checkbox"/> Others – Country <input style="width: 100px;" type="text"/> Country Code <input style="width: 20px;" type="text"/></p> <p>Residential Status* <input type="checkbox"/> Resident Individual <input type="checkbox"/> Non Resident Indian  <input type="checkbox"/> Foreign National <input type="checkbox"/> Person of Indian Origin</p> <p>Occupation Type* <input type="checkbox"/> S-Service (<input type="checkbox"/> Private Sector <input type="checkbox"/> Public Sector <input type="checkbox"/> Government Sector)  <input type="checkbox"/> O-Others (<input type="checkbox"/> Professional <input type="checkbox"/> Self Employed <input type="checkbox"/> Retired <input type="checkbox"/> Housewife <input type="checkbox"/> Student)  <input type="checkbox"/> B-Business <input type="checkbox"/> X-Not Categorised</p> <div style="text-align: right;">  <p>Photo</p> <p>Signature/Thumb Impression</p> </div>									
<p><input type="checkbox"/> <b>2. Proof of Identity (PoI)*</b> (for PAN exempt Investor or if PAN card copy not provided) (Please refer instruction C &amp; K at the end)                      (Certified copy of <u>any one</u> of the following Proof of Identity [PoI] needs to be submitted)</p>									
<p><input type="checkbox"/> A- Passport Number <input style="width: 100px;" type="text"/> Passport Expiry Date <input style="width: 100px;" type="text"/></p> <p><input type="checkbox"/> B- Voter ID Card <input style="width: 100px;" type="text"/></p> <p><input type="checkbox"/> D- Driving Licence <input style="width: 100px;" type="text"/> Driving Licence Expiry Date <input style="width: 100px;" type="text"/></p> <p><input type="checkbox"/> F- NREGA Job Card <input style="width: 100px;" type="text"/></p> <p><input type="checkbox"/> Z- Others (any document notified by the central government) <input style="width: 100px;" type="text"/> Identification Number <input style="width: 100px;" type="text"/></p>									
<p><b>3. Proof of Address (PoA)*</b></p>									
<p><input type="checkbox"/> <b>3.1 Current / Permanent / Overseas Address Details</b> (Please see instruction D at the end)</p>									
<p><b>Address</b></p> <p>Line 1* <input style="width: 100%;" type="text"/></p> <p>Line 2 <input style="width: 100%;" type="text"/></p> <p>Line 3 <input style="width: 100%;" type="text"/> City / Town / Village*</p> <p>District* <input style="width: 100px;" type="text"/> Zip / Post Code* <input style="width: 100px;" type="text"/> State/UT Code <input style="width: 20px;" type="text"/> as per Indian Motor Vehicle Act, 1988</p> <p>State/UT* <input style="width: 100px;" type="text"/> Country* <input style="width: 100px;" type="text"/> Country Code <input style="width: 20px;" type="text"/> as per ISO 3166</p> <p>Address Type* <input type="checkbox"/> Residential / Business <input type="checkbox"/> Residential <input type="checkbox"/> Business <input type="checkbox"/> Registered Office <input type="checkbox"/> Unspecified</p> <p>(Certified copy of <u>any one</u> of the following Proof of Address [PoA] needs to be submitted)</p> <p>Proof of Address*</p> <p><input type="checkbox"/> Passport Number <input style="width: 100px;" type="text"/> Passport Expiry Date <input style="width: 100px;" type="text"/></p> <p><input type="checkbox"/> Voter ID Card <input style="width: 100px;" type="text"/></p> <p><input type="checkbox"/> Driving Licence <input style="width: 100px;" type="text"/> Driving Licence Expiry Date <input style="width: 100px;" type="text"/></p> <p><input type="checkbox"/> Aadhaar Card <input style="width: 100px;" type="text"/> Aadhaar Number to be fully masked / redact / blackedout</p> <p><input type="checkbox"/> NREGA Job Card <input style="width: 100px;" type="text"/></p> <p><input type="checkbox"/> Others (any document notified by the central government) <input style="width: 100px;" type="text"/> Identification Number <input style="width: 100px;" type="text"/></p>									
<p><input type="checkbox"/> <b>3.2 Correspondence / Local Address Details*</b> (Please see instruction E at the end)</p>									
<p><input type="checkbox"/> Same as Current / Permanent / Overseas Address details (In case of multiple correspondence / local addresses, please fill 'Annexure A1'. Submit relevant documentary proof)</p> <p>Line 1* <input style="width: 100%;" type="text"/></p> <p>Line 2 <input style="width: 100%;" type="text"/></p> <p>Line 3 <input style="width: 100%;" type="text"/> City / Town / Village*</p> <p>District* <input style="width: 100px;" type="text"/> Zip / Post Code* <input style="width: 100px;" type="text"/> State/UT Code <input style="width: 20px;" type="text"/> as per Indian Motor Vehicle Act, 1988</p> <p>State/UT* <input style="width: 100px;" type="text"/> Country* <input style="width: 100px;" type="text"/> Country Code <input style="width: 20px;" type="text"/> as per ISO 3166</p>									

**4. Contact Details** (All communications will be sent on provided Mobile no. / Email-ID) (Please refer instruction **F** at the end)

Email ID   
Mobile  Tel. (Off)  Tel. (Res)

**6. FATCA/CRS Information** (Tick if Applicable)  Residence for Tax Purposes in Jurisdiction(s) Outside India (Please refer instruction **B** at the end)

Additional Details Required\* (Mandatory only if above option (5) is ticked)  
Country of Jurisdiction of Residence\*  Country Code of Jurisdiction of Residence  as per ISO 3166  
Tax Identification Number or equivalent (If issued by jurisdiction)\*   
Place / City of Birth\*  Country of Birth\*  Country Code  as per ISO 3166  
Address  
Line 1\*   
Line 2   
Line 3  City / Town / Village\*   
District\*  Zip / Post Code\*  State/UT Code  as per Indian Motor Vehicle Act, 1988  
State/UT\*  Country\*  Country Code  as per ISO 3166

**6. Details of Related Person** (Optional) (please refer instruction G at the end) (in case of additional related persons, please fill 'Annexure B1')

Addition of Related Person  Deletion of Related Person KYC Number of Related Person (if available)\*

Related Person Type\*  Guardian of Minor  Assignee  Authorized Representative  
Name\*  Prefix  First Name  Middle Name  Last Name   
(If KYC number and name are provided, below details of section 6 are optional)

Proof of Identity [PoI] of Related Person\* (Please see instruction (H) at the end)

(Certified copy of any one of the following Proof of Identity[PoI] needs to be submitted)

A- Passport Number  Passport Expiry Date   
 B- Voter ID Card   
 C- PAN Card   
 D- Driving Licence  Driving Licence Expiry Date   
 F- NREGA Job Card   
 Z- Others (any document notified by the central government)  Identification Number

**7. Remarks (If any)**

**8. Applicant Declaration**

I hereby declare that the details furnished above are true and correct to the best of my knowledge and belief and I undertake to inform you of any changes therein, immediately. In case any of the above information is found to be false or untrue or misleading or misrepresenting, I am aware that I may be held liable for it. I hereby declare that I am not making this application for the purpose of contravention of any Act, Rules, Regulations or any statute of legislation or any notifications/directions issued by any governmental or statutory authority from time to time.

I hereby consent to receiving information from Central KYC Registry through SMS/Email on the above registered number/email address.

Date:  Place:

[Signature / Thumb Impression]  
  
Signature / Thumb Impression of Applicant

**9. Attestation / For Office Use Only**

**Documents Received**  Certified Copies

**KYC Verification Carried Out by (Refer Instruction I)\***  
Date   
Emp. Name   
Emp. Code   
Emp. Designation   
  
[Employee Signature]

**Institution Details**  
Name   
Code   
Emp. Branch   
  
[Institution Stamp]

**In-Person Verification (IPV) Carried Out by (Refer Instruction J)\***  
Date   
Emp. Name   
Emp. Code   
Emp. Designation   
  
[Employee Signature]

**Institution Details**  
Name   
Code   
Emp. Branch   
  
[Institution Stamp]

## Instructions/Guidelines for filling Individual KYC Application Form

### General Instructions:

1. Self-Certification of documents is mandatory.
2. KYC number of applicant is mandatory for update/change of KYC details.
3. For particular section update, please tick (✓) in the box available before the section number and strike off the sections not required to be updated.
4. Copies of all documents that are submitted need to be compulsorily self-attested by the applicant and accompanied by originals for verification. In case the original of any document is not produced for verification, then the copies should be properly attested by entities authorized for attesting the documents, as per the list mentioned under [I].
5. If any proof of identity or address is in a foreign language, then translation into English is required duly attested by the official mentioned in Point I 4
6. Name & address of the applicant mentioned on the KYC form, should match with the documentary proof submitted.
7. If correspondence & permanent addresses are different, then proofs for both have to be submitted.
8. Sole proprietor must make the application in his individual name & capacity.
9. For non-residents and foreign nationals, (allowed to trade subject to RBI and FEMA guidelines), copy of passport/PIOCard/OCICard and overseas address proof is mandatory.
10. In case of Merchant Navy NRI's, Mariner's declaration or certified copy of CDC (Continuous Discharge Certificate) is to be submitted.
11. For opening an account with Depository participant or Mutual Fund, for a minor, photocopy of the School Leaving Certificate/Mark sheet issued by Higher Secondary Board/ Passport of Minor/Birth Certificate must be provided.

### A. Clarification / Guidelines on filling 'Identity Details' section

1. **Name:** Please state the name with Prefix (Mr/Mrs/Ms/Dr/etc.). The name as mentioned in this (KYC application) form should match the name as mentioned in the Proof of Identity submitted failing which the application is liable to be rejected.
2. Either father's name or spouse's name is to be mandatorily furnished. In case PAN is not available father's name is mandatory.

### B. Clarification/Guidelines on filling details if applicant residence for tax purposes in jurisdiction(s) outside India

1. **Tax identification Number (TIN):** TIN need not be reported if it has not been issued by the jurisdiction. However, if the said jurisdiction has issued a high integrity number with an equivalent level of identification (a "Functional equivalent"), the same may be reported. Examples of that type of number for individual include, a social security/insurance number, citizen/personal identification/services code/number, and resident registration number)

### C. Clarification / Guidelines on filling 'Proof of Identity [PoI]' section, if PAN Card copy is not enclosed/For PAN exempt Investors

1. If driving license number or passport is provided as proof of identity then expiry date is to be mandatorily furnished.
2. Mention identification / reference number if 'Z - Others (any document notified by the central government)' is ticked.
3. Others - Identity card with applicant's photograph issued by any of the following: Central/ State Government Departments, Statutory/Regulatory Authorities, Public Sector Undertakings, Scheduled Commercial Banks, Public Financial Institutions, Colleges affiliated to Universities, Professional Bodies such as ICAI, ICWAI, ICSI, Bar Council, etc., to their Members; and Credit cards/Debit cards issued by Banks.
4. Letter issued by a gazetted officer, with a duly attested photograph of the person.

### D. Clarification / Guidelines on filling 'Proof of Address [PoA] - Current / Permanent / Overseas Address Details section

1. PoA to be submitted only if the submitted PoI does not have an address or address as per PoI is invalid or not in force.
2. State / U.T Code and Pin / Post Code will not be mandatory for Overseas addresses.
3. Others includes - Utility bill which is not more than two months old of any service provider (electricity, telephone, post-paid mobile phone, piped gas, water bill); Bank account or Post Office savings bank account statement; Documents issued by Government departments of foreign jurisdictions and letter issued by Foreign Embassy or Mission in India; Identity card with applicant's photograph and address issued by any of the following: Central/ State Government Departments, Statutory/Regulatory Authorities, Public Sector Undertakings, Scheduled Commercial Banks, Public Financial Institutions, Colleges affiliated to Universities, Professional Bodies such as ICAI, ICWAI, ICSI, Bar Council, etc., to their Members; and Credit cards/Debit cards issued by Banks.

### E. Clarification / Guidelines on filling 'Proof of Address [PoA] - Correspondence / Local Address details' section

1. To be filled only in case the PoA is not the local address or address where the customer is currently residing. No separate PoA is required to be submitted.
2. In case of multiple correspondence / local addresses, Please fill 'Annexure A1'
3. Others includes - Utility bill which is not more than two months old of any service provider (electricity, telephone, post-paid mobile phone, piped gas, water bill); Bank account or Post Office savings bank account statement; Documents issued by Government departments of foreign jurisdictions and letter issued by Foreign Embassy or Mission in India; Identity card with applicant's photograph and address issued by any of the following: Central/ State Government Departments, Statutory/Regulatory Authorities, Public Sector Undertakings, Scheduled Commercial Banks, Public Financial Institutions, Colleges affiliated to Universities, Professional Bodies such as ICAI, ICWAI, ICSI, Bar Council, etc., to their Members; and Credit cards/Debit cards issued by Banks.

### F. Clarification / Guidelines on filling 'Contact details' section

1. Please mention two- digit country code and 10 digit mobile number (e.g. for Indian mobile number mention 91-9999999999).
2. Do not add '0' in the beginning of Mobile number.

### G. Clarification / Guidelines on filling 'Related Person details' section

1. Provide KYC number of related person if available.

### H. Clarification / Guidelines on filling 'Related Person details - Proof of Identity [PoI] of Related Person' section

1. Mention identification / reference number if 'Z- Others (any document notified by the central government)' is ticked.

### I. List of people authorized to attest the documents after verification with the originals:

1. Authorised officials of Asset Management Companies (AMC).
2. Authorised officials of Registrar & Transfer Agent (R&T) acting on behalf of the AMC.
3. KYD compliant mutual fund distributors.
4. Notary Public, Gazetted Officer, Manager of a Scheduled Commercial/Co-operative Bank or Multinational Foreign Banks (Name, Designation & Seal should be affixed on the copy).
5. In case of NRIs, authorized officials of overseas branches of Scheduled Commercial Banks registered in India, Notary Public, Court Magistrate, Judge, Indian Embassy/ Consulate General in the country where the client resides are permitted to attest the documents.
6. Government authorised officials who are empowered to issue Apostille Certificates.

### J. List of people authorized to perform In Person Verification (IPV):

1. Authorised officials of Asset Management Companies (AMC).
2. Authorised officials of Registrar & Transfer Agent (R&T) acting on behalf of the AMC.
3. KYD compliant mutual fund distributors.
4. Manager of a Scheduled Commercial/Co-operative Bank or Multinational Foreign Banks (for investors investing directly).
5. In case of NRI applicants, a person permitted to attest documents, may also conduct the In Person Verification and confirm this in the KYC Form.

### K. PAN Exempt Investor Category

1. Investments (including SIPs), in Mutual Fund schemes up to INR 50,000/- per investor per year per Mutual Fund.
2. Transactions undertaken on behalf of Central/State Government, by officials appointed by Courts, e.g., Official liquidator, Court receiver, etc.
3. Investors residing in the state of Sikkim.
4. UN entities/multilateral agencies exempt from paying taxes/filing tax returns in India.

**List of Two-Digit state / U.T Codes as per Indian Motor Vehicle Act, 1988**

State / U.T	Code	State / U.T	Code	State / U.T	Code
Andaman & Nicobar	AN	Himachal Pradesh	HP	Pondicherry	PY
Andhra Pradesh	AP	Jammu & Kashmir	JK	Punjab	PB
Arunachal Pradesh	AR	Jharkhand	JH	Rajasthan	RJ
Assam	AS	Karnataka	KA	Sikkim	SK
Bihar	BR	Kerala	KL	Tamil Nadu	TN
Chandigarh	CH	Lakshadweep	LD	Telangana	TS
Chattisgarh	CG	Madhya Pradesh	MP	Tripura	TR
Dadra and Nagar Haveli	DN	Maharashtra	MH	Uttar Pradesh	UP
Daman & Diu	DD	Manipur	MN	Uttarakhand	UA
Delhi	DL	Meghalaya	ML	West Bengal	WB
Goa	GA	Mizoram	MZ	Other	XX
Gujarat	GJ	Nagaland	NL		
Haryana	HR	Orissa	OR		

**List of ISO 3166 Two-Digit Country Code**

Country	Country Code	Country	Country Code	Country	Country Code	Country	Country Code
Afghanistan	AF	Dominican Republic	DO	Libya	LY	Saint Pierre and Miquelon	PM
Aland Islands	AX	Ecuador	EC	Liechtenstein	LI	Saint Vincent and the Grenadines	VC
Albania	AL	Egypt	EG	Lithuania	LT	Samoa	WS
Algeria	DZ	El Salvador	SV	Luxembourg	LU	San Marino	SM
American Samoa	AS	Equatorial Guinea	GQ	Macao	MO	Sao Tome and Principe	ST
Andorra	AD	Entrea	ER	Macedonia, the former Yugoslav Republic of	MK	Saudi Arabia	SA
Angola	AO	Estonia	EE	Madagascar	MG	Senegal	SN
Anguilla	AI	Ethiopia	ET	Malawi	MW	Serbia	RS
Antarctica	AQ	Falkland Islands (Malvinas)	FK	Malaysia	MY	Seychelles	SC
Antigua and Barbuda	AG	Faroe Islands	FO	Maldives	MV	Sierra Leone	SL
Argentina	AR	Fiji	FJ	Mali	ML	Singapore	SG
Armenia	AM	Finland	FI	Malta	MT	Sint Maarten (Dutch part)	SX
Aruba	AW	France	FR	Marshall Islands	MH	Slovakia	SK
Australia	AU	French Guiana	GF	Martinique	MQ	Slovenia	SI
Austria	AT	French Polynesia	PF	Mauritania	MR	Solomon Islands	SB
Azerbaijan	AZ	French Southern Territories	TF	Mauritius	MU	Somalia	SO
Bahamas	BS	Gabon	GA	Mayotte	YT	South Africa	ZA
Bahrain	BH	Gambia	GM	Mexico	MX	South Georgia and the South Sandwich Islands	GS
Bangladesh	BD	Georgia	GE	Micronesia, Federated States of	FM	South Sudan	SS
Barbados	BB	Germany	DE	Moldova, Republic of	MD	Spain	ES
Belarus	BY	Ghana	GH	Monaco	MC	Sri Lanka	LK
Belgium	BE	Gibraltar	GI	Mongolia	MN	Sudan	SD
Belize	BZ	Greece	GR	Montenegro	ME	Suriname	SR
Benin	BJ	Greenland	GL	Montserrat	MS	Svalbard and Jan Mayen	SJ
Bermuda	BM	Grenada	GD	Morocco	MA	Swaziland	SZ
Bhutan	BT	Guadeloupe	GP	Mozambique	MZ	Sweden	SE
Bolivia, Plurinational State of	BO	Guam	GU	Myanmar	MM	Switzerland	CH
Bonaire, Sint Eustatius and Saba	BQ	Guatemala	GT	Namibia	NA	Syrian Arab Republic	SY
Bosnia and Herzegovina	BA	Guernsey	GG	Nauru	NR	Taiwan, Province of China	TW
Botswana	BW	Guinea	GN	Nepal	NP	Tajikistan	TJ
Bouvet Island	BV	Guinea-Bissau	GW	Netherlands	NL	Tanzania, United Republic of	TZ
Brazil	BR	Guyana	GY	New Caledonia	NC	Thailand	TH
British Indian Ocean Territory	IO	Haiti	HT	New Zealand	NZ	Timor-Leste	TL
Brunei Darussalam	BN	Heard Island and McDonald Islands	HM	Nicaragua	NI	Togo	TG
Bulgaria	BG	Holy See (Vatican City State)	VA	Niger	NE	Tokelau	TK
Burkina Faso	BF	Honduras	HN	Nigeria	NG	Tonga	TO
Burundi	BI	Hong Kong	HK	Niue	NU	Trinidad and Tobago	TT
Cabo Verde	CV	Hungary	HU	Norfolk Island	NF	Tunisia	TN
Cambodia	KH	Iceland	IS	Northern Mariana Islands	MP	Turkey	TR
Cameroon	CM	India	IN	Norway	NO	Turkmenistan	TM
Canada	CA	Indonesia	ID	Oman	OM	Turks and Caicos Islands	TC
Cayman Islands	KY	Iran, Islamic Republic of	IR	Pakistan	PK	Tuvalu	TV
Central African Republic	CF	Iraq	IQ	Palau	PW	Uganda	UG
Chad	TD	Ireland	IE	Palestine, State of	PS	Ukraine	UA
Chile	CL	Isle of Man	IM	Panama	PA	United Arab Emirates	AE
China	CN	Israel	IL	Papua New Guinea	PG	United Kingdom	GB
Christmas Island	CX	Italy	IT	Paraguay	PY	United States	US
Cocos (Keeling) Islands	CC	Jamaica	JM	Peru	PE	United States Minor Outlying Islands	UM
Colombia	CO	Japan	JP	Philippines	PH	Uruguay	UY
Comoros	KM	Jersey	JE	Pitcairn	PN	Uzbekistan	UZ
Congo	CG	Jordan	JO	Poland	PL	Vanuatu	VU
Congo, the Democratic Republic of the	CD	Kazakhstan	KZ	Portugal	PT	Venezuela, Bolivarian Republic of	VE
Cook Islands	CK	Kenya	KE	Puerto Rico	PR	Viet Nam	VN
Costa Rica	CR	Kiribati	KI	Qatar	QA	Virgin Islands, British	VG
Cote d'Ivoire   Côte d'Ivoire	CI	Korea, Democratic People's Republic of	KP	Reunion   Réunion	RE	Virgin Islands, U.S.	VI
Croatia	HR	Korea, Republic of	KR	Romania	RO	Wallis and Futuna	WF
Cuba	CU	Kuwait	KW	Russian Federation	RU	Western Sahara	EH
Curacao   Curaçao	CW	Kyrgyzstan	KG	Rwanda	RW	Yemen	YE
Cyprus	CY	Lao People's Democratic Republic	LA	Saint Barthelemy   Saint Barthélemy	BL	Zambia	ZM
Czech Republic	CZ	Latvia	LV	Saint Helena, Ascension and Tristan da Cunha	SH	Zimbabwe	ZW
Denmark	DK	Lebanon	LB	Saint Kitts and Nevis	KN		
Djibouti	DJ	Lesotho	LS	Saint Lucia	LC		
Dominica	DM	Liberia	LR	Saint Martin (French part)	MF		



## INSTRUCTIONS / CHECK LIST FOR FILLING KYC FORM

### A. IMPORTANT POINTS:

1. Self attested copy of PAN card is mandatory for all clients, including Promoters/Partners/Karta/Trustees and whole time directors and persons authorized to deal in securities on behalf of company/firm/others.
2. Copies of all the documents submitted by the applicant should be self-attested and accompanied by originals for verification. In case the original of any document is not produced for verification, then the copies should be certified true by Karta/Partner/Trustee/Authorized Official/Director/Company Secretary (Name, Designation & Seal should be affixed on the copy) and properly attested by entities authorized for attesting the documents, as per the list mentioned under [E].
3. If any proof of identity or address is in a foreign language, then translation into English is required.
4. Name & address of the applicant mentioned on the KYC form, should match with the documentary proof submitted.
5. If correspondence & registered office addresses are different, then proofs for both have to be submitted.
6. Sole proprietor must make the application in his individual name & capacity. If you are a sole proprietor, please use the KYC Application Form for Individuals.
7. For foreign entities, CIN is optional; and in the absence of DIN for the directors, their passport copy should be given.
8. Politically Exposed Persons (PEP) are defined as individuals who are or have been entrusted with prominent public functions in a foreign country, e.g., Heads of States or of Governments, senior politicians, senior Government/judicial/military officers, senior executives of state owned corporations, important political party officials, etc.

### B. Permanent Account Number (PAN):

PAN is a mandatory requirement for all applicants except those who are specifically exempt from obtaining PAN (listed in Section D).

In case of institutional clients, namely, FIs, MFs, VCFs, FVCIs, Scheduled Commercial Banks, Multilateral and Bilateral Development Financial Institutions, State Industrial Development Corporations, Insurance Companies registered with IRDA and Public Financial Institution as defined under section 4A of the Companies Act, 1956, Custodians shall verify the PAN card details with the original PAN card and provide duly certified copies of such verified PAN details to the intermediary.

### C. Proof of Address (POA):

List of documents admissible as Proof of Address:

(\*Documents having an expiry date should be valid on the date of submission)

1. Latest Land Line Telephone Bill
2. Latest Electricity Bill
3. Latest Bank Passbook / Bank Account Statement
4. Registered Lease / Sale Agreement of office premises
5. Proof of address issued by any of the following: Bank Managers of Scheduled Commercial Banks/Scheduled Co-operative Bank/Multinational Foreign Banks/Gazetted Officer/Notary public/Elected representatives to the Legislative Assembly or Parliament/ Documents issued by any Govt. or Statutory Authority.
6. For FII/sub account, Power of Attorney given by FII/sub-account to the Custodians (which are duly notarized and/or apostilled or consularised) that gives the registered address should be taken.
7. Registration Certificate issued under Shops and Establishments Act

Documents having an expiry date should not be more than three months old as on the date of submission of this form.

### D. Exemptions/clarifications to PAN (\*Sufficient documentary evidence in support of such claims to be collected.)

1. In case of transactions undertaken on behalf of Central Government and/or State Government and by officials appointed by Courts e.g. Official liquidator, Court receiver etc.
  2. UN entities/multilateral agencies exempt from paying taxes/filing tax returns in India.
  3. Investors residing in the state of Sikkim.
- ### E. List of people authorized to attest the documents after verification with the originals:
1. Authorised officials of Asset Management Companies (AMC).
  2. Authorised officials of Registrar & Transfer Agent (R&T) acting on behalf of the AMC.
  3. KYD compliant mutual fund distributors.
  4. Notary Public, Gazetted Officer, Manager of a Scheduled Commercial Co-operative Bank or Multinational Foreign Banks.
  5. Government authorised officials who are empowered to issue Apostille Certificates.

### F. In case of Non-Individuals, additional documents to be obtained from non-individuals, over & above the POI & POA, as mentioned below:

Type of entity	Documentary requirements
<b>Corporate</b>	<ul style="list-style-type: none"> <li>• Copy of the balance sheets for the last 2 financial years (to be submitted every year)</li> <li>• Copy of latest share holding pattern including list of all those holding control, either directly or indirectly, in the company in terms of SEBI takeover Regulations, duly certified by the company secretary/Whole time director/MD (to be submitted every year)</li> <li>• Photograph, POI, POA, PAN and DIN numbers of whole time directors/two directors in charge of day to day operations</li> <li>• Photograph, POI, POA, PAN of individual promoters holding control – either directly or indirectly</li> <li>• Copies of the Memorandum and Articles of Association and certificate of incorporation</li> <li>• Copy of the Board Resolution for investment in securities market</li> <li>• Authorised signatories list with specimen signatures</li> </ul>
<b>Partnership firm</b>	<ul style="list-style-type: none"> <li>• Copy of the balance sheets for the last 2 financial years (to be submitted every year)</li> <li>• Certificate of registration (for registered partnership firms only)</li> <li>• Copy of partnership deed</li> <li>• Authorised signatories list with specimen signatures</li> <li>• Photograph, POI, POA, PAN of Partners</li> </ul>
<b>Trust</b>	<ul style="list-style-type: none"> <li>• Copy of the balance sheets for the last 2 financial years (to be submitted every year)</li> <li>• Certificate of registration (for registered trust only). Copy of Trust deed</li> <li>• List of trustees certified by managing trustees/CA</li> <li>• Photograph, POI, POA, PAN of Trustees</li> </ul>
<b>HUF</b>	<ul style="list-style-type: none"> <li>• PAN of HUF</li> <li>• Deed of declaration of HUF/List of coparceners</li> <li>• Bank pass-book/bank statement in the name of HUF</li> <li>• Photograph, POI, POA, PAN of Karta</li> </ul>
<b>Unincorporated Association or a body of individuals</b>	<ul style="list-style-type: none"> <li>• Proof of Existence/Constitution document</li> <li>• Resolution of the managing body &amp; Power of Attorney granted to transact business on its behalf</li> <li>• Authorized signatories list with specimen signatures</li> </ul>
<b>Banks/Institutional Investors</b>	<ul style="list-style-type: none"> <li>• Copy of the constitution/registration or annual report/balance sheet for the last 2 financial years</li> <li>• Authorized signatories list with specimen signatures</li> </ul>
<b>Foreign Institutional Investors (FII)</b>	<ul style="list-style-type: none"> <li>• Copy of SEBI registration certificate</li> <li>• Authorized signatories list with specimen signatures</li> </ul>
<b>Army/Government Bodies</b>	<ul style="list-style-type: none"> <li>• Self-certification on letterhead</li> <li>• Authorized signatories list with specimen signatures</li> </ul>
<b>Registered Society</b>	<ul style="list-style-type: none"> <li>• Copy of Registration Certificate under Societies Registration Act</li> <li>• List of Managing Committee members</li> <li>• Committee resolution for persons authorised to act as authorised signatories with specimen signatures</li> <li>• True copy of Society Rules and Bye Laws certified by the Chairman/Secretary</li> </ul>

Please Submit the KYC Documents on A4 Size Paper Only.



**Details of Promoters/Partners/Karta/Trustees and whole time directors forming a part of Know Your Client (KYC) Application Form for Non-Individuals (contd.)**

Sr. No.	PAN	Name	DIN (For Directors)/ UID (For others if available)	Residential Address	Relationship with Applicant (i.e. promoters, whole time directors etc.)	Whether Politically Exposed*	Photograph
	(Please attach a copy of your PAN Card)			(Please attach proof of your residential address)		<input type="checkbox"/> PEP <input type="checkbox"/> RPEP <input type="checkbox"/> NO	
	(Please attach a copy of your PAN Card)			(Please attach proof of your residential address)		<input type="checkbox"/> PEP <input type="checkbox"/> RPEP <input type="checkbox"/> NO	
	(Please attach a copy of your PAN Card)			(Please attach proof of your residential address)		<input type="checkbox"/> PEP <input type="checkbox"/> RPEP <input type="checkbox"/> NO	
	(Please attach a copy of your PAN Card)			(Please attach proof of your residential address)		<input type="checkbox"/> PEP <input type="checkbox"/> RPEP <input type="checkbox"/> NO	
	(Please attach a copy of your PAN Card)			(Please attach proof of your residential address)		<input type="checkbox"/> PEP <input type="checkbox"/> RPEP <input type="checkbox"/> NO	
	(Please attach a copy of your PAN Card)			(Please attach proof of your residential address)		<input type="checkbox"/> PEP <input type="checkbox"/> RPEP <input type="checkbox"/> NO	

Name & Signature of the Authorised Signatory(ies)

Date    /    /

\*PEP: Politically Exposed Person  
\*RPEP: Related to Politically Exposed Person

## Appendix 9: KYC Details Change Form for Individuals

<b>C</b>	<b>KYC Details Change form (For Individuals Only)</b>	Application No. : _____	 www.camskra.com												
Please fill this update / modification form in ENGLISH and in BLOCK LETTERS (Please strike off Sections that are not used).															
<table style="width: 100%; border: 1px solid black;"> <tr> <td style="width: 25%;">PAN _____</td> <td style="width: 25%;">PAN Exempt Ref. No. _____</td> <td colspan="2" style="width: 50%;">UID/Aadhaar, if any: _____</td> </tr> <tr> <td colspan="4">                     Title Please tick (✓) Mr. <input type="checkbox"/> Ms. <input type="checkbox"/> </td> </tr> <tr> <td colspan="4">                     Name _____                 </td> </tr> </table>				PAN _____	PAN Exempt Ref. No. _____	UID/Aadhaar, if any: _____		Title Please tick (✓) Mr. <input type="checkbox"/> Ms. <input type="checkbox"/>				Name _____			
PAN _____	PAN Exempt Ref. No. _____	UID/Aadhaar, if any: _____													
Title Please tick (✓) Mr. <input type="checkbox"/> Ms. <input type="checkbox"/>															
Name _____															
(please see guidelines overleaf)															
<b>1. New Name</b> (As appearing in supporting identification document). _____															
<b>2. New Status</b> Please tick (✓) <input type="checkbox"/> Resident Individual <input type="checkbox"/> Non Resident (Passport Copy Mandatory for NRIs & Foreign Nationals)															
<b>3. New PAN</b> _____ Please enclose a duly attested copy of your PAN Card															
<b>4. Father's / Spouse's Name</b> _____															
<b>5. Marital Status</b> Please tick (✓) <input type="checkbox"/> Single <input type="checkbox"/> Married															
<b>6. Nationality</b> Please tick (✓) <input type="checkbox"/> Indian <input type="checkbox"/> Others _____ Please specify															
C. New Address Details (please see guidelines overleaf)															
<b>1. New Address for Correspondence</b> _____ _____ City / Town / Village: _____ Country: _____ Pin Code: _____ State: _____															
<b>2. New Contact Details</b> Tel. (Off.) (ISD) (STD) _____ Tel. (Res.) (ISD) (STD) _____ Mobile (ISD) (STD) _____ Fax (ISD) (STD) _____ E-Mail Id. _____															
<b>3. Proof of address to be provided by Applicant. Please submit ANY ONE of the following valid documents &amp; tick (✓) against the document attached.</b> <input type="checkbox"/> Passport <input type="checkbox"/> Ration Card <input type="checkbox"/> Registered Lease/Sale Agreement of Residence <input type="checkbox"/> Driving License <input type="checkbox"/> Voter Identity Card <input type="checkbox"/> *Latest Bank A/c Statement/Passbook <input type="checkbox"/> *Latest Telephone Bill (only Land Line) <input type="checkbox"/> *Latest Electricity Bill <input type="checkbox"/> *Latest Gas Bill <input type="checkbox"/> Others (Please specify) _____ *Not more than 3 Months old. Validity/Expiry date of proof of address submitted <u>  </u> / <u>  </u> / <u>  </u>															
<b>4. New Permanent Address of Resident Applicant if different from above C1 OR Overseas Address (Mandatory) for Non-Resident Applicant</b> _____ _____ City / Town / Village: _____ Country: _____ Pin Code: _____ State: _____															
<b>5. Proof of address to be provided by Applicant. Please submit ANY ONE of the following valid documents &amp; tick (✓) against the document attached.</b> <input type="checkbox"/> Passport <input type="checkbox"/> Ration Card <input type="checkbox"/> Registered Lease/Sale Agreement of Residence <input type="checkbox"/> Driving License <input type="checkbox"/> Voter Identity Card <input type="checkbox"/> *Latest Bank A/c Statement/Passbook <input type="checkbox"/> *Latest Telephone Bill (only Land Line) <input type="checkbox"/> *Latest Electricity Bill <input type="checkbox"/> *Latest Gas Bill <input type="checkbox"/> Others (Please specify) _____ *Not more than 3 Months old. Validity/Expiry date of proof of address submitted <u>  </u> / <u>  </u> / <u>  </u>															
D. Other Details (please see guidelines overleaf)															
<b>1. Gross Annual Income Details</b> Please tick (✓) <input type="checkbox"/> Below 1 Lac <input type="checkbox"/> 1-5 Lacs <input type="checkbox"/> 5-10 Lacs <input type="checkbox"/> 10-25 Lacs <input type="checkbox"/> >25 Lacs Net-worth in ₹ _____ (* Net worth should not be older than 1 year) as on (date) <u>  </u> / <u>  </u> / <u>  </u>															
<b>2. New Occupation</b> (Please tick (✓) any one and give brief details): <input type="checkbox"/> Private Sector Service <input type="checkbox"/> Public Sector <input type="checkbox"/> Government Service <input type="checkbox"/> Business <input type="checkbox"/> Professional <input type="checkbox"/> Agriculturist <input type="checkbox"/> Retired <input type="checkbox"/> Housewife <input type="checkbox"/> Student <input type="checkbox"/> Forex Dealer <input type="checkbox"/> Others (Please specify) _____															
<b>3. Please tick, if applicable:</b> <input type="checkbox"/> Politically Exposed Person <input type="checkbox"/> Related to a Politically Exposed Person For definition of PEP, please refer guideline overleaf															
<b>4. Any other information:</b> _____															
DECLARATION		SIGNATURE OF APPLICANT													
I hereby declare that the details furnished above are true and correct to the best of my knowledge and belief and I undertake to inform you of any changes therein, immediately. In case any of the above information is found to be false or untrue or misleading or misrepresenting, I am aware that I may be held liable for it. I hereby declare that I am not making this application for the purpose of contravention of any Act, Rules, Regulations or any statute of legislation or any notifications directions issued by any governmental or statutory authority from time to time. I hereby authorise sharing of the information furnished on this form with all SEBI registered KYC Registration Agencies/ SEBI Registered Intermediaries															
Place: _____ Date: _____															
FOR OFFICE USE ONLY															
AMC/Intermediary name OR code _____ <input type="checkbox"/> (Originals Verified) Self Certified Document copies received <input type="checkbox"/> (Attested) True copies of documents received Main Intermediary _____	Seal/Stamp of the intermediary should contain Staff Name Emp.No./ARN. No Designation Name of the Organization Signature Date	Seal/Stamp of the intermediary should contain Staff Name Emp.No./ARN. No Designation Name of the Organization Signature Date	IPV Done <input type="checkbox"/> on <u>  </u> / <u>  </u> / <u>  </u>												

Version 1.3-November 2012



**A. IMPORTANT POINTS:**

**1. Self attested copy of PAN card is mandatory for all clients in all type of change request.**

2. Copies of all documents that are submitted need to be compulsorily self-attested by the applicant and accompanied by originals for verification. In case the original of any document is not produced for verification, then the copies should be properly attested by entities authorized for attesting the documents, as per the list mentioned under [E].
3. If any proof of identity or address is in a foreign language, then translation into English is required.
4. Name & address of the applicant mentioned on the KYC form, should match with the documentary proof submitted.
5. If correspondence & permanent addresses are different, then proofs for both have to be submitted.
6. Sole proprietor must make the application in his individual name & capacity.
7. For non-residents and foreign nationals, (allowed to trade subject to RBI and FEMA guidelines), copy of passport/PIO Card/OC Card and overseas address proof is mandatory.
8. In case of Merchant Navy NRI's, Mariner's declaration or certified copy of CDC (Continuous Discharge Certificate) is to be submitted.
9. Politically Exposed Persons (PEP) are defined as individuals who are or have been entrusted with prominent public functions in a foreign country, e.g., Heads of States or of Governments, senior politicians, senior Government/judicial/military officers, senior executives of state owned corporations, important political party officials, etc.

**B. Proof of Identity (POI): List of documents admissible as Proof of Identity (\*Documents having an expiry date should be valid on the date of submission.):**

1. PAN card with photograph. This is a mandatory requirement for all applicants except those who are specifically exempt from obtaining PAN (listed in Section D).
2. Unique Identification Number (UID) (Aadhaar)/Passport/Voter ID card/Driving license.
3. Identity card/ document with applicant's Photo, issued by any of the following: Central/State Government and its Departments, Statutory/Regulatory Authorities, Public Sector Undertakings, Scheduled Commercial Banks, Public Financial Institutions, Colleges affiliated to Universities, Professional Bodies such as ICAI, ICWAI, ICSI, Bar Council etc., to their Members; and Credit cards/Debit cards issued by Banks.

**C. Proof of Address (POA): List of documents admissible as Proof of Address: (\*Documents having an expiry date should be valid on the date of submission.)**

1. Passport/Voters Identity Card/Ration Card/Registered Lease or Sale Agreement of Residence/Driving License/Flat Maintenance bill/Insurance Copy.

2. Utility bills like Telephone Bill (only land line), Electricity bill or Gas bill -Not more than 3 months old.
3. Bank Account Statement/Passbook -Not more than 3 months old.
4. Self-declaration by High Court and Supreme Court judges, giving the new address in respect of their own accounts.
5. Proof of address issued by any of the following: Bank Managers of Scheduled Commercial Banks/Scheduled Co-operative Bank/Multinational Foreign Banks/Gazetted Officer/Notary public/Elected representatives to the Legislative Assembly or Parliament/Documents issued by any Govt. or Statutory Authority.
6. Identity card/document with address, issued by any of the following: Central/State Government and its Departments, Statutory/Regulatory Authorities, Public Sector Undertakings, Scheduled Commercial Banks, Public Financial Institutions, Colleges affiliated to Universities and Professional Bodies such as ICAI, ICWAI, ICSI, Bar Council etc., to their Members.
7. The proof of address in the name of the spouse may be accepted.

**D. List of people authorized to attest the documents after verification with the originals:**

1. Authorised officials of Asset Management Companies (AMC).
2. Authorised officials of Registrar & Transfer Agent (R&T) acting on behalf of the AMC.
3. KYD compliant mutual fund distributors.
4. Notary Public, Gazetted Officer, Manager of a Scheduled Commercial/Co-operative Bank or Multinational Foreign Banks (Name, Designation & Seal should be affixed on the copy).
5. In case of NRIs, authorized officials of overseas branches of Scheduled Commercial Banks registered in India, Notary Public, Court Magistrate, Judge, Indian Embassy/Consulate General in the country where the client resides are permitted to attest the documents.
6. Government authorised officials who are empowered to issue Apostille Certificates.

**E. List of people authorized to perform In Person Verification (IPV):**

1. Authorised officials of Asset Management Companies (AMC).
2. Authorised officials of Registrar & Transfer Agent (R&T) acting on behalf of the AMC.
3. KYD compliant mutual fund distributors.
4. Manager of a Scheduled Commercial/Co-operative Bank or Multinational Foreign Banks (for investors investing directly).
5. In case of NRI applicants, a person permitted to attest documents in E(5) above, may also conduct the In Person Verification and confirm this in the KYC Form.

Please Submit the KYC Documents on A4 Size Paper Only.



## INSTRUCTIONS / CHECK LIST FOR FILLING KYC FORM

### A. IMPORTANT POINTS:

1. Self attested copy of PAN card is mandatory for all clients in all type of change request.
2. Copies of all the documents submitted by the applicant should be self-attested and accompanied by originals for verification. In case the original of any document is not produced for verification, then the copies should be properly attested by entities authorized for attesting the documents, as per the below mentioned list.
3. If any proof of identity or address is in a foreign language, then translation into English is required.
4. Name & address of the applicant mentioned on the KYC form, should match with the documentary proof submitted.
5. If correspondence & permanent address are different, then proofs for both have to be submitted.
6. Sole proprietor must make the application in his individual name & capacity.
7. For non-residents and foreign nationals, (allowed to trade subject to RBI and FEMA guidelines), copy of passport/PIO Card/OCICard and overseas address proof is mandatory.
8. For foreign entities, CIN is optional; and in the absence of DIN no. for the directors, their passport copy should be given.
9. In case of Merchant Navy NRI's, Mariner's declaration or certified copy of CDC (Continuous Discharge Certificate) is to be submitted.
10. For opening an account with Depository participant or Mutual Fund, for a minor or photocopy of the School Leaving Certificate/Mark sheet issued by Higher Secondary Board/Passport of Minor/Birth Certificate must be provided.
11. Politically Exposed Persons (PEP) are defined as individuals who are or have been entrusted with prominent public functions in a foreign country, e.g., Heads of States or of Governments, senior politicians, senior Government/judicial/military officers, senior executives of state owned corporations, important political party officials, etc.

### B. Proof of Identity (POI): List of documents admissible as Proof of Identity:

1. PAN card with photograph. This is a mandatory requirement for all applicants except those who are specifically exempt from obtaining PAN (listed in Section D).
2. Unique Identification Number (UID) (Aadhaar)/Passport/Voter ID card/Driving license.
3. Identity card/ document with applicant's Photo, issued by any of the following: Central/State Government and its Departments, Statutory/Regulatory Authorities, Public Sector Undertakings, Scheduled Commercial Banks, Public Financial Institutions, Colleges affiliated to Universities, Professional Bodies such as ICAI, ICWAI, ICSI, Bar Council etc., to their Members; and Credit cards/Debit cards issued by Banks.

### C. Proof of Address (POA): List of documents admissible as Proof of Address: (\* Documents having an expiry date should be valid on the date of submission.)

1. Passport/Voters Identity Card/Ration Card/Registered Lease or Sale Agreement of Residence/Driving License/Flat Maintenance bill/Insurance Copy.
2. Utility bills like Telephone Bill (only land line), Electricity bill or Gas bill - Not more than 3 months old.
3. Bank Account Statement/Passbook - Not more than 3 months old.
4. Self-declaration by High Court and Supreme Court judges, giving the new address in respect of their own accounts.
5. Proof of address issued by any of the following: Bank Managers of Scheduled Commercial Banks/Scheduled Co-Operative Bank/Multinational Foreign Banks/Gazetted Officer/Notary public/Elected representatives to the Legislative Assembly/Parliament/Documents issued by any Govt. or Statutory Authority.
6. Identity card/document with address, issued by any of the following: Central/State Government and its Departments, Statutory/Regulatory Authorities, Public Sector Undertakings, Scheduled Commercial Banks, Public Financial Institutions, Colleges affiliated to Universities and Professional Bodies such as ICAI, ICWAI, ICSI, Bar Council etc., to their Members.
7. For FI/sub account, Power of Attorney given by FI/sub-account to the Custodians (which are duly notarized and/or apostilled or consularised) that gives the registered address should be taken.
8. The proof of address in the name of the spouse may be accepted.

### D. Exemptions/clarifications to PAN

(\* Sufficient documentary evidence in support of such claims to be collected.)

1. In case of transactions undertaken on behalf of Central Government and/or State Government and by officials appointed by Courts e.g. Official Liquidator, Court receiver etc.
2. Investors residing in the state of Sikkim.
3. UN entities/multilateral agencies exempt from paying taxes/filing tax returns in India.
4. SIP of Mutual Funds upto Rs 50,000/- p.a.
5. In case of institutional clients, namely, FIs, MFs, VCFs, FVCIs, Scheduled Commercial Banks, Multilateral and Bilateral Development Financial Institutions, State Industrial Development Corporations, Insurance Companies registered with IRDA and Public Financial Institution as defined under section 4A of the Companies Act, 1956, Custodians shall verify the PAN card details with the original PAN card and provide duly certified copies of such verified PAN details to the intermediary.

### E. List of people authorized to attest the documents:

1. Notary Public, Gazetted Officer, Manager of a Scheduled Commercial/Co-operative Bank or Multinational Foreign Banks (Name, Designation & Seal should be affixed on the copy).
2. In case of NRIs, authorized officials of overseas branches of Scheduled Commercial Banks registered in India, Notary Public, Court Magistrate, Judge, Indian Embassy/Consulate General in the country where the client resides are permitted to attest the documents.

### F. In case of Non-Individuals, additional documents to be obtained from non-individuals, over & above the POI & POA, as mentioned below:

Types of entity	Documentary requirements
Corporate	<ul style="list-style-type: none"> <li>• Copy of the balance sheets for the last 2 financial years (to be submitted every year)</li> <li>• Copy of latest share holding pattern including list of all those holding control, either directly or indirectly, in the company in terms of SEBI takeover Regulations, duly certified by the company secretary/Whole time director/MD (to be submitted every year)</li> <li>• Photograph, POI, POA, PAN and DIN numbers of whole time directors/two directors in charge of day to day operations</li> <li>• Photograph, POI, POA, PAN of individual promoters holding control – either directly or indirectly</li> <li>• Copies of the Memorandum and Articles of Association and certificate of incorporation</li> <li>• Copy of the Board Resolution for investment in securities market</li> <li>• Authorised signatories list with specimen signatures</li> </ul>
Partnership firm	<ul style="list-style-type: none"> <li>• Copy of the balance sheets for the last 2 financial years (to be submitted every year)</li> <li>• Certificate of registration (for registered partnership firms only)</li> <li>• Copy of partnership deed</li> <li>• Authorised signatories list with specimen signatures</li> <li>• Photograph, POI, POA, PAN of Partners</li> </ul>
Trust	<ul style="list-style-type: none"> <li>• Copy of the balance sheets for the last 2 financial years (to be submitted every year)</li> <li>• Certificate of registration (for registered trust only). Copy of Trust deed</li> <li>• List of trustees certified by managing trustees/CA</li> <li>• Photograph, POI, POA, PAN of Trustees</li> </ul>
HUF	<ul style="list-style-type: none"> <li>• PAN of HUF</li> <li>• Deed of declaration of HUF/List of coparceners</li> <li>• Bank pass-book/bank statement in the name of HUF</li> <li>• Photograph, POI, POA, PAN of Karta</li> </ul>
Unincorporated Association or a body of individuals	<ul style="list-style-type: none"> <li>• Proof of Existence/Constitution document</li> <li>• Resolution of the managing body &amp; Power of Attorney granted to transact business on its behalf</li> <li>• Authorised signatories list with specimen signatures</li> </ul>
Banks/Institutional Investors	<ul style="list-style-type: none"> <li>• Copy of the constitution/registration or annual report/balance sheet for the last 2 financial years</li> <li>• Authorised signatories list with specimen signatures</li> </ul>
Foreign Institutional Investors (FII)	<ul style="list-style-type: none"> <li>• Copy of SEBI registration certificate</li> <li>• Authorised signatories list with specimen signatures</li> </ul>
Army/Government Bodies	<ul style="list-style-type: none"> <li>• Self-certification on letterhead</li> <li>• Authorised signatories list with specimen signatures</li> </ul>
Registered Society	<ul style="list-style-type: none"> <li>• Copy of Registration Certificate under Societies Registration Act</li> <li>• List of Managing Committee members</li> <li>• Committee resolution for persons authorised to act as authorised signatories with specimen signatures</li> <li>• True copy of Society Rules and Bye Laws certified by the Chairman/Secretary</li> </ul>

Please Submit the KYC Documents on A4 Size Paper Only.

## ***Appendix 11: Process for Aadhaar e-KYC of investors (resident) in the securities markets<sup>86</sup>***

### **Online Portal based Investor (Resident) e-KYC Process (Aadhaar as an OVD)**

- a. Investor visits portal of KUA or the SEBI registered intermediary which is also a Sub-KUA to open account/invest through intermediary.
- b. For Aadhaar e-KYC, investor is redirected to KUA portal. Investor enters the Aadhaar Number or Virtual Id and provides consent on KUA portal. Adequate controls shall be in place to ensure that Aadhaar Number is not stored anywhere by the Sub-KUA or KUA.
- c. Investor will then receive OTP in mobile number registered with Aadhaar. Investor enters the OTP sent by UIDAI on KUA portal for Aadhaar e-KYC.
- d. KUA will receive the e-KYC details from UIDAI upon successful Aadhaar authentication which will be further forwarded to Sub-KUA in encrypted format (using KUAs own encryption key) and will be displayed to the investor on portal. Sharing of e-KYC data by the KUA with Sub-KUA may be allowed under Regulation 16(2) of Aadhaar (Authentication) Regulation, 2016. Sub-KUA shall clearly specify the name of the KUA and Sub- KUA, and details of sharing of data among KUA and Sub-KUA while capturing investor consent.
- e. Investor will fill the additional detail as required under KYC format.
- f. SEBI registered Intermediary will upload additional KYC details to the KUA.

### **B. Assisted Investor (Resident) e-KYC process (Aadhaar as an OVD)**

- a. Investor approaches any of the SEBI Registered Entity/ Sub-KUAs i.e. Mutual Fund Distributors or appointed persons for e-KYC through Aadhaar.
- b. SEBI registered entities (Sub-KUAs) will perform e-KYC using registered / Whitelisted devices with KUAs.
- c. KUA will be required to ensure that all devices and device operators of Sub-KUA are registered / whitelisted devices with KUA.
- d. Investor will then be required to enter Aadhaar No. or Virtual Id and provide consent on the registered device.
- e. Investor would then have to provide biometric on the registered device.
- f. SEBI registered intermediary (Sub-KUA) fetches the e-KYC details through the KUA from UIDAI which will be displayed to the investor on the registered device.
- g. Investor will also provide the additional detail as required.

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<sup>86</sup> Candidates are advised to read the entire circular: [https://www.sebi.gov.in/legal/circulars/nov-2019/e-kyc-authentication-facility-under-section-11a-of-the-prevention-of-money-laundering-act-2002-by-entities-in-the-securities-market-for-resident-investors\\_44864.html](https://www.sebi.gov.in/legal/circulars/nov-2019/e-kyc-authentication-facility-under-section-11a-of-the-prevention-of-money-laundering-act-2002-by-entities-in-the-securities-market-for-resident-investors_44864.html)

The KUA/ sub-KUA while performing the Aadhaar authentication shall also comply with the following:

- a. For sharing of e-KYC data with Sub-KUA under Regulation 16(2) of Aadhaar (Authentication) Regulations, 2016, KUA shall obtain special permission from UIDAI by submitting an application in this regard. Such permissible sharing of e- KYC details by KUA can be allowed with their associated Sub-KUAs only.
- b. KUA shall not share UIDAI digitally signed e-KYC data with other KUAs. However, KUAs may share data after digitally signing it using their own signature for internal working of the system.
- c. e-KYC data received as response upon successful Aadhaar authentication from UIDAI will be stored by KUA and Sub-KUA in the manner prescribed by Aadhaar Act/Regulations and circulars issued by UIDAI time to time.
- d. KUA/Sub-KUA shall not store Aadhaar number in their database under any circumstances. It shall be ensured that Aadhaar number is captured only using UIDAI`s Aadhaar Number Capture Services (ANCS).
- e. The KUA shall maintain auditable logs of all such transactions where e-KYC data has been shared with sub-KUA, for a period specified by the Authority.
- f. It shall be ensured that full Aadhaar number is not stored and displayed anywhere in the system and wherever required only last 4 digits of Aadhaar number may be displayed.
- g. As per Regulation 14(i) of the Aadhaar (Authentication) Regulation, 2016, requesting entity shall implement exception-handling mechanisms and backup identity authentication mechanism to ensure seamless provision of authentication services to Aadhaar number holders.
- h. UIDAI may conduct audit of all KUAs and Sub KUAs as per the Aadhaar Act, Aadhaar Regulations, AUA/KUA Agreement, Guidelines, circulars etc. issued by UIDAI from time to time.
- i. Monitoring of irregular transactions - KUAs shall develop appropriate monitoring mechanism to record irregular transactions and their reporting to UIDAI.
- j. Investor Grievance Handling Mechanism - Investor may approach KUA for their grievance redressal. KUA will ensure that the grievance is redressed within the timeframe as prescribed by UIDAI. KUA will also submit report on grievance redressal to UIDAI as per timelines prescribed by UIDAI.

KUAs and Sub-KUA shall also comply with the Aadhaar Act Regulations, circulars, guidelines etc. issued by UIDAI from time to time. In case of any non-compliance on the part of KUAs/sub KUAs, SEBI may take necessary action.

## **Appendix 12: Procedure for Transmission of Units on Death of a Unitholder<sup>87</sup>**

Transmission of Units is a process whereby units held by a deceased unitholder are transferred either to the nominee or to the legal heirs of the deceased unitholder as the case may be.

The detailed guidelines for Transmission of Units under various situations / scenarios and the forms/formats and supporting documents to be submitted by the claimants under each scenario is provided below.

### **1. DELETION OF NAMES OF THE DECEASED UNIT HOLDERS IN CASE OF DEATH OF 2ND AND/OR 3RD HOLDER :**

- i. Request Form (Form T1) from surviving unitholder(s) requesting for Deletion of Name of Deceased 2nd and/or 3rd Holder.
- ii. Death Certificate in original or photocopy duly attested by a Notary Public or a Gazetted Officer.
- iii. Fresh Bank Mandate Form along with cancelled cheque of the new bank account (only if there is a change in existing bank mandate)
- iv. Fresh Nomination Form in case there is no nomination or a change in existing nomination is desired by the surviving unit holders.
- v. KYC Acknowledgment OR KYC Form of the surviving unit holder(s), if not KYC compliant.

### **2. Transmission of units to surviving unit holder(s) in case of death of the 1st holder :**

- i. Transmission Request Form (Form T2) for Transmission of Units to the surviving unitholder/s.
- ii. Death Certificate of the deceased unitholder(s) in original OR photocopy duly attested by a Notary Public or a Gazetted Officer.
- iii. Copy of PAN Card of the Surviving Joint Holder(s) (if PAN is not provided already)
- iv. Cancelled cheque of the new first unitholder, with the claimant's name pre-printed OR Recent Bank Statement/Passbook (not more than 3 months old) of the new first holder.
- v. KYC Acknowledgment OR KYC Form of the surviving unit holder(s), if not KYC compliant.

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<sup>87</sup> refer to <https://www.amfiindia.com/investor-corner/investor-center/procedure-to-claim.html>

### 3. TRANSMISSION OF UNITS TO THE REGISTERED NOMINEE/S IN CASE OF DEATH OF SOLE OR ALL UNITHOLDERS:

- i. Transmission Request Form (Form T3) for Transmission of Units in favour of the Nominee(s).
- ii. Death Certificate of the deceased unitholder(s) in original OR photocopy duly attested by a Notary Public or a Gazetted Officer.
- iii. Copy of Birth Certificate, in case the Nominee is a minor.
- iv. Copy of PAN Card of the Nominee(s) / Guardian (in case the Nominee is a minor)
- v. KYC Acknowledgment OR KYC Form of the Nominee(s) / Guardian (where Nominee is a Minor)
- vi. Cancelled cheque with the Nominee's name pre-printed OR Copy of the Nominee's recent Bank Statement/Passbook (which is not more than 3 months old).
- vii. If the transmission amount is upto Rs. 2 Lakh, Nominee's signature attested by the Bank Manager as per Annexure-Ia. In case the Nominee is a Minor, signature of the Guardian (as per the bank account of the Minor or the joint account of the Minor with the Guardian) shall be attested. If the transmission amount is for more than Rs. 2 Lakh, as an operational risk mitigation measure, signature of the Nominee shall be attested by a Notary Public or a Judicial Magistrate First Class (JMFC) in the space provided for signature attestation in the TRF itself below the signature of the claimant.

### 4 TRANSMISSION OF UNITS TO THE CLAIMANT/S ON DEATH OF SOLE UNITHOLDER OR ALL UNITHOLDERS, WHERE THERE IS NO NOMINATION REGISTERED

- i. Transmission Request Form (Form T3) for Transmission of Units to the Claimant
- ii. Death Certificate of the deceased unitholder(s) in original OR photocopy duly attested by a Notary Public or a Gazette Officer.,
- iii. Copy of Birth Certificate in case the Claimant is a minor.
- iv. Copy of PAN Card of the Claimant / Guardian (in case the Claimant is a minor).
- v. KYC Acknowledgment OR KYC Form of the Claimant / Guardian (in case the Claimant is a Minor)

vi. Cancelled cheque with the claimant's name pre-printed OR Copy of the Claimant's recent Bank Statement/Passbook (which is not more than 3 months old). If the transmission amount is up to Rs. 2 Lakh –

a. Bank Attestation of signature of the Claimant by the Bank Manager as per Annexure-Ia. In case the Claimant is a Minor, the signature of the Guardian (as per the bank account of the Minor or the joint account of the Minor with the Guardian) shall be attested.

b. Any appropriate document evidencing relationship of the claimant/s with the deceased unitholder/s.

c. Bond of Indemnity - as per Annexure-II to be furnished by Legal Heirs for Transmission of Units without production of Legal Representation.

Provided that in case the legal heir(s)/claimant(s) is submitting the Succession Certificate or Probate of Will or Letter of Administration wherein the claimant is named as a beneficiary, an affidavit as per Annexure-III from such legal heir/claimant(s) alone would be sufficient; i.e., Bond of Indemnity is not required.

d. Individual Affidavits to be given by each legal heir as per Annexure-III

e. NOC from other Legal Heirs as per Annexure – IV, where applicable.

If the transmission amount is more than Rs. 2 Lakh –

a. Signature of the Claimant duly attested by a Notary Public or a Judicial Magistrate First Class (JMFC) in the space provided for signature attestation in the TRF itself below the signature of the claimant. In case the Claimant is a Minor, the signature of the Guardian (as per the bank account of the Minor or the joint account of the Minor with the Guardian) shall be attested.

b. Individual Affidavits to be given each legal heir as per Annexure-III

c. Any one of the documents mentioned below:

- Notarised copy of Probated Will; OR
- Succession Certificate issued by a competent court; OR
- Letter of Administration or court decree, in case of Intestate Succession.

## 5 Change of Karta upon death of the Karta of Hindu Undivided Family (HUF)

If the case of a HUF, the property of the HUF is managed by the Karta and the HUF does not come to an end in the event of death of the Karta. In such a case, the members of the HUF will need to appoint a new Karta, who needs to submit following documents for transmission:

- i. Request Form (Form T4) for change of Karta upon demise of the registered Karta.
- ii. Death Certificate of the deceased Karta in original OR photocopy duly attested by a Notary Public or a Gazette Officer.
- iii. Bank's letter certifying that the signature and details of new Karta have been updated in the bank account of the HUF & attesting the Signature of the new Karta as per Annexure-1b.
- iv. KYC Acknowledgment OR KYC Form of the new Karta and the HUF, if not KYC compliant.
- v. Indemnity Bond as per Annexure V signed by all surviving coparceners (including new Karta).
- vi. If the transmission amount is upto Rs. 2 Lakh, any appropriate document evidencing relationship of the new Karta and the other coparceners with the deceased Karta.
- vii. If the transmission amount is more than Rs. 2 Lakh, any one of the documents mentioned below –
  - Notarized copy of Settlement Deed, or
  - Notarized copy of Deed of Partition, or
  - Notarized copy of Decree of the relevant competent court.

6 Transmission of Units to the Claimant/S Upon Death of the Karta of HUF, where there is no surviving co-parcener or the HUF has been dissolved/partitioned after demise of the Karta

- i. Transmission Request Form (Form T5) for Transmission of Units to the Claimant.
- ii. Death Certificate of the deceased Karta in original OR photocopy duly attested by a Notary Public or a Gazette Officer.
- iii. Copy of Birth Certificate in case the Claimant is a minor.
- iv. Copy of PAN Card of the Claimant(s) / Guardian (in case the Claimant is a minor)
- v. KYC Acknowledgment OR KYC Form of the Claimant(s) / Guardian (in case the Claimant is a Minor)
- vi. Cancelled cheque with the claimant's name pre-printed OR Copy of the Claimant's recent Bank Statement/Passbook (which is not more than 3 months old).
- vii. If the transmission amount is upto ₹2 Lakh, attestation of signature of the claimant by Bank Manager as per Annexure-1a. In case the claimant is a Minor, the signature of the

Guardian (as per the Minor's bank account / Minors joint account with the Guardian) shall be attested.

If the transmission amount is for more than Rs. 2 Lakh, signature of the claimant shall be attested by a Notary Public or a Judicial Magistrate First Class (JMFC) in the space provided for signature attestation in the TRF itself below the signature of the claimant.

viii. Bond of Indemnity to be furnished by the Claimant as per Annexure-VI.

ix. If the HUF has been dissolved/partitioned by the surviving members after demise of the Karta, the transmission of units should be effected only on the basis of any of the following documents:

- Notarized copy of Settlement Deed, OR
- Notarized copy of Deed of Partition, OR
- Notarized copy of Decree of the relevant competent Court.

## 7 IMPORTANT POINTS TO NOTE

a. In case of death of the 1st holder, if there are two surviving joint holders, the surviving 2nd holder will be treated as the new primary / 1st holder.

b. PAN card copy of the nominee /claimant/s need not be insisted separately, if the same is available in KYC data. In case of residents of Sikkim, appropriate Id. proof shall be collected in lieu of PAN card.

c. Where the units are to be transmitted to a claimant who is a minor, various documents like KYC, PAN, Indemnity should be of the Guardian of the minor nominee / legal heir. Bank Attestation of the Signature of the Guardian of the minor shall be as per the bank account of the Minor or the joint account of the Minor with the Guardian.

d. In case of multiple nominees/ claimants, the monetary threshold of more than ₹2 lakh for the purpose of obtaining the Indemnity Bond shall be determined on the basis of the aggregate value of the Units under all the folios for which the claim is being submitted as per the latest NAV as on the date of receipt of the claim, before dividing / splitting the claim amongst multiple nominees or claimants/ surviving co-parceners.

e. Also, where there are more than one nominees/legal heirs (claimants) in a folio or set of folios, the nominees/legal heirs should be encouraged/requested to submit the Transmission request together, so that all the Units held by the deceased unitholder(s) could be transmitted in one-go to for operational efficiency and convenience.

f. If the deceased unitholder(s) held units in several folios, as 1st holder(s) in some folios and as joint holder in other(s), a single claim form may be accepted for operational ease, provided the ALL the deceased holders are common across the multiple folios (irrespective of the order of names) AND the nominee(s)/claimant(s) is/are also common/same across ALL the folios.

g. Once a transmission request is received, it is incumbent upon the AMC/RTA to determine if the deceased unitholder had any unit holdings under any other scheme / folio, and put a flag in the system against all other folios of the deceased unitholder, basis PAN / PEKRN with a suitable communication to the surviving unitholders / nominee/s (if any, registered against the folios) to submit the claim form with reqd. documents in respect of the remaining folios.

h. In such cases where the deceased was the 1st holder in respect any one of the folios/funds, units in all other holdings across all other folios/schemes, where the deceased was the 1st unitholder shall be 'Stop' marked/blocked against any further transactions basis PAN or PEKRN.

i. The process and documentation for transmission of units where the claimant / nominee is a mentally unsound person, shall be the same as applicable to a Minor claimant, except that the Guardian shall be a court appointed guardian. Additionally, a Medical Certificate from an appropriate registered medical practitioner may be obtained regarding the Mentally unsound person.

j. Copies of all supporting documents submitted for settlement of the claim, such as the Death Certificate of the deceased, Birth certificate of the minor, Probate of Will, Succession Certificate, Letter of Administration shall be duly attested by a Notary Public or a Gazette Officer.

k. If the transmission amount is for more than Rs. 2 Lakh, as an operational risk mitigation measure, the signature of the Nominee/ Claimant shall be attested only by a Notary Public or a Judicial Magistrate First Class (JMFC) in lieu of banker's attestation. For this purpose, space has been provided for signature in the TRF itself below the signature of the claimant.

l. While the list of documents mentioned above should be taken in all cases, in specific cases and situations related to transmission of units that are not enumerated in section 1 to 6 above, AMCs should adopt proper due diligence and request for appropriate documents depending on the circumstances of each case and apply the general principles enumerated in sections above before transmitting the units in favour of the claimant/s.

## ANNEXURES AND FORMS<sup>88</sup>

1. Annexure B - Transmission Documents Matrix - Ready Reckoner
2. Form T1 - for Deletion of Name of the deceased 2nd or 3rd Jt. Holder
3. Form T2 - for Transmission of Units - Where the 1st holder is Deceased
4. Form T3 Transmission Request Form for Nominee & Legal Heir
5. Form T4 Transmission Request Form for change of Karta upon demise of the registered Karta
6. Form T5 Transmission Request Form where HUF is dissolved upon demise of Karta
7. Annexure-Ia – Form for Bank Attestation of Signature & bank account details
8. Annexure-Ib – Form for Bank Attestation of Signature of the new Karta
9. Annexure-II - Bond of Indemnity furnished jointly by all Legal Heirs for Transmission without Legal Representation
10. Annexure-III - Individual Affidavits to be given by ALL the Legal Heirs
11. Annexure-IV - NOC from other legal heirs (when there is no
12. Annexure-V - Indemnity from coparceners for change of Karta
13. Annexure-VI - Bond of Indemnity by surviving member of dissolved HUF
14. Standard MF Nomination Form

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<sup>88</sup> <https://www.amfiindia.com/investor-corner/investor-center/procedure-to-claim.html>

***Answer Key to Chapter-end Sample questions:***

	<b>Chapter 1</b>	<b>Chapter 2</b>	<b>Chapter 3</b>	<b>Chapter 4</b>	<b>Chapter 5</b>	<b>Chapter 6</b>
1	b	b	c	a	d	b
2	a	a	a	a	c	b
3	c	c	b	c	c	a
4	d	b	b	a	b	b
5	c	c	d	d	a	a
	<b>Chapter 7</b>	<b>Chapter 8</b>	<b>Chapter 9</b>	<b>Chapter 10</b>	<b>Chapter 11</b>	<b>Chapter 12</b>
1	a	b	a	a	b	d
2	b	a	b	a	d	a
3	a	c	c	c	d	b
4	c	b	b	c	a	a
5	b	a	d	a	b	a

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