Chapter 1

INTRODUCTION

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1.1 Mutual Fund

1.1.1 Meaning & Need

Mutual Fund is a tool of investment for the investors who have a common goal of investment. It has been a part of the capital market of the economy. Almost every economy in the world which is having its own capital market has the mutual fund industry. The name MUTUAL FUND indicates itself that the people who MUTUALLY agree to carry out a common activity i.e. investment with a common goal by creating a pool of investment which is called as FUND.

A mutual fund is a managed group of owned securities of several corporations. These corporations receive profits on the shares that they hold and realize capital gains or losses on their securities traded. Investors purchase units in the mutual funds as if it was an individual security. After paying operating costs, the earnings (dividends, capital gains or losses) of the mutual fund are distributed to the investors, in proportion to the amount of money invested.

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Mutual Funds are useful as a tool of investment for various classes of the society. For a retail investor, mutual funds provide a very simple way of investment through which they can invest in stock market and other investment options. A retail investor who is not aware about the workings of stock market but still is interested in the investment in stock market can start his investments through mutual funds. During the last few years, mutual funds have emerged as the instrument of investment and is considered for the investment planning for the post-retirement investment.

It is equally useful for the HNIs (High Net-worth Individuals) who wish to park their money in relatively riskier instrument and thereby getting an opportunity to get higher returns. Some types of mutual funds are very much useful for the corporate who wish to park their large amount of money for a short period of time in an instrument where they can get an opportunity of getting handsome rate of returns.

1.1.2 Classification of Mutual Funds

A mutual fund scheme has to be well defined and structured before it is offered to the investors. As a result there are different types of mutual funds. At present following types of mutual funds are available in the industry.

A) By Structure

- i) Open - Ended Funds
- ii) Close - Ended Funds
- iii) Interval Schemes

B) By Investment Objectives

- i) Growth/Equity Oriented Funds
- ii) Income/Debt Oriented Funds
- iii) Balanced funds
- iv) Money Market / Liquid Funds
- v) Gilt Funds
- vi) Index Funds

A) Classification by Structure

i) Open-ended Fund

An **open-ended Mutual fund** is one that is available for subscription and repurchase on a continuous basis. These Funds do not have a **fixed maturity period**. Investors can conveniently buy and sell units at **Net Asset Value (NAV)** related prices which are declared on a daily basis. The key feature of open-end schemes is liquidity.

ii) Close-ended Fund

A close-ended Mutual fund has a stipulated maturity period e.g. 5-7 years. The fund is open for subscription only during a specified period at the time of launch of the scheme. Investors can invest in the scheme at the time of the initial public issue and thereafter they can buy or sell the units of the scheme on the stock exchanges where the units are listed. In order to provide an exit route to the investors, some close-ended funds give an option of selling back the units to the mutual fund through periodic repurchase at NAV related prices. SEBI Regulations stipulate that at least one of the two exit routes is provided to the investor i.e. either repurchase facility or through listing on stock exchanges. These mutual funds schemes disclose NAV generally on weekly basis.

iii) Interval Schemes

A fund that combines the features of open-ended and closed-ended schemes, making the fund open for sale or redemption during pre-determined intervals. In other words, this is a mutual fund with redemption features in between those of closed-end and open-end funds

B) Classification by Investment Objectives

A scheme can also be classified as growth fund, income fund, or balanced fund considering its investment objective. Such schemes may be open-ended or close-ended schemes as described earlier. Such schemes may be classified mainly as follows:

i) Growth / Equity Oriented Funds

The aim of growth funds is to provide capital appreciation over the medium to long- term. Such schemes normally invest a major part of their corpus in equities. Such funds have comparatively high risks. These schemes provide different options to the investors like dividend option, capital appreciation, etc. and the investors may choose an option depending on their preferences. The investors have to indicate the option in the application form. The mutual funds also allow the investors to change the options at a later date. Growth schemes are good for investors having a long-term outlook seeking appreciation over a period of time.

ii) Income / Debt Oriented Funds

The aim of income funds is to provide regular and steady income to investors. Such schemes generally invest in fixed income securities such as bonds, corporate debentures, Government securities and money market instruments. Such funds are less risky compared to equity schemes. These funds are not affected because of fluctuations in equity markets. However, opportunities of capital appreciation are also limited in such funds. The NAVs of such funds are affected because of change in interest rates in the country. If the interest rates fall, NAVs of such funds are likely to increase in the short run and vice versa. However, long term investors may not bother about these fluctuations.

iii) Balanced Funds

The aim of balanced funds is to provide both growth and regular income as such schemes invest both in equities and fixed income securities in the proportion indicated in their offer documents. These are appropriate for investors looking for moderate growth. They generally invest 40-60% in equity and debt instruments. These funds are also affected because of fluctuations in share prices in the stock markets. However, NAVs of such funds are likely to be less volatile compared to pure equity funds.

iv) Money Market or Liquid Fund

These funds are also income funds and their aim is to provide easy liquidity, preservation of capital and moderate income. These schemes invest exclusively in safer short-term instruments such as treasury bills, certificates of deposit, commercial paper and inter-bank call money, government securities, etc. Returns on these schemes fluctuate much less compared to other funds. These funds are appropriate for corporate and individual investors as a means to park their surplus funds for short periods.

v) Gilt Fund

These funds invest exclusively in government securities. Government securities have no default risk. NAVs of these schemes also fluctuate due to change in interest rates and other economic factors as is the case with income or debt oriented schemes.

vi) Index Funds

Index Funds replicate the portfolio of a particular index such as the BSE Sensitive index, S & P NSE 50 index (Nifty), etc these schemes invest in the securities in the same weightage comprising of an index. NAVs of such schemes would rise or fall in accordance with the rise or fall in the index, though not exactly by the same percentage due to some factors known as "tracking error" in technical terms. Necessary disclosures in this regard are made in the offer document of the mutual fund scheme. There are also exchange traded index funds launched by the mutual funds which are traded on the stock exchanges

1.1.3 Advantages of Mutual Funds' Investment

Mutual Funds offer several advantages. They act as an instrument to enter into big companies' stocks to a retail investor with his small investment. As pointed out in earlier points, mutual funds offer opportunities of investment to different classes of the society. More specifically, some of the important advantages of mutual funds are listed below

Figure 1 -Advantages of Mutual Funds' Investment

1. Well regulated investment

In every country mutual funds are governed by well designed regulations. In India, mutual funds are regulated by Securities & Exchange Board of India (SEBI). The rules and regulations framed and enforced by SEBI protect the interest of the investors and as a result the mutual funds' investments have been very transparent.

2. Diversified Investment

One of the basic guidelines for the successful investing is diversification in the overall investment. It has been proven many times that a crucial element in investing is assets allocation which plays a very important part in the success of any portfolio. However, small investors may not have enough money to properly allocate their assets. By pooling funds with others, the investor enjoys the benefits from greater diversification. Mutual Funds invest in a broad range of securities. This reduces investment risk by reducing the effect of a possible decline in the value of any single security. Mutual Fund unit-holders can benefit from diversification techniques usually available only to investors wealthy enough to buy significant positions in a wide variety of securities.

3. Scope for selection of Schemes

Mutual Funds provide investors with various options with different investment objectives. Investors have the option of investing in a scheme having a correlation between its investment objectives and their own financial goals. These schemes further have different plans & options. The availability of these options makes them a good option. While equity funds can be as risky like the stock markets themselves, debt funds offer the kind of security that is generally aimed at the time of making investments.

4. Professional Management

The investment decisions in a mutual fund are made by professionally qualified managers with sound experience. Fund manager carries out extensive research work and has better investment management skills which ensure higher returns to the investor than what he can manage on his own. The transaction costs are low because they deal in large volumes. The earnings of the funds are distributed to the investor after deducting expenses. A mutual fund investor can enjoy the benefits of high return from investment in share and other instruments, and at the same time reduce the risk associated with it to a minimum. Two components of returns are capital appreciation and revenue income.

5. **Lesser risk**

An individual investor in mutual funds acquires a diversified portfolio of securities even with a small investment in a mutual fund. The risk in a diversified portfolio is lesser than investing in merely two or three securities. As a result, an investor investing in mutual funds get all the benefits of investing in stock market but carry lesser risk.

6. **Low transaction costs**

Due to the economies of large scale i.e. benefits of larger volumes, mutual funds pay lesser transaction costs. These benefits are passed on to the investors. SEBI has restricted mutual fund companies for charging the expenses to investors beyond a certain limit.

7. **Liquidity**

Units of an open-ended mutual fund schemes are very liquid in nature. The can redeemed on any working day. Any investor can book his profit by selling the units either fully or partly.

1.1.4 Risks associated with mutual funds investment.

Mutual Funds are not free from investment risks. Like any other investments, they carry risks and costs associated with returns. As an investor, the risks of a fund directly have an impact on the returns. Risk refers to the possibility of losing money(both principal and any earnings) or failure to make money on an investment. A Fund's investment objective and its holdings are influential factors in determining how risk a fund is. Generally speaking, risk and potential return are related. This is the risk-return trade-off. Following are the major risks involved in mutual fund investments

Figure 2 -Risks associated with mutual fund investment

a) **Country Risk:** If the nation is facing problems, automatically the mutual fund investment also gets affected by the same problems. The possibility of political events like war, terrorism etc., financial problems like inflation, government defaults or natural disasters like earthquake, poor harvest will weaken a country's economy and cause investments in that country to decline.

b) **Income Risk:** The possibility that a fixed-income funds' dividends will decline as result of falling overall interest rate. This is called as income risk which as explained above mainly affects the fixed income funds.

c) **Industry Risk:** The possibility that a group of stocks in a single industry will decline in price due to developments in that industry. This risk is mainly for the Sectoral mutual funds in which major part of investment is allocated to a specific sector.

d) **Inflation Risk:** The possibility that increases in the cost of living will reduce or eliminate a fund's real inflation-adjusted returns

e) **Fund Manager's Risk:** The possibility that an actively managed mutual funds 'investment adviser will fail to execute the funds' investment strategy effectively resulting in the failure of stated objectives. Though this risk remains there in short run only, it may deteriorate the financials of the fund.

f) **Market risk:** The possibility that stock fund or bond fund prices overall will decline over short or even extended periods. Stock and bond markets tend to move in cycle, with period when prices rise and other periods when prices fall.

g) **Principal risk:** The possibility that an investment will go down in value or 'lose money' from the original or invested amount.

1.2 INDEX

1.2.1 Meaning of Index

Index is a statistical indicator which is used in measurement and reporting of changes in the market value of a group of stocks/shares. An index is considered as an instrument which derives its value from other instruments. The index may be weighted index to reflect the market capitalization of its components, or may be a simple index which just represents the net change in the prices of the underlying instruments.

An index is classified according to the method used to determine its price. In a Price Weighted index, the price of each component stock is the only consideration when determining the value of the index. Thus, price movement of even a single security influences the value of the index even though the price shift may be less significant in a relatively highly valued issue. Thus it may ignore the importance of relative size of the company as a whole.

On the other hand, in case of a market value weighted or capitalization weighted index the size of the company is also taken in to consideration. Thus, a relatively small change in the price of a large company may have a heavy influence on the value of the index. Thus it is important and crucial to have a proper type of index for the capital market so that the movements in the stock markets are demonstrated properly.

1.2.2 Free-float Methodology of Index

Traditionally, capitalization- or share-weighted indices all had a full weighting. In other words, all outstanding shares were considered for the calculation of the index. However there is change in the methodology of calculation of the index. As per the other method of calculation of index which is called Free Float Index an index construction methodology takes into consideration only the free-float market capitalization of a company for the purpose of index calculation. By this way it assigns weights to stocks in the Index. Free-float market capitalization takes into account those shares only which are issued by the company and that are readily available for trading in the market. It generally excludes following holdings for the calculation of index.

- promoters' holding
- government holding
- strategic holding and
- other locked-in shares

The shareholdings mentioned above do not come to the market for trading in the normal course. Thus the market capitalization of each company in a Free-float index is reduced to the extent of its readily available shares in the market.

Major Advantages of Free-float Methodology

Following are the major advantages of free-float methodology of index calculation

1) As the free float index considers those shares which are available for trading in the market, it reflects the market trends in a more rational way.

2) Free-float methodology index is more broad-based which reduces the concentration of top few companies in Index.

3) A Free-float index has the benefits of active investment as well as passive investment. It is a passive investment approach as it takes only those scripts which fulfill the eligibility criteria. In other words, there is no biasness towards or against a specific company for inclusion or exclusion of the stock from the index. It is equally active way of investment as it takes into consideration the available number of stocks for actual trading a company having very less number of shares available for trading cannot have its impact on the index.

4) Free-float Methodology improves flexibility of the index calculation. In other words in can include or exclude any of the stock which does not fulfill the criteria of the same. It improves market coverage and sector coverage of the index.

Thus, under a full-market capitalization methodology, companies with large market capitalization and low free-float are not included in the Index because they tend to distort the index by having an undue influence on the index movement. However, under the free-float Methodology, since only the free-float market capitalization of each company is considered for index calculation, it includes such closely held companies also in the index while at the same time preventing their undue influence on the index movement.

1.2.3 Parameters considered for constructing the index.

As pointed out above, index is the indicator of representative stocks in the market. There are specific guidelines for constructing the index which are explained below.[1]

1) Liquidity of the stock –

Usually highly liquid stocks are considered for including in the index. Here, the impact cost of the stock is considered as the determining factor for the liquidity of the stock. The impact cost is determined by the cost that is paid by the trader when actually trading that stock. For example if a stock cost is Rs. 100 in the market but when the stock is bought by the trader he is paying Rs.101, then the market impact cost of the stock will be 1% and this stock will be considered as a highly liquid stock because of the lower impact cost of the stock.

2) Optimum Size of the index –

The size of the index has to be optimum. Though more number of stocks in the stock index may reduce the level of risk for the investors, beyond a point increasing the number of stocks in the index hardly has any effect on the index. Hence it is important to determine first the number of stocks that is perfect for the index. This is done by the determining the optimum size of the index.

[1] www.nseindia.com/content/ncfm/DMDM_rev

3) **Diversification of sectors** –

Another important point considering while constructing an index is that the stock are selected in such a manner so that the overall balanced representation of all the sectors of the listed companies is maintained. The idea behind the same is to avoid over-dependence of the index on a specific sector or even total ignorance to a particular sector's stocks. This also is done to reduce the 'stock noise' of the index. In other words, the debacle in a certain sector should not adversely and intensely affect the index as a whole.

4) **Market capitalization of the stocks** –

As pointed out above, the basic criteria for inclusion of stocks in an index is its market capitalization. Usually while constructing the index the stocks with large market capitalization are selected. Large companies that are listed in that stock exchange are considered for making the index. This is basically done to ensure that whenever there is major change in the price of that particular stock that change is reflected to the index. Thus the basic concern for the selection of any stock for the inclusion in the index its capacity to portraying the market condition.

5) **Reflection of condition of the economy-**

The index construction is done in such a way that it reflects the condition of the economy rather than a condition of a particular company or a sector. Thus while making the index and selecting the company for the index it is important that the averaging of stock is done in way that will minimize the effect of the price of one stock on the index.

1.3. Index Funds

1.3.1 Meaning & Advantages of Index Fund Investments

Index Funds are those mutual funds which invest in stocks included in index. As indexing is a way of getting benefits by having exposure to an index, Index Funds also are expected to gain same exposure. As Indices cover maximum industry sectors in the stock market, index funds are also expected to reflect the same picture.

The active fund managers always try to outperform the index by picking sectors and securities they believe will outperform in the future. The index funds, on the other hand believe that rather than trying to guess which investments will outperform in the future, it is better to replicate the stock market. Thus index funds in all the stocks of the index or sometimes only few stocks from the index

The concept of indexing is based on the assumption that investors as a group cannot beat the market. It also believes that picking consistently outperforming is very difficult, so indexing provides a way of accessing market performance without high costs.

Thus it can be pointed out an investor interested to invest in all the scripts which are included in a specific index, should invest in Index Funds. Investing in representation of stocks in a market index can maximise diversification and reduce risk. Buying and holding securities over the long term reduces volatility and investment costs (including tax) and can lead to better returns in the long run.

1.3.2 Types of index funds

Following are the types of index funds.

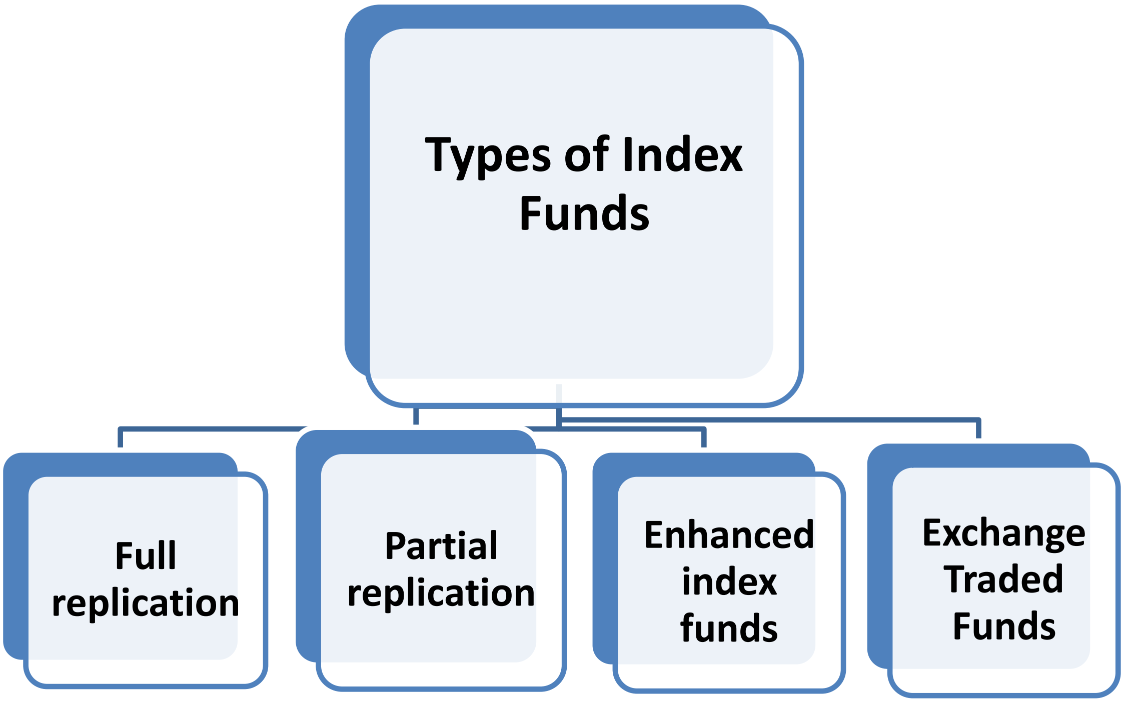

Figure 3 -Types of Index Funds

- **Full replication** –

  This type of Index Fund invests in all securities in an index. For example, an Index Fund investing all the 30 stocks comprised in Sensex can be called as an Index Fund with replication

- **Partial replication** –

  An Index Fund which holds a representative sample of securities in an index. For example an Index Fund which invests in some of the stocks only which are the part of CNX Nifty Index is an Index Fund with partial replication.

- **Exchange Traded Funds** –

  Index Funds which are traded on the stock exchange like shares. The major benefit of these types of funds is that they track real time value of the benchmark index.

- **Enhanced index funds** –

  Enhanced Index Funds are the index funds which offer enhanced performance by investing in scripts of the benchmark index as well as in some other scripts which the fund manager may think fit.

1. 3.3 Working of Index Mutual Fund

1) Lesser costs

The working of index funds is very simple as they have come from academic economics into the real world. Indexing is based on the assumption that if markets are fairly efficient, then it would prove difficult for active managers to obtain excess returns, after considering their higher fees and costs that they have to run up. Hence, instead of actively involving in stock picking, index funds simply try to replicate the returns on a chosen market index and aim to deliver the returns and the risk of that index.

2) 'Lower Tracking Error' is the key to success.

Another factor which governs the working of index funds is their lower tracking error. Thus evaluating an index fund's performance mainly concentrates on observing how closely a fund tracks the underlying index. This is measured in terms of 'tracking error'. A well–managed index fund is one which incurs low tracking error. The job of an index fund manager is therefore to minimise the tracking error.

3) Practical difficulties in "full replication of an Index."

In principle, managing an index portfolio requires investment in all constituent index securities in the exact proportion as the underlying benchmark. This is called a "full replication" approach. In practice, fund managers have the difficulties of replicating the benchmark index returns[2]. The index represents a mathematical calculation derived from a portfolio of securities that are not subject to the same market frictions as those faced by index mutual funds. Index funds incur transactions costs that are associated with portfolio implementation, re-balancing and capital flows. When the composition of the underlying index changes, either due to additions or deletions of constituents or due to corporate restructuring, the index assumes that the theoretical portfolio's new weights to each security can be achieved automatically. However, for the index fund, adjusting the portfolio to mimic the underlying benchmarks involves physical trading in stock and the transactions costs incurred thereby. Hence, factors driving tracking error include transactions costs, fund cash flows, un-invested /buffer cash, treatment of dividends by the index, corporate actions, and index composition changes.

4) Challenge to maintain liquidity

The liquidity of the underlying index securities also has implications for transaction costs (in terms of impact cost) and in turn the tracking error incurred by funds. As a result of ongoing subscriptions and redemptions, open–ended index mutual funds may face liquidity problems. At the time of subscriptions, index funds are required to immediately invest the cash flow across index securities,

[2] "Difficulties in managing Index Funds" by Mr Chiang & Mr Perold 1998

and at the time of redemptions, to sell securities to generate cash. Index funds often maintain cash balance to meet redemptions' requisitions. Thus it is always a challenge for the index fund managers to maintain the liquidity of their funds.

5) Timings of Cash Flows

The size and timing of cash flows also has an impact on tracking error. Liquidity of index stocks has implications for transactions costs, both implicit and explicit. Full–replication index funds could be required to have part of their assets in illiquid index securities. When faced with large subscriptions or redemptions, the fund is forced to trade on the market under non–ideal liquidity conditions, resulting in high transactions costs and tracking error. Typically there is a timing delay between when the index incorporates the dividend (at the ex–dividend date) and the actual receipt of the dividend by the index fund (after the ex–dividend date). Most indexes assume that accrued dividends are reinvested the day the stock goes ex–dividend. Actual receipt of dividends could take as long as several weeks.

6) Changes in Index due to corporate restricting.

When index securities are subject to corporate restructuring such as mergers, acquisitions or takeover by another company outside the index, there may be a timing delay between the date the company is removed from the index and the date the index fund receives the cash settlement. In addition, front– running by risk arbitrageurs who acquire securities ahead of their inclusion in the index may also have an undesirable impact. If the index fund is perfectly aligned with the index, the volatility of the underlying index will not result in tracking error. Since the index fund owns exactly the same portfolio as the index, however volatile the index movements are, the fund will perfectly track them. If however, the index fund portfolio does not perfectly mirror the index, volatility of the underlying index will result in tracking error.

7) Successful use of Optimisation Technique[3]

It looks very simple apparently to invest in the stocks of the index however many times index volatility is of greater concern to the index funds. Many times they hold a portfolio that is different from the index portfolio in the hope of minimising transactions costs associated with trading illiquid stocks. The portfolio is chosen such that it has a high correlation with the index. When the index movement is normal and within range, such an optimized portfolio will perform accordingly. However, sometimes when there is high volatility in the index in a very short period of time, the idea of optimized portfolio may fail to track the index, resulting in higher tracking error.

1.4 Structure of Indian mutual funds:

The Mutual Funds in India are regulated by SEBI Mutual Funds Regulations, 1996[4]. Under the regulations mutual fund is formed as a Public Trust under the Indian Trusts Act, 1882. These regulations stipulate a three tiered structure of entities – sponsor, trustees, and Asset Management Company. All these three entities carry out different functions of a mutual fund with the common objectives. The primary responsibility, however, remains with the trustees. Following are the brief details of these three entities and other related institutions as well.

[3] "Successful use of Optimisation Technique in Index funds management" by Rudd 1980 and Jansen & Can Dijk 2002.
[4] SEBI Mutual Funds Regulations, 1996

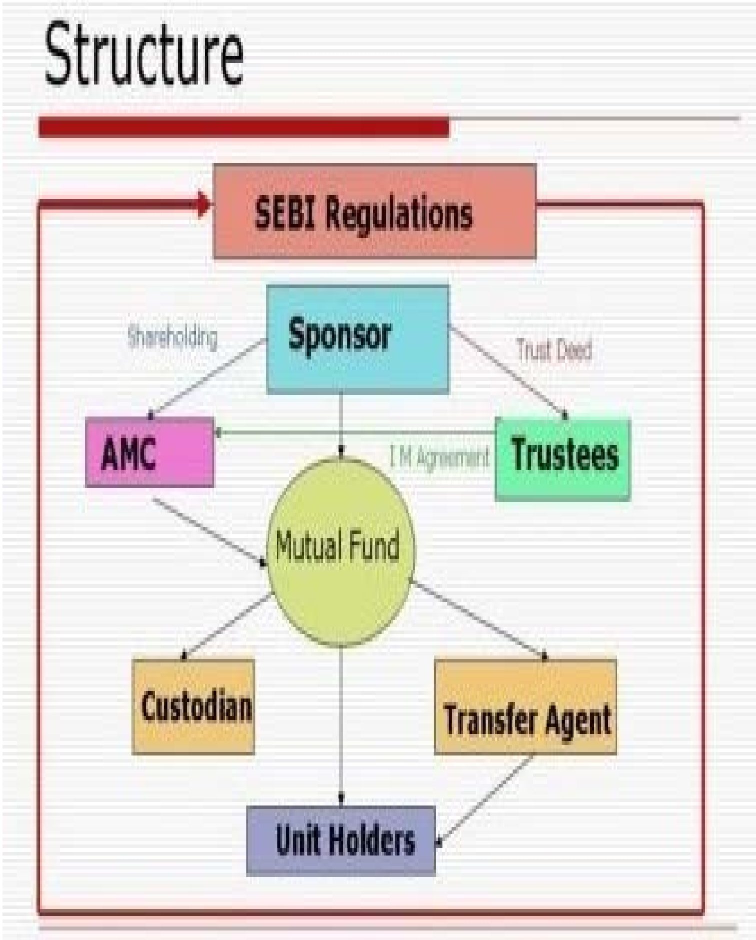

Figure 4 -Structure of Mutual Funds

1) Sponsor

The Sponsor is the person who either itself or in association with another body corporate establishes a mutual fund. Sponsor sets up a mutual fund to earn money by doing fund management through its subsidiary company which acts as Investment manager of the fund. In other words, a sponsor can be compared with a promoter of a company. Sponsors activities include setting up a Public Trust under Indian Trust Act, 1882 (the mutual fund), appointing trustees to manage the trust with the approval of SEBI, creating an Asset Management Company under Companies Act, 1956 (the Investment Manager) and getting the trust registered with SEBI.

Mutual funds involve managing retail investor’s money and hence, it becomes important to ensure that it is run by entities with capabilities and professional merits. SEBI (Mutual fund) Regulations, 1996 specifies the following eligibility criteria in this regard:

(i) The person or an institute who intends to act as a sponsor must have the financial services business experience of at least 5 years. The net worth in all the preceding five years must be positive.

(ii) Another eligibility criteria for the sponsor is that his net worth in the immediately preceding year is required to be more than the capital contribution to AMC.

(iii) Sponsor is required to be profit making in at least three out of the last five years including the last year.

(iv) Sponsor must contribute at least 40% of the Net worth of the Asset Management Company

2) Trustees

Trustees play an important role in the workings of the mutual fund companies. A trust is formed by a document called the trust deed which is executed by the fund sponsor in favor of the trustees. Trustees manage the trust and are responsible to the investors in the mutual funds. They are the primary guardians of the unit-holders funds and assets. Trustees can be formed in either by forming a Board of Trustees, or a Trustee Company. The provisions of Indian Trust Act, 1882, govern board of trustees or the Trustee Company.

A trustee company is also subject to provisions of Companies Act, 1956.

Trustees ensure that the activities of the mutual fund are in accordance with SEBI (Mutual Funds) regulations, 1996. They check that the AMC has proper systems and procedures in place. Trustees also make sure that all the other fund constituents are appointed and that proper due diligence is exercised by the AMC in the appointment of constituents and business associates. All schemes floated by the AMC have to be approved by the trustees. Trustees review and ensure that the net worth of the AMC is as per the regulatory norms. They furnish to SEBI, on a half-yearly basis, a report on the activities of AMC.

The Trustees are required to fulfill several duties and obligations in accordance with SEBI (Mutual Funds) Regulations, 1996 and the Trust Deed constituting the Mutual Fund.[5]

The major duties of the trustees include

1. Entering into an Investment Management Agreement (IMA) with the approval from SEBI.

2. Carrying out the duties as mentioned in the Fourth Schedule of the SEBI (MFs) Regulations, 1996[6] and other such clauses as are necessary for making investments.

3. Obtaining information from the Asset Management Company as considered necessary.

[5] www.**mutualfunds**india.com/sebi/mf3.htm
[6] *www.sebi.gov.in/acts/mfreg96.html*

4. Ensuring before the launch of any scheme that the Asset Management Company possesses/has done the following:[7]

   a. Systems in place for its back office, dealing room and accounting;

   b. Appointed all key personnel including fund manager(s) for the Scheme(s) and submitted their bio-data which shall contain the educational qualifications, past experience in the securities market to SEBI, within 15 days of their appointment;

   c. Appointed Auditors to audit its accounts;

   d. Appointed a Compliance Officer to comply with regulatory requirement and to redress investor grievances;

   e. Appointed Registrars and laid down parameters for their supervision;

   f. Prepared a compliance manual and designed internal control mechanisms including internal audit systems; and

   g. Specified norms for empanelment of brokers and marketing agents

[7] *www.sebi.gov.in/mfsid/jpmorgansai.pdf*

3) Asset Management Company

The Asset Management Company (AMC) is the investment Manager of the Trust. The sponsor, or the trustees is so authorized by the trust deed, appoints the AMC as the "Investment Manager" of the trust (Mutual Fund) via an agreement called as 'Investment Management Agreement'. An asset management company is a company registered under the Companies Act, 1956. Sponsor creates the asset management company and this is the entity, which manages the funds of the mutual fund (trust). The mutual fund pays a small fee to the AMC for management of its fund. The AMC acts under the supervision of Trustees and is subject to regulations of SEBI [8].

The AMC is an operational arm of the mutual fund.AMC is responsible for all carrying out all functions related to management of the assets of the trust. The AMC structures various schemes, launches the scheme and mobilizes initial amount, manages the funds and give services to the investors. In fact, AMC is the first major constituent appointed. Later on AMC solicits the services of other constituents like Registrar, Bankers, Brokers, Auditors, Lawyers etc and works in close co-ordination with them.

Restrictions on business activities of the Asset Management Company – In India, regulator has ensured that an AMC focuses just on its core business and that the activities of AMC's are not in conflict of each other. These are ensured through the following restrictions on the business activities of an AMC. a. An AMC shall not undertake any business activity except in the nature of portfolio

[8] www.nseindia.com/content/ncfm/MFBM-workbook.pdf

management services, management and advisory services to offshore funds etc, provided these activities are not in conflict with the activities of the mutual fund. b. An AMC cannot invest in any of its own schemes unless full disclosure of its intention to invest has been made in the offer document c. An AMC shall not act as a trustee of any mutual fund

4) Custodian

The custodian play very crucial role in the mutual fund business because, though the securities are bought and held in the name of trustees, they are not kept with them. The responsibility of keeping the securities safe is on the custodian. Securities, which are in material form, are kept in safe custody of a custodian. The securities in the dematerialized form are deposited with the with a Depository participant. The depository participant has to work on the basis of the instructions given by the custodian. Thus the custodian performs a very important back office operations. Following are the benefits of having a custodian for a mutual fund scheme.

1) They ensure that delivery has been taken of the securities, which are bought, and that they are transferred in the name of the mutual fund.

2) They ensure that funds are paid out when securities are bought.

3) They keep the investment account of the mutual fund. They also have to collect and account for the dividends and interest receivables on mutual fund investments.

4) They keep track of various corporate actions like bonus issue, rights issue, and stock split; buy back offers, open offer etc and act on these as per instructions of the Investment manager.

Following are important responsibilities of a custodian:

(i) To provide post-trading and custodial services to the Mutual Fund;

(ii) To keep securities and other instruments belonging to the Scheme in safe custody;

(iii) To ensure smooth inflow and outflow of securities and such other instruments as and when necessary, in the best interests of the unit holders;

(iv) To ensure that the benefits due to the holdings of the Mutual Fund are recovered;

(v) To remain responsible for loss of or damage to the securities due to negligence on its part or on the part of its approved agents.

The Custodian normally charge portfolio fee, transaction fee and out-of -pocket expenses in accordance with the terms of the Custody Agreement and as per any modification made thereof from time to time.

Regulation imposes responsibility on the trustees to ensure that the AMC has proper system and procedures in place and has appointed key personnel and other constituents like R & T agents, brokers etc.

5) Registrar and transfer agent –

As explained above, mutual fund manages money of many unit-holders across cities and towns of the country. Investor servicing not only becomes important but challenging as well. This includes

- processing investors' application,
- recording the details of investors,
- sending them account statements and other reports on periodical basis,
- processing dividend payouts, making changes in investor details
- keeping investor records updated by adding details of new investors and by removing details of investors who withdraw their funds from the mutual funds.

It is very impractical and expensive for any mutual fund to have adequate workforce all over India for this purpose. Instead, they use entities called as Registrars and transfer agents, which generally provide services to many mutual funds. This ensures quality services across all location and keeps the costs lower for the unit-holders.

6) Auditor –

Investor money is held by the trustees in trust. Regulation has ensured proper accounting norms to ensure fair and responsible record keeping of investor's money. Separate books of account are maintained for each scheme of the mutual fund and individual annual report is prepared. The books of accounts and the annual reports of the scheme are audited by auditors. The AMC is a company under the Companies Act, 1956 and therefore is required to get its accounts audited as per the provisions of the companies act. In order to maintain high standards of integrity and transparency regulations stipulate that the auditor of the mutual fund schemes and the auditor of the AMC will have to be different.

7) Brokers[9] –

Brokers are registered members of the stock exchange whose services are utilized by AMCs to buy and sells securities on the stock exchanges. Many brokers also provide the Investment Manager (AMC) with research reports on the performance of various companies, sector and market outlook, investment recommendations etc. Regulations have imposes restrictions on the involvement of brokers in the investment process of any mutual fund in the following ways- a. If a broker is related to the sponsor or its associate, then the AMC shall not purchase or sell securities through that broker in excess of 5% of the aggregate of purchase and sale of securities made by the mutual fund in all its schemes. b. For transactions through any other broker the AMC can exceed the limit of 5% provided it has recorded justification in writing and report of such exceeding has been sent to the trustee on a quarterly basis

Securities and Exchange Board of India (SEBI) is the primary regulator of mutual funds in India. SEBI is also apex regulator of capital markets. Issuance and trading of capital market instruments and the regulation of capital market intermediaries is under the purview of SEBI. Apart from SEBI, mutual funds follow the regulations of other regulators in limited manner.

[9] www.nseindia.com/education/content/module_nism.htm

1. **RBI** - RBI acts as regulator of sponsors of bank-sponsored mutual funds, especially in case of funds offering guaranteed/assured returns. No mutual fund is allowed to bring out a guaranteed returns scheme without taking approval from RBI

2. **Companies Act, 1956** – Asset Management Company and Trustee Company will be subject to the provisions of the Companies Act, 1956.

3. **Stock Exchange** – Closed-end funds might list their units on a stock exchange. In such a case, the listings are subject to the listing regulation of stock exchanges. Mutual funds have to sign the listing agreement and abide by its provisions, which primarily deal with periodic notifications and disclosure of information that may impact the trading of listed units.

4. **Indian Trusts Act, 1882** – Recall that mutual funds are formed and registered as a public trusts under the Indian trusts Act, 1882. Hence, they have to follow the provisions of the Indian Trusts Act, 1882.

5. **Ministry of Finance (MoF)** – The finance ministry is the supervisor of both the RBI and SEBI. The MoF is also the appellate authority under SEBI regulations. Aggrieved parties can make appeals to the MoF on the SEBI rulings relating to mutual funds.