Trading of Units of Mutual Funds on Stock Exchanges

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According to the SEBI-NCAER survey, at the end of March 1999, 23 million unit holders had invested in units of mutual funds while 19 million individual investors had invested in equity or debentures. The proliferation in the number of mutual funds and their schemes has made investors bewildered and more often the small investor has no means to know which fund or scheme to choose. In such a scenario this article seeks to examine whether units of mutual funds are securities.

"PUT your money in trust, not trust in money" entices the small investors, who generally lack expertise to invest on their own in the securities market and prefer some kind of collective investment vehicle which can pool their marginal resources, invest in securities and distribute the returns therefrom among them on co-operative principles. The investors benefit in terms of reduced risk, and higher returns arising from professional expertise of fund managers employed by such investment vehicle. This was the original appeal of mutual funds (MFs), which offer a path far simpler and safer to stock market than the traditional call-a-broker-and-buy-securities route. This caught the fancy of small investors leading to proliferation of MFs. In developed financial markets, MFs have overtaken bank deposits and total assets of insurance funds. In the USA, the number of MFs far exceeds the number of listed securities.

Experimentation with MFs in India began in 1964 with the establishment of the Unit Trust of India (UTI), a statutory corporation with the objective of encouraging saving and investment. This was followed by entry of MFs promoted by public sector banks and insurance companies in 1987. The industry was opened to the private sector in 1993 providing Indian investors a broader choice. Starting with an asset base of Rs. 25 crore in 1964, the industry has grown exponentially to Rs. 90,587 crore at the end of March 2001. The number of households owning units of MFs exceeds the number of households owning equity and debentures. At the end of March 1999, according to the SEBI-NCAER survey of Indian Investors (2000), 23 million unit holders had invested in units of MFs, while 19 million individual investors invested in equity and or debentures.

The 1990s witnessed emergence of a variety of funds. There are funds which invest in growth stocks, funds which specialise in stocks of a particular sector, funds which assure returns to the investors, funds which invest in debt instruments and funds which invest aggressively and fund which do not do all these. Thus we have income funds, balanced funds, liquid funds, Gilt funds, index funds, sectoral funds and there are open-ended funds, close-ended finds and assured return funds - there is a fund for everybody. The number of Funds and Schemes offered by them increased to 35 and 393 respectively at the end of March 2001. The number of units/Schemes available today compare favourably with the number of securities/companies listed on stock exchanges and far exceeds the number of active securities. Such proliferation of number of MFs and their Schemes has made investors as bewildered as they are with the securities. The small investor has no means to know which fund or scheme to chose. He likes choice, but he is lost with too many choices.

UNITS *VERSUS* SECURITIES

The units of MFs not only compete with securities in terms of numbers, but also resemble securities to a large extent and hence compete with securities for attention of investors. Units represent the interest of the unit holder in the specific scheme just as securities represent the interest of the holder in the issuer. The unit holder has a similar right as a security holder has on the future performance of any underlying asset or group of assets. Special kinds of units (units of assured return schemes), which represent the rights of investors on a fixed income flow over the future years or a fixed maturity value at the end of a specified period, are similar to debentures issued by companies. UTI and other MFs issue units in a manner similar to issue of shares, debentures and other securities. These are listed and traded on various recognised stock exchanges like shares, debentures and other securities. These are transferred from one holder to another or sold back to the issuer, at pre-specified or market determined values, just like shares, debentures and other securities are. UTI and other MFs, as issuers of units, also have to adhere to all the requirements under the listing agreement with the respective exchanges as are applicable to the issuers of shares and debentures. The holders of units and securities have the same need for safety, liquidity and return. Despite such close similarities between units and securities, they are not treated at par. The units of non-UTI MFs are not considered securities in law. There is no regulatory framework that governs trading of units of MFs and this is one of the reasons why the secondary market for units has not developed to an appreciable extent. If there were a suitable regulatory framework and a vibrant market for units, the suspension of trading of units of US-64, which are securities, would not have invited wrath of small investors. Markets develop in a secured environment and this security is provided by a reliable regulatory framework. Market for derivatives did not develop till

* *The views expressed and the approach suggested in this paper are of the author and not necessarily of his employer.*

1. The Board should set up a Remuneration Committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the Company's policy on specific remuneration packages for Executive Directors including pension rights and any compensation payment.
2. To avoid conflicts of interest, the Remuneration Committee, which would determine the remuneration packages of the Executive Directors should comprise of at least three Directors, all of whom should be Non-Executive Directors, the Chairman of the Committee being an independent Director.
3. All the members of the Remuneration Committee should be present at the meeting.
4. The Chairman of the Remuneration Committee should be present at the Annual General Meeting, to answer the shareholder queries. However, it would be upto the Chairman to decide who should answer the queries.

Remuneration Committee under Schedule XIII as amended

Schedule XIII to the Companies Act, 1956 as now recently amended has introduced the concept of Remuneration Committee under the Companies Act, 1956, whereby Remuneration Committee has been defined as a committee which consists of at least three Non-Executive Independent Directors, including Nominee Director or Nominee Directors, if any. One could question the validity of the amendment with regard to making constitution of Remuneration Committee mandatory. However, it is not entirely wrong for doing so, if one takes into account the fact that the Schedule XIII, Part II is basically only a provision to facilitate the payment of minimum remuneration to the managerial personnel. In other words, no Company is required to constitute a Remuneration Committee, if it does not want this facility given in this part of the Schedule.

The amendment has for the first time introduced the concept of Independent Directors in the Companies Act, 1956, as this term does not exist in the said Act and is not defined anywhere therein. It is only to be presumed that this provision would adopt the definition given in Clause 49 of the Listing Agreement.

A chart giving the comparative legal position under Clause 49 and Schedule XIII to the Companies Act on the aspect of Remuneration Committee is given hereinbelow :

Particulars	*Clause 49*	*Schedule XIII*
No. of members in the committee	At least 3 Non-Executive Directors	At least 3 Non-Executive Independent Directors
Chairman of the Committee	Only an Independent Director to be the Chairman.	No provision on this point
Quorum for the Committee	All members of the Committee to be present.	No provision on this point
Presence of Chairman at the Annual General Meeting	Chairman should be present at the AGM to answer shareholder queries, but he can decide on who should answer the queries.	No provision on this point
Companies to which applicable	Only listed Companies, but a non-mandatory requirement.	Only to Companies with Paid-up Capital of Rs.5 crores or more, and only where minimum managerial remuneration is payable in case of absence of profits or inadequate profits.
Terms of Reference	To determine Company's policy on specific remuneration packages for Executive Directors, including pension rights and compensation payment.	No specific provision; But shall take into account financial position of the Company, trends in the industry, appointee's qualification, experience, past performance, past remuneration etc. while approving remuneration payable to Executive Directors; Interest of Company and share-holders should also be clearly considered.

In light of the above, in order to fall in line with the non-mandatory requirements of Clause 49 of the Listing Agreement, which would be a step in the right direction towards greater Corporate Governance and to be in a position to provide for minimum remuneration for the managerial personnel, it would be advisable for all listed companies to constitute at the earliest a Remuneration Committee, if not already done, with three Non-executive independent directors and with one of them being the Chairman of the Committee.

By keeping the requirements quite stringent for companies opting to avail of the provisions of minimum remuneration contained in Section II of Part II of Schedule XIII, while at the same time liberalising the ceiling limits, the Department of Company Affairs has done a good balancing act and it is hoped that this would promote better Corporate Governance in the country. ❑

2000 as there was no regulatory framework governing trading of derivatives even though there was no ban on derivatives trading.

INVESTORS DILEMMA

Now that the units and securities resemble each other both in terms of their numbers and the essential features, the investor is again back to square one. To address his problem of choice, he probably needs a mutual fund of MFs! The units appear even more risky as compared to securities as the fund managers churn the portfolio on daily basis while the issuers of securities do not reshuffle the assets so frequently. In order to help investor take informed decisions while choosing units of MFs, he needs to be guided and protected by a regulatory framework not less rigorous than that applicable to securities. Strangely, the units are not even subject to same level of regulatory discipline and compliance as applicable for securities. In case of securities, say issued by companies, the whole process of issue, allotment and transfer of securities and various aspects relating to company management etc. are provided in the Companies Act, 1956 and administered by the Department of Company Affairs. In addition, SEBI's jurisdiction extends over corporates in the issuance of capital and transfer of securities. All these matters relating to units of MFs are provided in the regulations framed by SEBI under the SEBI Act, 1992. Further, the trading of securities issued by corporates are governed by the Securities Contracts (Regulation) Act, 1957 (SCRA) and regulatory framework developed thereunder, while trading of units are not subject to similar regulatory framework. In fact, trading of units is not subject to any regulatory framework and this presents a case of regulatory gap. It is no argument that SEBI's jurisdiction over regulation of mutual funds under the SEBI Act, 1992 also extends over the trading of their units. If that were so, the Department of Company Affairs would be having regulatory jurisdiction over trading of securities as well as the powers to regulate companies. The governance of the company and trading of securities issued by them are provided explicitly in two different statutes and administered by two separate regulators. Similarly the powers of SEBI under the SEBI Act, 1992 to regulate collective investment scheme (CIS) is not enough to regulate trading of units of CIS. The regulatory framework for trading of units of CIS follows from the SCRA, which includes these units under the ambit of securities. It is also no argument that since MFs is a type of CIS (SEBI Act, 1992 empowers SEBI to regulate CIS, including MFs), the regulatory framework applicable to trading of units of CIS can govern the trading of units of MFs. This could have been presumed, if the SEBI Act, 1992 had not explicitly excluded the MFs from the definition of CIS. The SEBI Act, 1992 categorically states that the CIS does not include any scheme or arrangement under which contributions made are in the nature of subscription to a MF. Thus, the governance of entity issuing units/securities and trading of such units/securities need to be provided explicitly in the statutes. It is not enough if SEBI regulations require every close-ended scheme to be listed on a recognised stock exchange within six months from the closure of the subscription. The statute must provide the remedy if a stock exchange refuses listing of any MF. The statute must also prescribe the requirements of listing as these have been done for units of CIS or other securities. The statute must specify who can prevent undesirable transactions in units of MFs and how. Unless these happen, the investors can not be rescued if something untoward happens in the trading of units of MFs, as no regulator has supervisory jurisdiction over trading of units. This requires policy makers to act before it is too late.

UNITS NOT SECURITIES?

Some people believe that units of MFs are securities and hence the regulatory framework of securities is applicable to trading of units. They believe that since units are listed and traded on stock exchanges just like securities, that is, these are marketable, these are *de facto* securities. It is not so. It is a wrong presumption that all those traded on a stock exchange are securities and all those not traded on a stock exchange are not securities. The exim scrips which were traded in early 1990s on stock exchanges are not securities, while unlisted shares / bonds of government companies/government securities, even though not listed/traded, are securities. In fact, the tradability or marketability is a necessary condition, but not a sufficient condition, for an instrument to be a security. While all securities are marketable, all marketable instruments are not securities. Even all marketable securities are not securities under the SCRA, which provides regulatory framework for trading of securities. Only those marketable securities, which have been specifically identified by SCRA as securities, are securities irrespective of the fact that they are listed/traded or not. The requirement of listing or facility of trading does not make an investment instrument a security.

The easiest way to develop markets for units of MFs and protect the investors in them is to consider the units to be securities so that trading framework applicable to trading of securities would also apply to trading of units and the market regulator, SEBI which has the responsibility to protect the interests of investors in securities, can protect the interest of holders of units of MFs also. Since the jurisdiction of SEBI is limited to securities market and the units of MFs (except for units of UTI) are not explicitly recognised as securities in law, it is apprehended that the actions of SEBI in protecting the interests of investors in units of MFs and developing a market for them may not be sustained in the court of law.

In fact, it was recently contended by an Appellant before the Securities Appellate Tribunal (SAT) that he was not covered by the Rules as he was not dealing in securities, but in units of MFs which are not securities and hence the SEBI had no powers, authority or jurisdiction to conduct any enquiry or impose any penalty on him. While disagreeing with this, the SAT considered the units of MFs to be securities in view of the object and purpose underlying the SEBI Act.

Let us explore the possibility of considering units of MFs to be securities. Security is a type of investment instrument. It is a generic term for both debt claim, such as bonds or promissory notes, and certificates representing ownership such as common stock or ordinary shares. These are written evidences of ownership giving their holders the right to demand and receive property not in their possession. These are usually tradable claims on a Corporation or a State. While this is the commonly understood meaning of the securities, it is a terrible pain to recognise a security or to determine if a particular instrument is a security. No statute has attempted to define securities in terms of ingredients or attributes a securities ought to have. We can not, therefore, consider a particular instrument to be a security as it has all the specified attributes of the security. Only attribute common to all securities is that they are most unsecured! All the legislations in India and elsewhere have provided an inclusive definition of the "securities". And the instruments included in the ambit of securities vary widely among the countries and also under different statutes within the country.

The Securities Act of 1993 (USA) probably provides the longest list of securities. The list includes any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganisation certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities, or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", ...but does not include currency, any note, draft or bill of exchange,...

A number of legislations in India have defined securities. The Capital Issues (Control) Act, 1947 (since repealed) provided the earliest definition, followed by the SCRA, the Unit Trust of India (UTI) Act, 1963 and the Foreign Exchange Management Act (FEMA), 1999. Under the UTI Act, 1963, the "security" means -

(a) any share, stock, bond, debenture or debenture stock, of any body corporate;

(b) any unit or sub-unit issued by, or other participation in a unit scheme framed by, any body or authority outside India or a mutual fund established outside India;

and includes -

(i) a government security;

(ii) a saving certificate;

(iii) any security issued by any local authority; and

(iv) any foreign security.

Under the FEMA, 1999, "security" means shares, stocks, bonds and debentures, government securities, savings certificates, deposit receipts in respect of deposits of securities, units of UTI or any mutual fund.

Section 2 (h) of the SCRA 1956 reads:

" 'Securities' to include -

(i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of like nature in or of any incorporated company or other body corporate;

 (ia) derivatives;

 (ib) units or any other instrument issued by any collective investment scheme to the investors in such schemes;

(ii) Government securities,

(iia) such other instruments as may be declared by Central Government to be securities; and

(iii) rights or interests in securities."

Of all the Acts, which have defined securities, the SCRA contains the narrowest definition. But the sub-clause (iia) of clause (h) of the section 2 of the SCRA confers power upon Central Government to declare such other instruments to be securities. This sub-clause follows a number of sub-clauses, which enumerate specific instruments as securities. This means that Central Government can declare certain instruments as 'securities' only if they resemble securities enumerated in earlier clauses, i.e., these must conform to the description "such other" instruments. Hence only those instruments which are similar to ones enumerated in earlier clauses can be declared as securities. Thus, in terms of the definition in the SCRA, an instrument can be treated as 'securities', if—

(a) it is enumerated in the definition, or

(b) it is

 (i) marketable,

 (ii) of like nature, and

 (iii) of or in any incorporated company or body corporate, or

(c) it is declared to be "securities" by Central Government.

The units of MFs are not explicitly listed in the definition. These have not been declared to be securities by the Central Government. The only other way these can considered to be securities is that these satisfy all the ingredients as at (b) above. These are clearly marketable as these are listed and traded on recognised stock exchanges. These are also of 'like nature' as these represent on undivided share in the assets of scheme of a MF, as shares represent a share in the capital of a company. According to SEBI Regulations, "unit" means the interest of the unit holders in a scheme, which consists of each unit representing one undivided share in the assets of a scheme. These are also similarly issued, dematerialised, listed, traded and transferred and also subject to similar stamp duty like shares and debentures. However, a MF (except UTI) being a fund established in the form of a trust to raise monies through sale of units to public is not a body corporate and hence the units issued by it do not satisfy all the three conditions as at (b) above and may not be covered within the ambit of 'securities'. However the units issued by UTI are securities, as UTI is a corporation under the UTI Act, 1963, although it is managed by a board of trustees. This is reinforced by the fact that the units of CIS despite satisfying all the three ingredients as at (b) above have been specifically included in the definition of securities. How can the units of MFs, which do not even satisfy all the ingredients, be presumed to be securities? Thus the units of MFs except those of UTI may not be strictly securities under the SCRA though these are treated alike in practice.

This understanding is corroborated by a few other Acts which recognise the difference between units of MFs and securities. For example, section 8A of the Indian Stamp Act, 1899 provides two separate sub-clauses to exempt stamp duty on transfer of beneficial ownership of securities and of units of MFs respectively. Section 112 of the Income Tax Act, 1961 provides relief in capital gains in respect of listed securities and units of MFs. If units of MFs were securities, as believed in some circles, these Acts would not be specifying them separately.

Thus, some of the Acts include units of MFs within the ambit of securities, while SCRA does not. Though the UTI Act, 1963 and the FEMA, 1999 consider units of MFs to be securities, they do not provide for supervision of trading of units of MFs. The SCRA, which provides for trading of securities, does not consider units of MFs, except those of the UTI, to be securities. This is so essentially because the SCRA precedes the emergence of MFs. The law has not kept pace with the developments in the market.

Since the units of MFs conform to the description "such other" instruments under the SCRA and can be declared as "securities" under the delegated powers, the Central Government should declare units of MFs as 'securities' under Section 2(h) of the SCRA. Such declaration would help—(i) the market regulator and stock exchanges to regulate trading of units more effectively with a view to protecting interest of investors therein, (ii) market for units to deepen, (iii) provide a level playing field to other MFs with UTI, and (iv) remove confusion about the status of units of MFs. More importantly, this would remove the regulatory gap. ❑