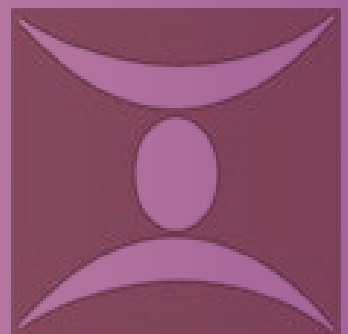
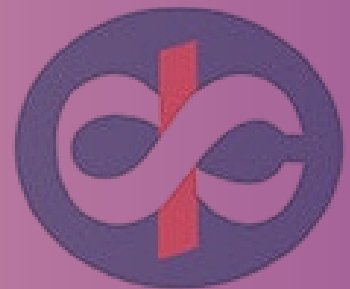
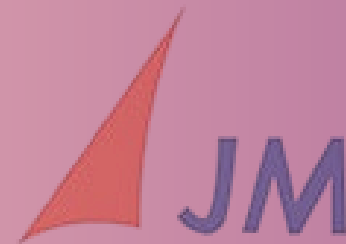
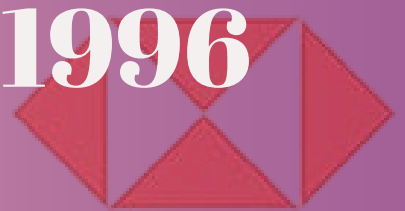
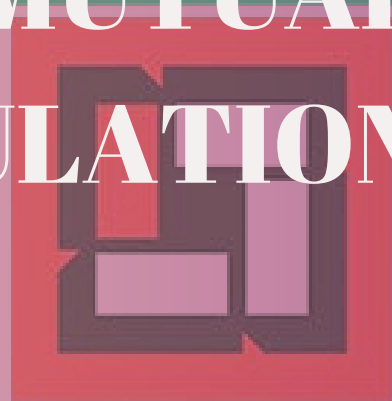


BOOKLET ON

SEBI (MUTUAL FUNDS) REGULATIONS, 1996



BOOKLET ON

SEBI (Mutual Funds) Regulations,

1996

By Bhatt & Joshi Associates

Preface

The Securities and Exchange Board of India (SEBI) (Mutual Funds) Regulations, 1996, notified on December 9, 1996, and effective from January 1997, form the bedrock of India's mutual fund regulatory framework. These regulations govern the establishment, operation, and management of mutual funds, ensuring investor protection, transparency, and market stability. This booklet provides a comprehensive analysis of the 1996 Regulations, detailing their provisions, amendments, and practical implications for asset management companies (AMCs), investors, and intermediaries. It is tailored for financial professionals, compliance officers, legal practitioners, and researchers navigating the evolving landscape of India's mutual fund industry.

The SEBI (Mutual Funds) Regulations, 1996, outline the eligibility criteria for AMCs, mandate robust governance structures, and enforce stringent disclosure norms. They cover scheme approvals, net asset value (NAV) calculations, investor grievance mechanisms, and restrictions on investments to safeguard unitholder interests. Amendments up to March 2025, including enhanced ESG integration, digital reporting, and tightened expense ratio norms, reflect SEBI's proactive approach to aligning with global standards and addressing market innovations like thematic funds and passive investing.

This booklet synthesizes the regulatory text, SEBI circulars, master circulars, and relevant case laws, offering a holistic perspective on the mutual fund ecosystem. It addresses compliance challenges, such as managing conflicts of interest and ensuring accurate NAV disclosures, while highlighting SEBI's enforcement actions. By

consolidating these insights, the booklet equips readers with practical tools to engage with India's mutual fund industry effectively.

The bibliography below compiles 70 authoritative sources, including SEBI's official documents, legal texts, academic journals, industry reports, and financial publications. This extensive collection supports rigorous research and practical application, underscoring the 1996 Regulations' critical role in fostering a transparent, investor-centric, and resilient mutual fund market in India.

Sincerely

Bhatt & Joshi Associates

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Chapter 1: Regulatory Evolution and Legal Framework

Introduction to Mutual Fund Regulation

The mutual fund industry in India has evolved significantly, driven by a robust regulatory framework designed to protect investors, ensure market stability, and foster transparency. The Securities and Exchange Board of India (SEBI), established under the SEBI Act, 1992, serves as the primary regulator overseeing mutual funds, ensuring compliance with stringent standards. This chapter examines the legal framework governing mutual funds, focusing on key provisions of the SEBI Act, 1992, the trust structure under the Indian Trusts Act, 1882, and the restraint of trade provisions under the Indian Contract Act, 1872. It also explores judicial interpretations, such as the *Unit Trust of India v. Jayantilal Mistry* (2006) case, and the constitutional validity of mutual fund regulations under Articles 14 and 19(1)(g) of the Constitution. By analyzing these elements, the chapter provides a comprehensive understanding of the regulatory evolution and legal foundation of mutual funds in India.

SEBI's Authority over Mutual Funds

Section 11(1) of the SEBI Act, 1992

Section 11(1) of the SEBI Act, 1992, is a cornerstone provision that empowers SEBI to undertake measures for investor protection, market development, and regulation of intermediaries, including mutual funds. This section grants SEBI the authority to

formulate regulations, issue directives, and enforce compliance to ensure that mutual funds operate transparently and in the best interests of investors. Specifically, Section 11(1) enables SEBI to regulate the structure, operations, and disclosures of mutual funds, addressing issues such as mis-selling, inadequate disclosures, and mismanagement. The broad scope of this provision allows SEBI to adapt its regulatory approach to the dynamic mutual fund industry, ensuring that evolving market practices align with investor protection objectives.

Enforcement and Regulatory Oversight

The enforcement of SEBI's powers under Section 11(1) involves the implementation of the SEBI (Mutual Funds) Regulations, 1996, which prescribe detailed guidelines for mutual fund operations. SEBI monitors compliance through inspections, audits, and reviews of mutual fund schemes, ensuring adherence to investment objectives, risk disclosures, and fiduciary duties. The provision also empowers SEBI to take corrective actions, such as imposing penalties, suspending operations, or canceling registrations, in cases of non-compliance. This proactive oversight has been instrumental in fostering investor confidence, as it ensures that mutual funds operate within a structured and transparent framework, minimizing risks associated with mismanagement or fraudulent practices.

Registration of Mutual Funds

Section 12 of the SEBI Act, 1992

Section 12 of the SEBI Act, 1992, mandates that no mutual fund can commence operations or solicit investments without obtaining registration from SEBI. This provision establishes a gatekeeping mechanism, ensuring that only entities meeting

SEBI's eligibility criteria can operate as mutual funds. The registration process involves a thorough evaluation of the sponsor's financial strength, the trustee's integrity, and the asset management company's (AMC) operational capabilities. By imposing stringent registration requirements, Section 12 ensures that mutual funds are managed by credible and competent entities, safeguarding investor interests and maintaining the integrity of the mutual fund industry.

Compliance and Operational Implications

Compliance with Section 12 requires mutual funds to submit detailed applications, including information on their organizational structure, investment policies, and risk management frameworks. SEBI scrutinizes these applications to verify compliance with regulatory standards, such as capital adequacy, governance norms, and investor protection measures. Once registered, mutual funds are subject to ongoing compliance obligations, including periodic reporting, adherence to investment limits, and transparency in scheme operations. The registration requirement under Section 12 enhances accountability, as it subjects mutual funds to continuous regulatory oversight, ensuring that they operate in alignment with their stated objectives and investor expectations.

Trust Structure for Mutual Funds

Indian Trusts Act, 1882

The Indian Trusts Act, 1882, provides the legal foundation for the trust structure of mutual fund schemes in India. Under this Act, a mutual fund is established as a trust, with the sponsor creating the trust, the trustee holding the assets, and the AMC managing the investments on behalf of unit holders. This tripartite structure ensures a

clear separation of roles and responsibilities, protecting investors from conflicts of interest and mismanagement. The Act mandates that trustees act in a fiduciary capacity, prioritizing the interests of unit holders and ensuring that the AMC adheres to the trust deed and regulatory guidelines. By anchoring mutual funds in a trust framework, the Indian Trusts Act enhances transparency and accountability in their operations.

Role of Trustees and Fiduciary Duties

The trust structure under the Indian Trusts Act places significant responsibilities on trustees, who are tasked with overseeing the AMC's activities and safeguarding investor interests. Trustees are required to ensure that the AMC complies with SEBI regulations, follows the scheme's investment objectives, and discloses material information to investors. The fiduciary duties imposed by the Act compel trustees to act with diligence, impartiality, and loyalty, ensuring that unit holders' investments are managed prudently. This legal framework strengthens investor protection by creating a robust governance structure, where trustees serve as a check on the AMC's operations, mitigating risks associated with mismanagement or non-compliance.

Restraint of Trade Provisions

Section 27 of the Indian Contract Act, 1872

Section 27 of the Indian Contract Act, 1872, declares agreements in restraint of trade as void, except in certain specified circumstances. In the context of mutual funds, this provision is relevant to contractual arrangements, such as non-compete clauses or exclusivity agreements, that may restrict the ability of AMCs, trustees, or other intermediaries to engage in business activities. SEBI's regulations ensure that mutual

fund agreements comply with Section 27, avoiding clauses that unduly limit competition or market access. By aligning mutual fund contracts with this provision, SEBI promotes a competitive and open market environment, ensuring that investors benefit from diverse investment options and fair practices.

Balancing Regulation and Market Freedom

The application of Section 27 in the mutual fund industry requires a delicate balance between regulatory oversight and market freedom. SEBI's guidelines prohibit restrictive practices that could hinder competition, such as agreements preventing AMCs from launching new schemes or engaging with multiple distributors. However, the regulator allows reasonable restrictions that protect investor interests, such as lock-in periods for certain schemes to ensure stability. This balanced approach ensures that mutual fund operations remain competitive while adhering to legal standards, fostering an environment where investors can access a wide range of investment opportunities without being constrained by anti-competitive practices.

Judicial Perspective on Investor Protection

Unit Trust of India v. Jayantilal Mistry (2006)

The Supreme Court's decision in *Unit Trust of India v. Jayantilal Mistry* (2006) is a landmark case that underscored the importance of investor protection in the mutual fund industry. The case arose from allegations of mismanagement and inadequate disclosures by the Unit Trust of India, leading to significant investor losses. The Supreme Court ruled that mutual funds, as public investment vehicles, have a fiduciary duty to prioritize investor interests, emphasizing the need for transparency, accountability, and regulatory compliance. The judgment reinforced SEBI's role in

enforcing investor protection measures, highlighting the legal obligations of mutual funds to act in the best interests of unit holders.

Implications of the Judgment

The Unit Trust of India case has far-reaching implications for the mutual fund industry, as it established a precedent for stringent regulatory oversight and investor-centric governance. The Supreme Court's emphasis on fiduciary duties has prompted SEBI to strengthen its regulations, introducing measures such as enhanced disclosures, risk management frameworks, and governance norms. The judgment also clarified that mutual funds are accountable for ensuring fair treatment of investors, reinforcing the importance of compliance with SEBI's guidelines and the trust structure under the Indian Trusts Act. By affirming the primacy of investor protection, the case has shaped the regulatory evolution of mutual funds, fostering a more transparent and accountable industry.

Constitutional Validity of Regulations

Article 14 and Article 19(1)(g)

The constitutional validity of SEBI's mutual fund regulations is grounded in Articles 14 and 19(1)(g) of the Constitution. Article 14 guarantees equality before the law and equal protection of laws, ensuring that SEBI's regulations apply uniformly to all mutual funds without discrimination. Article 19(1)(g) protects the right to practice any profession or carry on any occupation, trade, or business, subject to reasonable restrictions in the public interest. SEBI's regulations, including registration requirements and operational guidelines, constitute such reasonable restrictions, as they are designed to protect investors, ensure market stability, and prevent

mismanagement. The alignment of these regulations with constitutional principles ensures their legal legitimacy and enforceability.

Judicial Affirmation and Public Interest

Courts have consistently upheld the constitutional validity of SEBI's mutual fund regulations, recognizing their necessity for safeguarding public interest. The regulations are deemed reasonable under Article 19(6), as they address critical issues such as investor protection and market transparency without unduly restricting business freedom. Similarly, the uniform application of SEBI's guidelines satisfies the equality principle under Article 14, ensuring that all mutual funds operate within a fair and consistent framework. This constitutional alignment reinforces the legitimacy of SEBI's regulatory framework, enabling it to withstand legal challenges while promoting a robust and investor-friendly mutual fund industry.

Conclusion

The regulatory evolution and legal framework for mutual funds in India reflect a commitment to investor protection, transparency, and market stability. Section 11(1) of the SEBI Act, 1992, empowers SEBI to regulate mutual funds, while Section 12 ensures that only credible entities operate in the industry. The trust structure under the Indian Trusts Act, 1882, enhances governance, and Section 27 of the Indian Contract Act, 1872, promotes a competitive market environment. The Supreme Court's ruling in *Unit Trust of India v. Jayantilal Mistry* (2006) underscores the primacy of investor protection, while the constitutional validity of SEBI's regulations under Articles 14 and 19(1)(g) ensures their legal foundation. Together, these elements create a dynamic

and investor-centric framework, positioning India's mutual fund industry as a cornerstone of its financial market.

Chapter 2: Registration and Organizational Structure

The Securities and Exchange Board of India (SEBI) regulates mutual funds in India through the SEBI (Mutual Funds) Regulations, 1996, which establish a comprehensive framework to ensure investor protection, transparency, and operational efficiency in the mutual fund industry. The registration and organizational structure of mutual funds are critical components of this framework, as they define the legal and operational foundation for establishing and managing mutual funds. Chapter 2 of this booklet provides an in-depth analysis of the registration process, eligibility criteria for sponsors, trustee responsibilities, the three-tier organizational structure, relevant case law, and board composition requirements under the SEBI (Mutual Funds) Regulations, 1996. This chapter aims to elucidate the regulatory prerequisites and structural mechanisms that govern mutual funds in India, ensuring their alignment with investor interests and market integrity.

Regulation 7 - Application for Registration as Mutual Fund

Regulation 7 of the SEBI (Mutual Funds) Regulations, 1996, outlines the process for applying for registration as a mutual fund, a mandatory requirement for entities seeking to establish and operate mutual fund schemes in India. The application must be submitted to SEBI in the prescribed format, accompanied by a non-refundable application fee as specified in the Second Schedule of the regulations. The applicant, typically the sponsor, is required to provide detailed information about the proposed mutual fund's structure, including the trust deed, the appointment of trustees, and the

establishment of an Asset Management Company (AMC). This information ensures that SEBI can assess the applicant's compliance with regulatory standards and its capacity to safeguard investor interests.

The application process under Regulation 7 is rigorous, requiring the sponsor to disclose its financial statements, business history, and track record to demonstrate its suitability to manage public funds. The regulation mandates that the application include a draft trust deed, which outlines the objectives of the mutual fund, the responsibilities of the trustees, and the mechanisms for investor protection. Additionally, the applicant must provide details of the AMC's proposed operations, including its investment philosophy, risk management policies, and compliance framework. SEBI evaluates the application based on the sponsor's eligibility, the adequacy of the organizational structure, and the proposed mutual fund's alignment with regulatory objectives.

Upon receiving the application, SEBI may request additional information or clarifications to ensure that the applicant meets all regulatory requirements. If satisfied, SEBI grants a certificate of registration, allowing the mutual fund to commence operations. However, the registration is subject to ongoing compliance with the regulations, and SEBI retains the authority to suspend or cancel the registration in cases of non-compliance. Regulation 7 thus serves as the gateway to the mutual fund industry, ensuring that only credible and well-prepared entities can enter the market, thereby fostering investor confidence and market stability.

Regulation 8 - Eligibility Criteria for Sponsors

Regulation 8 of the SEBI (Mutual Funds) Regulations, 1996, specifies the eligibility criteria for sponsors, who are the entities or individuals responsible for establishing a

mutual fund. The sponsor plays a pivotal role in setting up the trust and appointing the trustees and the AMC, making their financial stability and reputation critical to the mutual fund's success. Regulation 8 mandates that the sponsor must have a sound track record, defined as a minimum of five years of experience in the financial services sector, particularly in areas such as banking, insurance, or asset management. This track record ensures that the sponsor possesses the expertise and operational competence to oversee the mutual fund's activities effectively.

In addition to the five-year track record, Regulation 8 requires the sponsor to maintain a minimum net worth of INR 100 crore at the time of application. This financial threshold is designed to ensure that the sponsor has sufficient resources to support the mutual fund's initial operations and absorb any unforeseen losses, thereby protecting investors from financial instability. The regulation further stipulates that the sponsor must have been profitable in at least three out of the preceding five years, with no accumulated losses, demonstrating consistent financial performance and operational sustainability.

Regulation 8 also emphasizes the sponsor's reputation and integrity, requiring that neither the sponsor nor its key personnel be involved in litigation or regulatory violations that could undermine investor trust. The sponsor must not be a willful defaulter or associated with activities prejudicial to the securities market, as determined by SEBI. These stringent eligibility criteria reflect SEBI's commitment to ensuring that only financially robust and ethically sound entities can sponsor mutual funds, thereby safeguarding the interests of investors and maintaining the integrity of the mutual fund industry.

Regulation 21 - Trustee Appointment and Responsibilities

Regulation 21 of the SEBI (Mutual Funds) Regulations, 1996, governs the appointment and responsibilities of trustees, who serve as the custodians of the mutual fund's assets and the protectors of unitholders' interests. The regulation mandates that a mutual fund be established as a trust under the Indian Trusts Act, 1882, with a board of trustees or a trustee company appointed to oversee its operations. The trustees are appointed by the sponsor through a trust deed, which must be approved by SEBI and contain provisions for the protection of unitholders, the segregation of assets, and the prevention of conflicts of interest.

The responsibilities of trustees under Regulation 21 are extensive, encompassing the oversight of the mutual fund's operations to ensure compliance with SEBI regulations and the trust deed. Trustees are required to monitor the activities of the AMC, including its investment decisions, risk management practices, and adherence to the scheme's objectives. They must ensure that the AMC acts in the best interests of unitholders, avoiding any undue influence from the sponsor or other related parties. The regulation also mandates that trustees review the AMC's financial statements, compliance reports, and investor grievance redressal mechanisms to maintain transparency and accountability.

Furthermore, Regulation 21 requires trustees to act as independent fiduciaries, with at least two-thirds of the board of trustees or trustee company comprising independent directors who have no association with the sponsor or its affiliates. This independence ensures that trustees can exercise objective judgment in their oversight role. Trustees are also responsible for approving key decisions, such as the launch of new schemes, changes in fund management, or the appointment of key personnel, ensuring that such decisions align with investor interests. By delineating these responsibilities, Regulation 21 establishes trustees as a critical safeguard in the mutual fund structure,

protecting unitholders from mismanagement and ensuring the fund's operational integrity.

Three-Tier Structure: Sponsor-Trustee-Asset Management Company

The SEBI (Mutual Funds) Regulations, 1996, mandate a three-tier organizational structure for mutual funds, comprising the sponsor, trustees, and the Asset Management Company (AMC). This structure is designed to segregate roles and responsibilities, ensuring checks and balances within the mutual fund ecosystem. The sponsor, as the initiator, establishes the mutual fund by creating the trust and appointing the trustees and the AMC. The sponsor's role is primarily foundational, providing the financial and operational backing to set up the mutual fund while adhering to the eligibility criteria under Regulation 8.

The trustees form the second tier, acting as the custodians of the mutual fund's assets and the protectors of unitholders' interests. Appointed through the trust deed, the trustees oversee the AMC's operations, ensuring compliance with SEBI regulations and the scheme's objectives. Their independent oversight role is critical in preventing conflicts of interest and ensuring that the mutual fund operates in the best interests of investors. The trustees also serve as a link between the sponsor and the AMC, facilitating communication and coordination while maintaining their fiduciary duty to unitholders.

The AMC, the third tier, is responsible for the day-to-day management of the mutual fund's schemes, including investment decisions, portfolio management, and investor services. Incorporated as a company under the Companies Act, 2013, the AMC

operates under a management agreement approved by the trustees and SEBI. The AMC employs professional fund managers and analysts to manage the fund's investments, adhering to the scheme's investment objectives and risk parameters. The three-tier structure ensures that each entity—sponsor, trustees, and AMC—has distinct roles, fostering accountability, transparency, and investor protection within the mutual fund framework.

This tripartite structure is a hallmark of SEBI's regulatory approach, balancing operational efficiency with robust governance. By segregating the roles of initiation, oversight, and management, the structure minimizes the risk of mismanagement and ensures that the mutual fund operates in a manner that prioritizes unitholder interests. The clear delineation of responsibilities also facilitates regulatory supervision, enabling SEBI to monitor compliance at each level of the mutual fund's operations.

Case Law: SEBI v. Sahara Asset Management Company (2012) - Sponsor Eligibility

The case of *SEBI v. Sahara Asset Management Company* (2012) before the Securities Appellate Tribunal (SAT) provides critical insights into the application of sponsor eligibility criteria under Regulation 8. In this case, SEBI rejected the registration application of Sahara Asset Management Company, citing concerns about the eligibility of its sponsor, Sahara India Financial Corporation Ltd. SEBI argued that the sponsor failed to meet the regulatory requirements for a sound track record and financial stability, particularly in light of ongoing investigations into Sahara's financial practices and allegations of regulatory violations in other business verticals.

Sahara contended that it satisfied the eligibility criteria, highlighting its five-year track record in financial services and a net worth exceeding INR 100 crore. The company argued that SEBI's rejection was based on extraneous considerations, such as unrelated investigations, rather than objective evidence of non-compliance with Regulation 8. Sahara further emphasized that its mutual fund operations were distinct from its other businesses, and the proposed AMC had robust governance mechanisms to protect unitholders.

The SAT, in its ruling, upheld SEBI's decision, emphasizing that the sponsor's reputation and integrity are integral to the eligibility criteria under Regulation 8. The tribunal noted that Sahara's involvement in regulatory disputes and questionable financial practices raised legitimate concerns about its suitability to sponsor a mutual fund, given the fiduciary nature of the role. The SAT clarified that SEBI has the discretion to consider the sponsor's overall conduct and market reputation, beyond mere financial metrics, to protect investor interests. However, the tribunal directed SEBI to provide Sahara with an opportunity to address the concerns through additional submissions, ensuring procedural fairness.

This case underscored the importance of a holistic evaluation of sponsor eligibility, encompassing not only financial parameters but also ethical and regulatory compliance. It established a precedent for SEBI's authority to scrutinize the sponsor's broader business practices, reinforcing the regulator's commitment to ensuring that only credible entities can enter the mutual fund industry. The ruling also highlighted the need for sponsors to maintain a clean regulatory record to gain SEBI's approval, protecting the mutual fund ecosystem from potential risks.

Board Composition Requirements under Regulation 18

Regulation 18 of the SEBI (Mutual Funds) Regulations, 1996, specifies the board composition requirements for the AMC, ensuring that the entity responsible for managing the mutual fund's investments operates with integrity, independence, and professionalism. The regulation mandates that the AMC's board of directors comprise at least 50% independent directors who are not associated with the sponsor or its affiliates. This requirement ensures that the AMC's decision-making process is free from undue influence, prioritizing the interests of unitholders over those of the sponsor.

Independent directors under Regulation 18 must possess relevant expertise in finance, investment management, or related fields, enabling them to provide informed oversight of the AMC's operations. The regulation also requires that the chairman of the AMC's board be an independent director, further strengthening the board's objectivity. The presence of independent directors is critical in key decision-making areas, such as approving investment policies, reviewing fund performance, and ensuring compliance with SEBI regulations and the trust deed.

Regulation 18 further stipulates that the AMC's board meet regularly to review the mutual fund's operations, including portfolio performance, risk management, and investor grievances. The board is responsible for approving the appointment of key personnel, such as fund managers and compliance officers, ensuring that the AMC is led by qualified professionals. The regulation also mandates that the AMC establish an audit committee, chaired by an independent director, to oversee financial reporting and internal controls, enhancing transparency and accountability.

These board composition requirements reflect SEBI's emphasis on robust corporate governance within the AMC, recognizing its pivotal role in managing unitholder

funds. By mandating a significant proportion of independent directors, Regulation 18 ensures that the AMC operates with impartiality and professionalism, safeguarding investor interests. The requirements also align with global best practices in asset management, fostering investor confidence and promoting the long-term sustainability of the mutual fund industry in India.

In conclusion, the registration and organizational structure of mutual funds under the SEBI (Mutual Funds) Regulations, 1996, form a robust framework for ensuring investor protection and market integrity. Regulation 7 establishes a rigorous application process for mutual fund registration, while Regulation 8 sets stringent eligibility criteria for sponsors, emphasizing financial stability and reputation. Regulation 21 delineates the critical role of trustees in overseeing the mutual fund's operations, and the three-tier structure of sponsor, trustees, and AMC ensures clear segregation of responsibilities. The *SEBI v. Sahara Asset Management Company* case highlights the importance of sponsor eligibility, while Regulation 18's board composition requirements promote governance and independence within the AMC. Together, these provisions create a transparent and accountable framework that supports the growth and credibility of India's mutual fund industry.

Chapter 3: Scheme Launch and Investment Restrictions

The launch and management of mutual fund schemes in India are governed by a comprehensive regulatory framework established by the Securities and Exchange Board of India (SEBI) under the SEBI (Mutual Funds) Regulations, 1996. These regulations aim to protect investors, ensure prudent portfolio management, and maintain market stability. Central to this framework are the investment restrictions and portfolio concentration limits that dictate how mutual funds allocate their assets. This chapter examines key provisions under Regulation 18(15A), including the 10% maximum investment in a single company's securities, the 25% limit for group companies in non-sectoral schemes, and the 35% single stock limit for sectoral/thematic schemes. It also explores the lessons from the Franklin Templeton Mutual Fund crisis of 2020 and the SEBI circular on stress testing and liquidity management issued in 2021. These regulations and developments collectively underscore SEBI's commitment to balancing investor protection with operational flexibility for mutual funds.

Regulation 18(15A) - Scheme Portfolio Concentration Limits

Overview of Regulation 18(15A)

Regulation 18(15A) of the SEBI (Mutual Funds) Regulations, 1996, sets out the portfolio concentration limits for mutual fund schemes to mitigate risks associated with overexposure to specific securities or issuers. This regulation is designed to

ensure diversification, reduce systemic risk, and safeguard investor interests by preventing mutual funds from concentrating their investments excessively in a single company or group. By imposing clear limits, SEBI aims to promote prudent investment practices while allowing asset management companies (AMCs) sufficient flexibility to pursue their investment objectives.

Rationale for Concentration Limits

The concentration limits under Regulation 18(15A) address the inherent risks of undiversified portfolios, such as liquidity challenges and price volatility. Overexposure to a single issuer or group can amplify losses if the issuer faces financial distress or market downturns. By capping investments in specific securities, SEBI ensures that mutual funds maintain a balanced portfolio, reducing the likelihood of significant losses that could erode investor confidence. These limits also align with global best practices, positioning India's mutual fund industry as a robust and investor-friendly market.

Implementation and Compliance

AMCs must monitor their portfolios continuously to ensure compliance with Regulation 18(15A). The regulation applies to all mutual fund schemes, with specific provisions tailored to the nature of the scheme, such as sectoral or thematic funds. SEBI's oversight, through periodic inspections and reporting requirements, ensures that AMCs adhere to these limits. Non-compliance can result in penalties, including restrictions on launching new schemes or monetary fines, emphasizing the importance of robust internal controls and risk management systems within AMCs.

10% Maximum Investment in Single Company Securities

Scope of the 10% Limit

Regulation 18(15A) stipulates that a mutual fund scheme cannot invest more than 10% of its net asset value (NAV) in the equity shares or equity-related instruments of a single company. This restriction applies across all types of mutual fund schemes, including equity, debt, and hybrid funds, ensuring broad diversification. The 10% cap is calculated based on the market value of the scheme's holdings at the time of investment, with AMCs required to rebalance their portfolios if market movements cause the limit to be breached.

Purpose and Impact

The 10% limit mitigates the risk of overexposure to a single issuer, protecting investors from idiosyncratic risks such as corporate governance failures or operational setbacks. For example, if a company faces a sudden financial crisis, a scheme adhering to the 10% limit would have limited exposure, cushioning the impact on its overall performance. This restriction also encourages AMCs to conduct thorough due diligence and diversify their investments across multiple companies, fostering a disciplined approach to portfolio management. For investors, the limit provides assurance that their funds are not overly reliant on the performance of a single entity.

Challenges in Adherence

Maintaining compliance with the 10% limit can be challenging in volatile markets, where rapid price movements may cause a scheme's holdings in a single company to exceed the threshold. AMCs must actively monitor their portfolios and rebalance as needed, which may involve selling securities at suboptimal prices. Additionally, in smaller schemes with limited assets under management, achieving diversification

while adhering to the 10% limit can be difficult, particularly in concentrated markets. SEBI's guidelines allow temporary breaches due to market movements, provided AMCs take corrective action promptly, balancing flexibility with regulatory compliance.

25% Limit in Group Companies for Non-Sectoral Schemes

Definition and Application

For non-sectoral or non-thematic mutual fund schemes, Regulation 18(15A) imposes a 25% limit on investments in the securities of companies belonging to the same group. A “group” is defined as entities under common control or ownership, such as subsidiaries, associates, or companies with shared promoters. This limit applies to the aggregate investment in equity and debt instruments of group companies, calculated as a percentage of the scheme's NAV. The restriction ensures that non-sectoral schemes, which typically aim for broad diversification, are not overly exposed to risks associated with a single corporate group.

Strategic Importance

The 25% limit addresses the risk of correlated losses within a corporate group, where financial difficulties in one group company could adversely affect others. For instance, a default by one group entity could trigger a downgrade in the credit ratings of related companies, impacting the scheme's portfolio. By capping exposure to group companies, SEBI encourages AMCs to diversify across unrelated issuers, reducing systemic risk. This provision is particularly relevant in India, where large

conglomerates dominate certain sectors, making group-level diversification critical for investor protection.

Compliance Monitoring

AMCs must implement robust systems to track investments in group companies, as identifying group affiliations can be complex, especially in cases of indirect ownership or promoter linkages. SEBI requires AMCs to disclose their holdings in group companies in periodic reports, enhancing transparency. Compliance with the 25% limit is monitored through quarterly filings and SEBI's inspections, with violations attracting regulatory action. The limit's enforcement underscores SEBI's focus on ensuring that non-sectoral schemes deliver on their promise of diversified investment strategies.

Sectoral/Thematic Schemes - 35% Single Stock Limit in Index Constituents

Special Provisions for Sectoral/Thematic Schemes

Sectoral and thematic mutual fund schemes, which focus on specific industries or themes (e.g., banking, technology, or infrastructure), are subject to a relaxed concentration limit under Regulation 18(15A). These schemes may invest up to 35% of their NAV in the equity shares of a single company, provided the company is a constituent of the scheme's benchmark index. This higher limit reflects the concentrated nature of sectoral/thematic schemes, which inherently require greater exposure to specific industries or themes to achieve their investment objectives.

Balancing Flexibility and Risk

The 35% single stock limit allows AMCs to capitalize on high-conviction investment opportunities within their chosen sector or theme while maintaining a degree of risk control. For example, a banking sector fund may allocate up to 35% of its NAV to a leading bank that dominates the benchmark index, aligning with the fund's investment strategy. However, the restriction to index constituents ensures that only well-established companies with sufficient market liquidity and transparency qualify for such concentrated investments. This balance enables AMCs to pursue aggressive strategies while mitigating the risks of overexposure to smaller or less liquid stocks.

Regulatory Oversight and Investor Protection

SEBI closely monitors compliance with the 35% limit, requiring AMCs to justify their investment decisions in sectoral/thematic schemes through detailed disclosures in the scheme information document (SID). Investors are informed of the concentrated nature of these schemes and the associated risks, such as higher volatility compared to diversified funds. The limit's alignment with benchmark index constituents ensures that investments are made in companies subject to rigorous market scrutiny, enhancing investor confidence. AMCs must also conduct regular portfolio reviews to ensure ongoing compliance, particularly in dynamic sectors where index compositions may change.

Case Law: Franklin Templeton Mutual Fund Crisis (2020) - Liquidity Management

Background of the Crisis

The Franklin Templeton Mutual Fund crisis of 2020 is a landmark case that exposed vulnerabilities in mutual fund liquidity management and underscored the importance of regulatory compliance. In April 2020, Franklin Templeton Mutual Fund announced the winding up of six debt schemes, citing unprecedented redemption pressures and illiquidity in the underlying securities. The decision affected approximately ₹25,000 crore in assets under management and sparked widespread investor concern. The crisis was triggered by the schemes' heavy exposure to low-rated, illiquid debt instruments, which became unsellable amid market stress caused by the COVID-19 pandemic.

Judicial and Regulatory Findings

The Karnataka High Court, in its 2020 ruling, upheld unitholders' rights to approve the winding-up process, emphasizing the need for transparency and investor consent. SEBI's subsequent investigation revealed that Franklin Templeton had violated concentration limits and liquidity norms, including Regulation 18(15A), by over-investing in high-risk securities without adequate diversification. The regulator imposed a ₹5 crore penalty on the AMC, barred it from launching new debt schemes for two years, and directed the disgorgement of ₹512 crore in management fees. The case highlighted the critical need for AMCs to adhere to concentration limits and maintain sufficient liquidity to meet redemption demands.

Lessons for the Industry

The Franklin Templeton crisis prompted SEBI to re-evaluate its regulatory framework for mutual funds, particularly regarding liquidity management. The case underscored the risks of concentrated investments in illiquid securities, which can exacerbate redemption pressures during market downturns. It also highlighted the importance of robust risk management practices, including stress testing and liquidity buffers, to

ensure that schemes can withstand adverse market conditions. The crisis serves as a cautionary tale for AMCs, reinforcing the need for strict compliance with concentration limits and proactive portfolio management to protect investor interests.

SEBI Circular on Stress Testing and Liquidity Management (2021)

Context and Objectives

In response to the Franklin Templeton crisis, SEBI issued a circular in January 2021, mandating stress testing and enhanced liquidity management practices for mutual fund schemes, particularly debt funds. The circular aimed to strengthen the resilience of mutual funds against redemption pressures and market volatility, ensuring that AMCs could meet investor demands without disrupting portfolio stability. By introducing mandatory stress tests and liquidity guidelines, SEBI sought to prevent a recurrence of liquidity-driven crises and enhance investor confidence.

Key Provisions of the Circular

The 2021 circular requires AMCs to conduct stress tests to assess the liquidity of their portfolios under various scenarios, such as sudden redemption spikes or market downturns. These tests evaluate the time required to liquidate portfolio holdings without significantly impacting market prices, with a focus on low-rated or illiquid securities. AMCs must maintain a minimum liquidity buffer, ensuring that at least 20% of the portfolio consists of highly liquid assets, such as government securities or cash equivalents. The circular also mandates quarterly disclosures of stress test results, enhancing transparency and enabling investors to assess the scheme's liquidity risk.

Implementation and Industry Impact

The implementation of the 2021 circular has transformed liquidity management practices in the mutual fund industry. AMCs have adopted advanced analytics and risk modeling tools to conduct stress tests, integrating liquidity considerations into their investment decisions. The requirement for liquidity buffers has reduced reliance on illiquid securities, aligning portfolios with the concentration limits under Regulation 18(15A). The circular's emphasis on transparency has empowered investors to make informed choices, as stress test disclosures provide insights into a scheme's ability to withstand market stress. SEBI's ongoing inspections ensure compliance, with non-adherent AMCs facing penalties or restrictions.

Alignment with Concentration Limits

The 2021 circular complements Regulation 18(15A) by reinforcing the importance of diversification and liquidity in portfolio management. By limiting investments in illiquid securities and encouraging diversified portfolios, the circular supports the 10% and 25% concentration limits for single companies and group companies, respectively. For sectoral/thematic schemes, the circular's stress testing requirements ensure that the 35% single stock limit does not compromise liquidity, particularly in volatile sectors. This integrated approach enhances the overall resilience of mutual fund schemes, aligning regulatory objectives with investor protection.

Conclusion

The regulatory framework governing scheme launch and investment restrictions under the SEBI (Mutual Funds) Regulations, 1996, plays a critical role in ensuring the stability and integrity of India's mutual fund industry. Regulation 18(15A) establishes

clear portfolio concentration limits, with the 10% cap on single company securities, 25% limit for group companies in non-sectoral schemes, and 35% single stock limit for sectoral/thematic schemes, promoting diversification and risk mitigation. The Franklin Templeton Mutual Fund crisis of 2020 exposed the dangers of non-compliance and illiquidity, prompting SEBI to introduce the 2021 circular on stress testing and liquidity management. These measures, combined with rigorous regulatory oversight, have strengthened the industry's ability to navigate market challenges while safeguarding investor interests. By fostering transparency, diversification, and liquidity, SEBI's framework ensures that mutual funds remain a reliable and resilient investment vehicle in India's capital markets.

Chapter 4: Valuation and Net Asset Value Computation

The valuation of securities and the computation of Net Asset Value (NAV) are critical processes in the functioning of mutual funds in India, ensuring transparency, fairness, and investor confidence. Governed by the Securities and Exchange Board of India (SEBI) under the SEBI (Mutual Funds) Regulations, 1996, these processes establish standardized methodologies for determining the value of mutual fund assets and liabilities. This chapter explores the regulatory framework surrounding valuation and NAV computation, focusing on Regulation 47, the daily NAV declaration requirement for open-ended schemes, the Third Schedule's valuation norms, the role of independent valuers, and measures to prevent market timing and late trading. Additionally, it examines the case of SEBI v. Benchmark Mutual Fund (2015) to highlight the consequences of valuation irregularities. The discussion provides a detailed understanding of the legal and procedural requirements that underpin the integrity of mutual fund operations.

Valuation of Securities and NAV Calculation

Regulation 47 of the SEBI (Mutual Funds) Regulations, 1996, sets out the principles for the valuation of securities and the computation of NAV for mutual fund schemes. The regulation mandates that mutual funds adopt consistent and transparent valuation policies to determine the fair value of their portfolio securities, ensuring that the NAV reflects the true economic value of the scheme's assets. NAV is calculated by dividing the total value of the scheme's assets, minus its liabilities, by the number of

outstanding units. This process is critical for investors, as NAV determines the price at which units are bought or sold in a mutual fund scheme. Regulation 47 requires mutual funds to value their securities in accordance with the norms specified in the Third Schedule, which provides detailed guidelines for different asset classes. The regulation also emphasizes that valuation policies must be approved by the board of the asset management company (AMC) and disclosed in the scheme's offer document to ensure transparency. For securities where market prices are readily available, such as listed equities, valuation is based on closing prices on recognized stock exchanges. However, for unlisted or illiquid securities, the regulation mandates the use of fair valuation techniques, often involving independent valuers. By establishing a robust framework for valuation, Regulation 47 ensures that mutual funds provide accurate and reliable NAVs, fostering investor trust and facilitating informed investment decisions. The regulation also requires AMCs to periodically review their valuation methodologies to align with market conditions and regulatory updates, maintaining the relevance and accuracy of NAV computations.

Daily NAV Declaration for Open-Ended Schemes

Open-ended mutual fund schemes, which allow investors to buy or redeem units on any business day, require frequent NAV updates to reflect the current value of the scheme's portfolio. SEBI mandates that AMCs declare the NAV of open-ended schemes on a daily basis, as per the provisions of the SEBI (Mutual Funds) Regulations. This requirement ensures that investors have access to up-to-date pricing information, enabling them to make timely investment or redemption decisions. The daily NAV is calculated based on the closing prices of the scheme's securities on the valuation date, adjusted for accrued income, expenses, and other liabilities. The NAV must be published on the AMC's website and the Association of Mutual Funds in

India (AMFI) website by 11:00 p.m. on each business day, ensuring accessibility to all stakeholders. This deadline was revised by SEBI in 2020 to provide AMCs with sufficient time to process valuations while maintaining transparency. For schemes investing in overseas securities, the NAV calculation accounts for time zone differences, using the closing prices of the relevant international markets. The daily NAV declaration requirement underscores SEBI's commitment to investor protection, as it minimizes pricing discrepancies and ensures that transactions are executed at fair values. AMCs must also maintain robust systems and controls to ensure the accuracy of daily NAV calculations, as any errors could lead to financial losses for investors and regulatory penalties for the fund house. This provision enhances the operational efficiency of open-ended schemes, making them a reliable investment vehicle for retail and institutional investors.

Valuation Norms for Different Types of Securities

The Third Schedule of the SEBI (Mutual Funds) Regulations provides a comprehensive framework for the valuation of various types of securities held in a mutual fund's portfolio, ensuring consistency and fairness in the valuation process. For listed equity shares, the schedule mandates that valuation be based on the closing price on the principal stock exchange, such as the National Stock Exchange (NSE) or Bombay Stock Exchange (BSE). If a security is listed on multiple exchanges, the closing price on the exchange with higher trading volume is used. For debt securities, such as bonds and debentures, valuation is based on the weighted average yield of trades reported on platforms like the Fixed Income Money Market and Derivatives Association of India (FIMMDA) or the Clearing Corporation of India Limited (CCIL). For securities with residual maturity up to 60 days, valuation may follow the amortized cost method, provided it approximates the fair value. The Third Schedule

also provides specific guidelines for money market instruments, government securities, and derivatives, ensuring that each asset class is valued using appropriate market-based or model-based techniques. For non-traded or thinly traded securities, the schedule requires AMCs to adopt fair valuation principles, often relying on independent valuers or internal valuation committees. The norms emphasize the importance of documenting valuation methodologies and maintaining audit trails to facilitate regulatory oversight. By providing detailed guidelines, the Third Schedule ensures that mutual funds adopt standardized and transparent valuation practices, minimizing the risk of overvaluation or undervaluation and protecting investors from potential mispricing.

Independent Valuers Appointment for Unlisted/Thinly Traded Securities

Valuing unlisted or thinly traded securities poses significant challenges due to the absence of active market prices, necessitating the involvement of independent expertise. The SEBI (Mutual Funds) Regulations mandate that AMCs appoint independent valuers for the valuation of unlisted securities or securities that are thinly traded, as defined by low trading volumes relative to the issued capital. These valuers, typically professional firms with expertise in financial valuation, are responsible for determining the fair value of such securities using recognized methodologies, such as discounted cash flow analysis, comparable company analysis, or net asset value-based approaches. The appointment of independent valuers ensures objectivity and impartiality in the valuation process, reducing the risk of conflicts of interest that may arise if AMCs value these securities internally. The regulations require that the valuer's methodology and assumptions be documented and disclosed to the AMC's

board and the trustee, ensuring transparency and accountability. Independent valuers must also adhere to the valuation norms outlined in the Third Schedule, aligning their assessments with SEBI's guidelines. The use of independent valuers is particularly critical for schemes with significant exposure to unlisted securities, such as private equity funds or debt funds investing in unrated instruments. By mandating their appointment, SEBI enhances the credibility of valuations for illiquid assets, protecting investors from potential mispricing and ensuring that NAV calculations reflect the true economic value of the portfolio. AMC's must periodically review the performance of independent valuers to ensure compliance with regulatory standards.

Case Law: SEBI v. Benchmark Mutual Fund (2015)

The case of SEBI v. Benchmark Mutual Fund (2015) is a significant legal precedent that underscores the importance of adhering to valuation norms in mutual fund operations. SEBI initiated an investigation into Benchmark Mutual Fund following allegations of irregularities in the valuation of certain debt securities held in one of its schemes. The investigation revealed that the AMC had failed to follow the valuation norms prescribed in the Third Schedule, resulting in an overvaluation of the securities and an inflated NAV. This mispricing misled investors, who transacted at incorrect unit prices, leading to financial losses when the true value of the securities was later reflected. SEBI's adjudicating officer found that the AMC had not engaged independent valuers for thinly traded securities and had relied on internal valuation models that were not aligned with regulatory guidelines. The case was escalated to the Securities Appellate Tribunal (SAT), which upheld SEBI's findings, emphasizing that compliance with valuation norms is non-negotiable to ensure investor protection. The AMC was penalized with a monetary fine and directed to compensate affected investors for the losses incurred due to the mispriced NAV. The case highlighted the

critical role of robust valuation policies and independent oversight in preventing mispricing and maintaining market integrity. It also prompted SEBI to issue additional guidance on valuation practices, reinforcing the need for AMCs to adopt transparent and compliant methodologies. The Benchmark Mutual Fund case remains a cautionary tale for mutual fund houses, underscoring the legal and reputational risks of valuation irregularities.

Market Timing and Late Trading Prevention Measures

Market timing and late trading are abusive practices that can distort NAV calculations and harm mutual fund investors by allowing certain participants to exploit pricing inefficiencies. Market timing involves frequent buying and selling of mutual fund units to take advantage of short-term price discrepancies, often in international or arbitrage funds. Late trading occurs when trades are executed after the NAV cut-off time but recorded at the same day's NAV, enabling investors to benefit from post-market information. SEBI has implemented several measures under the SEBI (Mutual Funds) Regulations to prevent these practices and protect investor interests. AMCs are required to establish cut-off times for accepting subscription and redemption requests, typically aligned with market closing hours (e.g., 3:00 p.m. for equity-oriented schemes). Transactions received after the cut-off time must be processed at the next business day's NAV, ensuring fairness in pricing. To deter market timing, SEBI permits AMCs to impose exit loads or restrictions on frequent trading, particularly for investors engaging in rapid in-and-out transactions. AMCs must also monitor investor trading patterns and report suspicious activities to SEBI. Additionally, SEBI mandates robust systems and controls, including time-stamping of transactions and segregation of front-office and back-office functions, to prevent late trading. The regulations require AMCs to conduct periodic audits of their transaction

processing systems to ensure compliance with cut-off timings. By implementing these measures, SEBI minimizes the risk of market timing and late trading, ensuring that all investors receive equitable treatment and that NAV calculations remain accurate and reliable. These safeguards enhance the integrity of mutual fund operations, fostering investor confidence in the fairness of the pricing process.

Conclusion

The valuation and NAV computation framework under the SEBI (Mutual Funds) Regulations provides a robust and transparent system for determining the value of mutual fund assets, ensuring fairness and investor protection. Regulation 47 establishes standardized valuation principles, while the daily NAV declaration requirement for open-ended schemes ensures timely and accurate pricing information. The Third Schedule provides detailed norms for valuing different securities, and the appointment of independent valuers enhances the credibility of valuations for unlisted or thinly traded assets. The case of SEBI v. Benchmark Mutual Fund (2015) underscores the consequences of valuation irregularities, emphasizing the need for strict compliance. Measures to prevent market timing and late trading further strengthen the integrity of NAV calculations, protecting investors from abusive practices. Together, these provisions create a disciplined environment that supports the growth and stability of India's mutual fund industry. AMCs must adopt rigorous valuation policies, robust systems, and proactive oversight to comply with these regulations, ensuring that investors can rely on the accuracy and fairness of NAVs in their investment decisions.

Chapter 5: Disclosure Requirements and Investor Communication

Regulation 59 - Scheme Information Document (SID) Requirements

Regulation 59 of the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, mandates that every mutual fund scheme must prepare and publish a Scheme Information Document (SID) before launching the scheme. The SID serves as a comprehensive disclosure document, providing investors with detailed information about the scheme's objectives, structure, and risks to facilitate informed investment decisions. The regulation requires the SID to include critical details such as the scheme's investment objective, asset allocation strategy, risk factors, and fee structure, including entry and exit loads. It must also disclose the qualifications and experience of the fund manager, the performance history of similar schemes managed by the asset management company (AMC), and the terms of redemption and liquidity. The SID is required to be written in clear, concise language to ensure accessibility for retail investors, avoiding technical jargon that could obscure understanding. SEBI mandates that the SID be filed with the regulator for approval before public distribution and updated annually or whenever material changes occur, such as alterations in the scheme's investment strategy or management team. This ensures that investors have access to current and accurate information. Additionally, the SID must be made available on the AMC's website and at designated investor service centers, enhancing accessibility. By enforcing these requirements, Regulation 59 aims to

promote transparency, protect investor interests, and ensure that mutual funds provide comprehensive disclosures to support sound investment choices.

Key Information Memorandum (KIM) Preparation and Distribution

The Key Information Memorandum (KIM) is a condensed version of the Scheme Information Document, designed to provide investors with a quick and accessible overview of a mutual fund scheme's essential features. Under SEBI's guidelines, every mutual fund is required to prepare a KIM for each scheme, ensuring that it is distributed to investors at the time of application or upon request. The KIM must summarize critical information, including the scheme's investment objective, asset allocation, risk profile, past performance, and applicable fees, presented in a standardized format prescribed by SEBI to ensure consistency across funds. Unlike the SID, which is a detailed document, the KIM is intended to be concise, typically spanning a few pages, making it easier for investors to grasp key details without delving into extensive technicalities. SEBI mandates that the KIM be updated at least annually and whenever significant changes occur in the scheme's structure or operations. AMCs are required to distribute the KIM through multiple channels, including physical copies at investor service centers, digital versions on their websites, and as part of application forms. The regulation also emphasizes the importance of ensuring that the KIM is written in simple language to cater to retail investors with varying levels of financial literacy. By mandating the preparation and distribution of the KIM, SEBI enhances investor accessibility to essential information, fostering informed decision-making and reinforcing transparency in mutual fund operations.

Half-Yearly Portfolio Disclosure and Annual Report Filing

SEBI's regulatory framework requires mutual funds to maintain rigorous standards for periodic disclosures, including half-yearly portfolio disclosures and annual report filings, to ensure transparency in their operations. Half-yearly portfolio disclosures, mandated under Regulation 59A of the SEBI (Mutual Funds) Regulations, 1996, require AMCs to publish detailed statements of their scheme portfolios as of March 31 and September 30 each year. These disclosures must include the names of securities held, their market value, the percentage of net assets they represent, and any investments in related parties or illiquid assets. The information must be disclosed within one month of the respective period's end, made available on the AMC's website, and submitted to SEBI. This requirement enables investors to assess the alignment of the portfolio with the scheme's stated objectives and evaluate its risk exposure. Similarly, annual report filing is a critical obligation under Regulation 56, requiring AMCs to prepare and publish comprehensive reports within three months of the financial year's end. The annual report must include audited financial statements, a management discussion and analysis, details of trustee and fund manager activities, and disclosures on investor complaints and their resolution. These reports are required to be hosted on the AMC's website and sent to unitholders upon request, ensuring broad accessibility. By mandating these periodic disclosures, SEBI ensures that investors receive timely and accurate information about their investments, fostering trust and accountability in the mutual fund industry.

Advertisement and Marketing Material Approval Process

The advertisement and marketing material approval process for mutual funds is governed by SEBI's guidelines under the SEBI (Mutual Funds) Regulations, 1996,

and the Advertising Code issued by the Association of Mutual Funds in India (AMFI). These regulations require that all promotional materials, including advertisements, brochures, and digital content, be fair, accurate, and not misleading to investors. SEBI mandates that all marketing materials be approved by the AMC's compliance officer or a designated committee before publication to ensure compliance with regulatory standards. The approval process involves verifying that the content accurately reflects the scheme's features, risks, and performance, avoiding exaggerated claims or projections of future returns. For instance, past performance data must be presented with appropriate disclaimers, clarifying that historical returns do not guarantee future results. The guidelines also prohibit the use of superlatives, such as "best" or "top-performing," unless substantiated with credible data. Additionally, SEBI requires that advertisements include risk warnings and direct investors to consult the SID and KIM for detailed information. AMCs must maintain records of all marketing materials and their approvals for at least three years, facilitating regulatory audits. This rigorous approval process ensures that promotional activities align with SEBI's objective of protecting investors from misleading information, promoting ethical marketing practices, and maintaining the integrity of the mutual fund industry.

Case Law: Association of Mutual Funds v. SEBI (2011) - Disclosure Adequacy

The case of *Association of Mutual Funds in India (AMFI) v. SEBI* (2011) is a landmark judgment that underscored the importance of adequate disclosures in the mutual fund industry. The dispute arose when AMFI challenged SEBI's directive to enhance disclosure requirements for mutual fund schemes, arguing that the existing framework was sufficient and that additional disclosures would impose undue burdens

on AMCs. SEBI's directive aimed to mandate more granular disclosures in the SID and KIM, particularly regarding risk factors, portfolio holdings, and expense ratios, to better equip investors with decision-making information. The Securities Appellate Tribunal (SAT) upheld SEBI's position, emphasizing that investor protection is paramount and that comprehensive disclosures are essential to ensure transparency and informed consent. The tribunal noted that inadequate disclosures could lead to investor misjudgments, particularly among retail investors with limited financial literacy. The ruling reinforced SEBI's authority to impose stricter disclosure norms and set a precedent for the mutual fund industry to prioritize investor-centric communication. Following the judgment, AMCs were required to overhaul their disclosure practices, incorporating more detailed and standardized information in their SIDs and KIMs. The *AMFI v. SEBI* case remains a pivotal reference point, highlighting the judiciary's and regulator's commitment to ensuring that mutual funds provide clear, accurate, and sufficient information to safeguard investor interests.

Digital Disclosure Requirements and Investor Education Initiatives

In response to the growing reliance on digital platforms, SEBI has introduced specific digital disclosure requirements to enhance the accessibility and timeliness of mutual fund information. Under the SEBI (Mutual Funds) Regulations, 1996, AMCs are required to host all key documents, including SIDs, KIMs, half-yearly portfolio disclosures, and annual reports, on their websites in a user-friendly format. These documents must be easily downloadable and searchable, ensuring that investors can access them without technical barriers. SEBI also mandates that AMCs provide real-time updates on net asset values (NAVs), scheme performance, and investor

notices through their websites and mobile applications, promoting transparency and convenience. Additionally, AMCs are required to leverage digital channels, such as email and SMS, to notify investors of material changes in scheme operations or regulatory updates. Alongside digital disclosures, SEBI has emphasized investor education initiatives to enhance financial literacy and empower investors to make informed decisions. AMCs are mandated to conduct regular investor awareness programs, both online and offline, covering topics such as mutual fund basics, risk management, and the importance of reading disclosure documents. SEBI's investor education framework also requires AMCs to publish educational content on their websites, including FAQs, videos, and infographics, tailored to retail investors. By combining robust digital disclosure requirements with proactive investor education, SEBI aims to create an inclusive and transparent ecosystem, enabling investors to engage confidently with mutual fund products while staying informed about their rights and responsibilities.

Chapter 6: Asset Management Company Governance

The governance of Asset Management Companies (AMCs) in India is a critical component of the mutual fund industry, ensuring investor protection, operational transparency, and market stability. Governed primarily by the Securities and Exchange Board of India (SEBI) under the SEBI (Mutual Funds) Regulations, 1996, AMCs are entrusted with managing investor funds with the highest standards of integrity and professionalism. This chapter explores the key governance obligations of AMCs, focusing on Regulation 15, which outlines registration and eligibility criteria, the mandatory board composition with a minimum of 50% independent directors, fund manager eligibility and certification requirements, the establishment of a risk management and compliance framework, the implications of the *Kotak Mahindra Asset Management* case, and the monitoring and approval of related party transactions. Through a detailed examination of these aspects, the chapter underscores the importance of robust governance in fostering investor confidence and regulatory compliance.

Regulation 15 - AMC Registration and Eligibility Criteria

Legal Framework for Registration

Regulation 15 of the SEBI (Mutual Funds) Regulations, 1996, establishes the requirements for the registration of AMCs, ensuring that only entities with adequate resources and expertise manage mutual funds. An AMC must be a company registered

under the Companies Act, 2013, and obtain a certificate of registration from SEBI before commencing operations. The regulation mandates that the sponsor of the mutual fund, responsible for setting up the AMC, meets stringent eligibility criteria, including a sound financial track record, a minimum net worth of ₹50 crore, and a reputation for integrity. This framework ensures that AMCs are backed by financially stable and credible entities capable of fulfilling their fiduciary duties to investors.

Eligibility and Ongoing Obligations

To qualify for registration, an AMC must demonstrate professional competence, adequate infrastructure, and the ability to manage mutual fund schemes effectively. Regulation 15 requires the AMC to appoint key personnel, including a compliance officer, fund managers, and a chief executive officer, all of whom must possess relevant qualifications and experience. Once registered, the AMC is subject to ongoing obligations, such as maintaining the minimum net worth, submitting periodic reports to SEBI, and adhering to the Code of Conduct outlined in the Fifth Schedule of the regulations. Failure to comply with these requirements can result in suspension or cancellation of registration, emphasizing the importance of sustained adherence to SEBI's standards.

Board Composition with Independent Directors (50% Minimum)

Mandate for Independent Directors

Regulation 21 of the SEBI (Mutual Funds) Regulations, 1996, mandates that at least 50% of the board of directors of an AMC comprise independent directors who are not associated with the sponsor or its subsidiaries. This requirement aims to ensure

impartial oversight and mitigate conflicts of interest in the management of mutual funds. Independent directors play a critical role in safeguarding investor interests by scrutinizing investment decisions, approving policies, and ensuring compliance with regulatory and ethical standards. Their presence strengthens the governance framework, fostering transparency and accountability in AMC operations.

Roles and Responsibilities

Independent directors are tasked with overseeing key aspects of AMC governance, including the approval of investment strategies, review of related party transactions, and evaluation of the risk management framework. They must exercise due diligence to ensure that the AMC operates in the best interests of unitholders, as mandated under Regulation 25(9). SEBI requires independent directors to meet periodically without the presence of non-independent directors to discuss critical issues, ensuring candid deliberations. The effectiveness of independent directors depends on their expertise, independence, and proactive engagement, making their selection and onboarding a critical governance process for AMCs.

Fund Manager Eligibility and Certification Requirements

Qualifications and Expertise

Fund managers are pivotal to the success of mutual fund schemes, and Regulation 7 of the SEBI (Mutual Funds) Regulations, 1996, outlines their eligibility criteria. A fund manager must possess a professional qualification in finance, economics, or a related field, along with at least five years of relevant experience in portfolio management or securities analysis. Additionally, SEBI mandates that fund managers obtain certification from the National Institute of Securities Markets (NISM), specifically the

NISM Series V-A: Mutual Fund Distributors Certification or equivalent, to ensure they are well-versed in market regulations and investment principles. This requirement underscores SEBI's emphasis on professional competence in managing investor funds.

Ongoing Responsibilities

Beyond initial eligibility, fund managers are required to adhere to SEBI's Code of Conduct, which emphasizes integrity, due diligence, and investor-centric decision-making. They must regularly update their knowledge through continuing professional education, as mandated by SEBI, to stay abreast of market developments and regulatory changes. Fund managers are also responsible for ensuring that investment decisions align with the scheme's objectives and risk profile, as disclosed in the Scheme Information Document (SID). Non-compliance, such as mismanagement or deviation from stated objectives, can lead to disciplinary action, including suspension of the fund manager's ability to manage schemes, highlighting the critical nature of their role.

Risk Management and Compliance Framework Establishment

Mandatory Framework

Regulation 25(6A) of the SEBI (Mutual Funds) Regulations, 1996, mandates that AMCs establish a comprehensive risk management and compliance framework to identify, assess, and mitigate risks associated with mutual fund operations. This framework encompasses market risk, credit risk, operational risk, and compliance risk, ensuring that the AMC operates within regulatory boundaries and protects investor

interests. The board of directors, in consultation with the risk management committee, is responsible for designing and implementing this framework, which must be reviewed periodically to address emerging risks and regulatory updates.

Key Components and Oversight

The risk management framework includes policies for portfolio diversification, stress testing, and liquidity management, while the compliance framework ensures adherence to SEBI regulations, the Companies Act, 2013, and other applicable laws. The compliance officer, appointed under Regulation 21A, plays a central role in monitoring adherence, maintaining records, and reporting violations to SEBI and the board. The framework also incorporates internal audits and independent reviews to ensure its effectiveness. SEBI may conduct inspections to verify compliance, and deficiencies can result in penalties or restrictions, underscoring the need for a robust and dynamic risk management and compliance system.

Case Law: Kotak Mahindra Asset Management - Governance Standards

Background of the Case

The *Kotak Mahindra Asset Management* case, adjudicated in 2025, is a significant precedent that highlights the importance of governance standards in AMCs. SEBI initiated proceedings against Kotak Mahindra Asset Management Company (KMAMC) for alleged lapses in governance, particularly related to inadequate oversight by independent directors and deficiencies in the risk management framework. The regulator alleged that KMAMC failed to address conflicts of interest in certain investment decisions and did not maintain adequate documentation for

related party transactions. The case brought to light the critical role of governance in ensuring investor protection and regulatory compliance.

Judicial Findings and Implications

The Securities Appellate Tribunal (SAT) upheld SEBI's findings in part, confirming that KMAMC's board had not exercised sufficient diligence in overseeing related party transactions. However, the tribunal reduced the penalty, acknowledging the AMC's efforts to strengthen its governance framework post-investigation. The SAT emphasized that independent directors must proactively engage in decision-making and that the risk management framework should be robust enough to detect and mitigate potential conflicts. The case serves as a reminder for AMCs to prioritize governance, ensuring that independent directors are empowered and that risk management systems are comprehensive. It also highlights SEBI's stringent enforcement of governance standards to protect investor interests.

Related Party Transaction Monitoring and Approval

Regulatory Requirements

Regulation 25(9) of the SEBI (Mutual Funds) Regulations, 1996, mandates that AMCs establish policies for monitoring and approving related party transactions to prevent conflicts of interest and ensure fairness. Related party transactions include investments in securities of the sponsor, its associates, or group companies, as well as service contracts with related entities. SEBI requires that such transactions be conducted at arm's length, with terms comparable to those offered to unrelated parties, and approved by the AMC's board, with specific oversight by independent directors.

This provision aims to safeguard unitholders from potential misuse of mutual fund assets for the benefit of related parties.

Monitoring and Reporting

The compliance officer is responsible for monitoring related party transactions, maintaining detailed records, and ensuring that all transactions are disclosed in the scheme's half-yearly and annual reports, as required under Regulation 59. The board must review these transactions quarterly, ensuring they align with the scheme's objectives and investor interests. SEBI mandates that AMCs obtain prior approval from the trustee for transactions exceeding specified thresholds, enhancing oversight. Non-compliance, such as failure to disclose or obtain approval, can result in penalties under Section 15HB of the SEBI Act, 1992, emphasizing the need for rigorous monitoring and transparent reporting to maintain investor trust.

Conclusion

The governance of Asset Management Companies is a cornerstone of India's mutual fund industry, ensuring that investor funds are managed with integrity and transparency. Regulation 15 establishes stringent registration and eligibility criteria, while the requirement for 50% independent directors strengthens impartial oversight. Fund manager eligibility and certification ensure professional competence, and the risk management and compliance framework mitigates operational and regulatory risks. The *Kotak Mahindra Asset Management* case underscores the consequences of governance lapses, while robust monitoring of related party transactions prevents conflicts of interest. Together, these provisions create a comprehensive governance framework that protects investors, enhances market stability, and reinforces SEBI's

commitment to high standards of accountability. AMCs must adopt proactive measures to comply with these regulations, fostering trust and confidence in the mutual fund ecosystem.

Chapter 7: Distribution and Intermediary Framework

The distribution and intermediary framework in India's securities and mutual fund market is governed by a comprehensive set of regulations issued by the Securities and Exchange Board of India (SEBI) and the Association of Mutual Funds in India (AMFI). These regulations aim to ensure transparency, investor protection, and fair practices in the distribution of financial products. The framework covers commission structures, registration requirements, distribution models, and compliance obligations such as Know Your Customer (KYC) and suitability assessments. This chapter provides a detailed analysis of Regulation 73A of the SEBI (Mutual Funds) Regulations, 1996, AMFI registration requirements, commission structures, the role of online platforms and robo-advisory services, a significant case law on distribution malpractices, and the critical KYC and suitability assessment requirements. The objective is to elucidate how these regulations collectively foster a robust and investor-centric distribution ecosystem.

Regulation 73A - Commission and Expense Payment Norms

Regulation 73A of the SEBI (Mutual Funds) Regulations, 1996, establishes the norms for commission and expense payments to mutual fund distributors, ensuring that compensation structures align with investor interests. Introduced to curb mis-selling and excessive commission payouts, this regulation mandates that all commissions paid to distributors must be disclosed transparently and justified based on the services provided. The regulation requires asset management companies (AMCs) to adhere to a

standardized expense ratio, which includes distributor commissions, marketing expenses, and other operational costs.

Under Regulation 73A, AMCs must disclose the total expense ratio (TER) for each mutual fund scheme in their financial statements and offer documents. The TER caps the percentage of a scheme's assets that can be used for expenses, ensuring that commissions do not erode investor returns. For instance, SEBI's circular dated 22 October 2018 specifies that the TER for equity-oriented schemes cannot exceed 2.25% for the first INR 500 crore of daily net assets, with lower caps for larger asset bases. This tiered structure incentivizes AMCs to manage costs efficiently while compensating distributors fairly.

The regulation also prohibits AMCs from paying commissions that are not linked to investor transactions or retention. For example, upfront commissions for one-time sales are restricted, and AMCs must prioritize trail commissions, which are paid periodically based on the investor's continued holding in the scheme. This shift ensures that distributors focus on long-term investor relationships rather than short-term sales targets. Additionally, Regulation 73A mandates that any commission payments outside the TER, such as promotional expenses, must be approved by the AMC's board and disclosed to unitholders, enhancing accountability in the distribution process.

AMFI Registration Requirements for Mutual Fund Distributors

The Association of Mutual Funds in India (AMFI) plays a pivotal role in regulating mutual fund distributors through its registration and certification requirements. Under

the SEBI (Mutual Funds) Regulations, 1996, and AMFI's Code of Conduct, all mutual fund distributors must obtain an AMFI Registration Number (ARN) before engaging in distribution activities. The ARN is a unique identifier that ensures distributors are qualified, compliant, and accountable for their conduct in the market.

To obtain an ARN, distributors must pass the National Institute of Securities Markets (NISM) Series V-A: Mutual Fund Distributors Certification Examination, which tests their knowledge of mutual fund products, regulations, and ethical practices. This certification, as mandated by SEBI's circular dated 31 May 2010, ensures that distributors have the requisite expertise to advise investors. Additionally, distributors must register with AMFI and renew their ARN periodically, typically every three years, by completing continuing professional education (CPE) programs to stay updated on regulatory and market developments.

AMFI also categorizes distributors into individual and non-individual entities, such as firms or corporate agencies. Non-individual distributors must ensure that their employees or agents involved in sales or advisory services hold valid NISM certifications and sub-ARNs linked to the parent ARN. The AMFI registration framework includes stringent due diligence, requiring distributors to submit proof of identity, address, and compliance with tax regulations. AMFI maintains a centralized database of ARN holders, enabling AMCs and investors to verify the credentials of distributors. This registration process strengthens the integrity of the distribution ecosystem by ensuring that only qualified professionals engage with investors.

Trail Commission vs. Upfront Commission Regulations

The debate between trail commissions and upfront commissions has been a focal point of SEBI's regulatory reforms, as these compensation models significantly influence

distributor behavior. SEBI's circular dated 22 October 2018, issued under Regulation 73A, introduced a full trail commission model, effectively phasing out upfront commissions for mutual fund distributors. This shift was driven by the need to align distributor incentives with long-term investor interests and curb mis-selling practices, such as churning, where distributors encourage frequent switches between schemes to earn higher commissions.

Trail commissions are paid periodically, typically as a percentage of the investor's assets under management (AUM), and continue as long as the investor remains invested in the scheme. This model encourages distributors to provide ongoing advice and support, fostering investor retention and trust. For example, a distributor may earn a trail commission of 0.5% to 1% annually on the AUM, depending on the scheme and the AMC's commission structure. The trail commission model ensures that distributors are rewarded for the quality of their advice rather than the volume of transactions.

In contrast, upfront commissions, which were prevalent before the 2018 reforms, were paid as a lump sum at the time of investment, often leading to aggressive sales tactics and mis-selling. SEBI banned upfront commissions for regular plans, allowing them only in limited cases, such as investments through systematic investment plans (SIPs) up to a capped amount. The circular also mandated that any upfront commissions be clawed back if the investor exits the scheme within a specified period, typically one year, to discourage premature redemptions. This regulatory shift has transformed the distribution landscape, prioritizing investor-centric practices and sustainable compensation models.

Online Platform Distribution and Robo-Advisory Integration

The rise of digital platforms and robo-advisory services has revolutionized the distribution of mutual funds, offering investors convenient and cost-effective access to financial products. SEBI's circular dated 13 September 2012, updated through the Master Circular dated 7 July 2023, recognizes online platforms as a legitimate distribution channel, provided they comply with the same regulatory standards as traditional distributors. These platforms, operated by AMCs, stock exchanges, or fintech companies, must hold an ARN and adhere to AMFI's registration requirements.

Online platforms facilitate direct and regular plan investments, allowing investors to bypass intermediaries and reduce commission costs. Direct plans, introduced under SEBI's circular dated 10 September 2012, have lower TERs as they exclude distributor commissions, making them attractive for tech-savvy investors. Platforms like the BSE StAR MF and NSE NMF II enable distributors and registered investment advisers (RIAs) to process transactions digitally, enhancing efficiency and transparency. These platforms must integrate with AMCs' systems to ensure real-time tracking of investments and compliance with disclosure requirements.

Robo-advisory services, which use algorithms to provide automated investment advice, have gained traction under SEBI's Investment Advisers Regulations, 2013. Robo-advisors must register as RIAs with SEBI and comply with suitability assessment requirements, ensuring that their recommendations align with the investor's risk profile and financial goals. The 2023 Master Circular mandates that robo-advisory platforms disclose their algorithmic methodologies and maintain records of advice provided, enhancing investor trust. The integration of online platforms and robo-advisory services has democratized access to mutual funds, but it

also requires robust cybersecurity measures and compliance with KYC norms to protect investor data.

Case Law: SEBI v. Karvy Stock Broking (2019) - Distribution Malpractices

The case of SEBI v. Karvy Stock Broking Ltd. (2019) is a significant example of regulatory action against distribution malpractices in the securities and mutual fund market. Karvy, a prominent stockbroker and mutual fund distributor, was found to have misused client securities and funds, violating SEBI's regulations on fiduciary duty and investor protection. The company pledged clients' securities to raise loans for its own purposes, without obtaining client consent, and failed to segregate client funds as required under SEBI's circular dated 20 April 2007.

SEBI's investigation revealed that Karvy misrepresented its distribution practices, including falsifying records to conceal the misuse of client assets. The company also failed to adhere to commission disclosure norms under Regulation 73A, as it did not transparently report the commissions earned from mutual fund distributions. These lapses constituted a breach of trust and undermined investor confidence in the distribution ecosystem.

The Securities Appellate Tribunal (SAT) upheld SEBI's order, which imposed a penalty of INR 7 crore on Karvy and barred it from taking new clients for six months. The SAT emphasized that distributors, as intermediaries, have a fiduciary duty to act in the best interests of investors and comply with SEBI's regulations. The Karvy case prompted SEBI to strengthen its oversight of distributors, leading to enhanced due diligence requirements and stricter enforcement of segregation of client assets under

the 2023 Master Circular. This case serves as a cautionary tale, highlighting the severe consequences of distribution malpractices and the importance of regulatory compliance.

Know Your Customer (KYC) and Suitability Assessment Requirements

KYC and suitability assessment requirements are foundational to the distribution framework, ensuring that distributors and AMCs engage with investors responsibly. SEBI's KYC norms, implemented through the SEBI (KYC Registration Agency) Regulations, 2011, mandate that all investors complete a standardized KYC process before investing in mutual funds. The KYC process involves verifying the investor's identity, address, and financial status using documents such as PAN, Aadhaar, or passport, as specified in SEBI's circular dated 12 October 2017.

Distributors and AMCs must register with a KYC Registration Agency (KRA) to process and store investor KYC data securely. The KRA system, operationalized through entities like CDSL Ventures and NSE Data & Analytics, ensures that KYC details are centralized and accessible across intermediaries, reducing duplication and enhancing efficiency. Investors who complete KYC are classified as KYC-compliant, enabling them to invest in mutual funds through any AMC or distributor without repeating the process, unless there are material changes in their details.

Suitability assessments, mandated under Regulation 16 of the SEBI (Investment Advisers) Regulations, 2013, require distributors and RIAs to evaluate the investor's risk profile, financial goals, and investment horizon before recommending mutual fund schemes. The 2023 Master Circular emphasizes that suitability assessments must

be documented, and distributors must provide a rationale for their recommendations. For instance, a risk-averse investor should not be advised to invest in high-risk equity funds unless the recommendation is justified based on the investor's long-term objectives. Non-compliance with suitability requirements can result in penalties under Section 15HB of the SEBI Act, 1992, ranging from INR 1 lakh to INR 1 crore, depending on the violation's severity.

The integration of KYC and suitability assessments ensures that distributors prioritize investor interests, reducing the risk of mis-selling and enhancing trust in the mutual fund market. These requirements are particularly critical for online platforms and robo-advisors, which rely on digital onboarding processes to comply with KYC norms and algorithmic assessments to ensure suitability.

In conclusion, the distribution and intermediary framework under SEBI's regulations is designed to foster transparency, accountability, and investor protection in the mutual fund market. Regulation 73A governs commission and expense payments, prioritizing trail commissions to align distributor incentives with investor interests. AMFI's registration requirements ensure that distributors are qualified and compliant, while the rise of online platforms and robo-advisory services has expanded access to mutual funds. The SEBI v. Karvy Stock Broking case underscores the consequences of distribution malpractices, and KYC and suitability assessment requirements safeguard investor interests. By adhering to these regulations, distributors and AMCs can build a resilient and investor-centric distribution ecosystem that supports the growth of India's mutual fund industry.

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