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MUTUAL FUND REGULATION VIOLATIONS IN INDIA

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ABSTRACT

Security market regulation violations should be dealt seriously because it involves public money and deviations will lead to large scale economic repercussion. Mutual Fund (MF) stakeholders such as Asset Management Companies (AMC) have the duty and responsibility to adhere and comply with the rules and regulatory stipulated by the regulators, run in accordance to governance standards, maintain transparency and make money and wealth for its investors. However, at times, they are found to be deviating norms and causing loss to investors and putting investor trust and confidence to test. This paper examines and documents some deviations found in the mutual fund industry and now regulators dealt with them. We study several deviations that got unearthed from the famous 2003 US Mutual Fund Scandal and later from the 2010 front-running episodes in India. We also examine several incidents as observed in the Indian mutual fund industry and how SEBI dealt with them. This study is significant in the Indian context because it is witnessing increased inflow of money, mostly from small retail investors. Strong regulations act as essential foundation and the architectural plan of an investment building which investors build by pooling up their hard-earned money as bricks with the help of a mason called the fund manager. This paper gives some suggestions to regulators to make the foundation much stronger and everlasting.

JEL Classification *G11, G23, G14, G28*

Keywords *Mutual funds, mf regulations, securities market, regulator, SEBI*

INTRODUCTION

Enforcing standards, protecting investors and regulating market are prime responsibilities of the Securities Market Regulatory Authorities (or Regulators). Regulators across the globe are constantly refining the rules and regulations of the securities market to ensure transparency and fair play amongst stakeholders. Despite strict norms being put in place, violations are happening here and there, often hampering investor returns or their confidence. When regulators catch hold industry stakeholders of the industry for deviations, they often take the consent plea route to settle charges by paying a penalty without admitting or denial of guilty and by a voluntary debarment from trading for some period. This paper attempts to apprise about certain key deviations in the mutual fund industry. The Indian securities market regulator Securities and Exchange Board of India (SEBI) announced mutual fund (MF) regulations in 1992 and gave it a formal shape in 1996. Key regulations that shaped the industry include: ensuring that the Net Asset Value (NAV) reflects the true worthiness of the

underlying securities (2000), risk management and international securities regulation (2002), introduction of cut-off time (2004), banning amortization of New Fund Offer (NFO) expenses (2008), capping expense ratio at 2.25% and ban on entry load (2009) etc.

OBJECTIVES OF THE STUDY

1. To study mutual fund regulatory deviations, particularly by Indian MFs
2. To understand resolution steps and outcomes
3. To make suitable suggestions to regulators

SIGNIFICANCE OF THE STUDY

This study helps us understand mf processes better, provide eye-opening insights to investors and help regulators make tougher rules to prevent subsequent violations. This is important for countries like India where the industry is in nascent stage and more money is entering capital market via MFs.

LITERATURE STUDY

When the securities market anticipates, or reveals any adverse events, such as a possible litigation on a mf company, that there will be abnormal "fund runs" during which panic investors indulge in abnormal concerted redemptions. These "fund runs" will be in the form of waves and the pre-event runs start as early as three months before the litigation even begins. Investors running out before the litigation announcement earn higher risk-adjusted returns. Further, securities held by litigated fund families significantly underperform than their peers (Qiana & Tanyerib, 2017). Studies show that market makers do front-running about one or two minutes ahead of the actual order to be placed for the client and yet significantly make quick gains (Cai, 2001). Because MF holding disclosures are publicly available, the information could lead to predatory trading at times of distress which would generate 0.5% per month alpha (Dyakov & Verbeek, 2013). Not much prior study is done on all these form of MF industry regulatory violations, particularly in the Indian mutual fund industry landscape. There is a clear literature gap in this regard and this paper is a step towards bridging it.

RESEARCH METHODOLOGY

This study uses Descriptive research to gather preliminary information about mf violations, observe and record the dispute resolution mechanisms followed and describe the implications.

DATA COLLECTION

Secondary data sources such as from several journals, research papers, websites including from the official websites such that of SEBI etc. were used to collect information necessary for this study.

THE 2003 MUTUAL FUND SCANDAL

Prior to 1968, MFs allowed investors to observe todays' market and if there is a gap-up opening or positive closing, they can "backward price" an order so that they buy mf units at previous day NAV and sell at today's closing price thereby making an assured profit. The SEC Rule 22c-1 fixed this loophole and insisted on forward pricing only. Time stamping allowed tracking time of placing the order though intentional falsified timestamps could not be checked.

On September 3, 2003, New York State Attorney General Eliot Spitzer made a complaint against several mf firms of violating funds and thereby not doing their fiduciary duties and hence violating securities laws. New Jersey-based hedge fund company Canary Capital Partners LLC and Bank of America (BoA)'s

Nations Funds are alleged of "late trading" in which BoA is charged of accepting orders beyond the stipulated 4:00 PM cut-off time and processing them at same-day NAV as if they are placed prior to 4 PM. Some funds are found not even time stamping adding to confusion as to when the order was taken. According to the New York's Martin Act, such trading gives an unfair advantage to a late trader (such as Canary) over other traders and hence is prohibited. Investigations found that at least 25% broker firms allowed this potential late trading while three funds even have an arrangement allowing the late timing! Canary Capital settled the dispute paying US$40 million either admitting or denying guilt. BoA agreed to compensate mf investors who incurred loss due to the illegal transactions.

Major fund houses, such as Janus, Bank One's One Group, and Strong Capital Management and others are found to allow "market timing" by certain trading clients to make profit from short-term market cycles. Though not illegal, trading frequency limits are put to discourage frequent buying and selling of mf units so that scheme transaction cost and turnover do not increase, particularly at expense of long-term investors. Some schemes are found not having any frequency cap in their prospectus itself! Few others allowed it beyond limits even when there was a cap in mentioned on paper thereby violating their own prospectus. Some advisors used market timing to artificially make Assets Under Management (AUM)s go up so that they can get higher commission.

Investigations by SEC and brokerage industry watchdog National Association of Securities Dealers (NASD) unearthed another scandal - about "breakpoints" - in which investors are overcharged and had to pay higher commissions than what was told to them by the broker or as mentioned in the prospectus. The extra money is found to go into the pockets of brokers and mf companies.

SEC November 2003 investigations found that partners of mf companies are "front running" by buying securities prior to their fund house buying them. SEC termed this practise as an "insider trading" activity and the chairmen of Strong Mutual Funds and Putnam Investments had to resign. In December, Invesco is charged of market-timing and Prudential Securities, for widespread late trading. Almost all funds named in the scandal settled with SEC by mid-2004. Post-scandal studies have found that traders are the scandal beneficiaries and that managements companies made poor decisions by allowing the trades and got hurt both *ex-post* and *ex-ante* (Patrick, 2008) and have to suffer losing AUM and report significant negative returns (Houge & Wellman, 2005).

FRONT-RUNNING

Front-running is an unethical malpractice in which a market intermediary such as a broker, analyst or a market executive does securities trading (buying or selling of shares) in his own or proxy account based on an advance information before the trade is being actually done in client account (such as that of MF) and thereby making illegal / wrongful gains. This increases acquisition cost or reduces sale proceed realisation for the scheme. SEBI unearthed two major front-running cases in 2010.

SEBI investigations found a strange trading pattern of certain individuals and that of HDFC MF between June 2000 and June 2010. An Assistant Vice-President of HDFC AMC tipped his college friend and others ahead of the mf actually placing the orders. Six entities, including five individuals, are found to have made illegal gains with the tips. SEBI and Securities Appellate Tribunal (SAT) ordered them to pay back the gains along with 12% interest apart from debarring them for certain periods. HDFC AMC failed in preventing its AMC employees from front running and had to pay fine. HDFC Trustee Company failed in ensuring the

activities were in accordance with the mf regulations and wrongly certified to SEBI that no key persons were involved in front running. The MD and CEO failed in his responsibility for the overall AMC risk management function. The three got the case resolved under consent terms and compensated mf investors for the loss. After the HDFC MF fiasco, SEBI extended the investigation to 9 more fund houses but not much information about this is available in public domain.

In a similar case, SEBI alleged that a fund manager of DSP Chola MF (now L&T MF) and a dealer colluded with outsiders (who are not part of dealing room) and gained access to advance information in regard to large trades that the fund house is going to place. The outsider-brothers did front running on seven days between during April 1, 2008 to May 31, 2008 making some gains. SEBI blamed the MF for failing to exercise due diligence and care and for not taking adequate measures to ensure non-leakage of information pertaining to its trading strategy to others. The fund house filed an affidavit of “undertakings and waivers” and settled through consent proceedings by paying fine.

SEBI introduced consent order mechanism in April 2007 in similar lines to out-of-court settlement and the US plea-bargaining. Critics found fault with the ad hoc manner of adjudication process, lacking transparency, issuing settlement orders without vital case details and penalty with no reasoning. The May 2012 amendment countered the critics by excluding certain serious offenses such as insider trading, front-running, NAV manipulation or other serious mutual fund defaults from using consent pleas (SEBI, 2012). Post-amendment, the number of consent applications and fines collected sharply reduced forcing parties to inevitably go for litigation process. Experts feel consent order system is for mature markets and India is not yet ready for it. Another section feel that this global practise is a norm in the US where 95% cases are settled in this manner and that India too should allow it but, on a case-to-case basis.

OTHER INSTANCES

In May 2011, the SAT felt HSBC MF violated SEBI rules when the fund house changed the scheme fundamental attributes without giving the advance mandatory exit option. SAT felt that the SEBI adjudicator who examined the case grossly erred in not issuing appropriate directions. This is an instance where tribunal stepped in to investor rescue when regulator failed.

In March 2013, SEBI took up two cases of price manipulation of UTI Sunder ETF which opened at Rs 660 on August 3, 2011 and closed at Rs 2,054 on November 4, 2011 on BSE. The adjudicator disposed the cases after it was found that two individuals have done only one trade each for Rs 1104 and Rs 2650 respectively. Lesson learnt? Trading for only one unit will not amount to artificially inflating the price.

In November 2016, SEBI fined Franklin Templeton MF for forming an informal group and dressing it as an investment committee. Basic details about minutes of meeting were not properly maintained. Further, it included international CEO in such committee as the panel first member in violation of SEBI rules prohibit certain operations such as trading desk, unit holder servicing and investment operations to be performed from outside the Indian Territory.

The March 2018 ICICI Securities IPO allowed its sponsor ICICI Bank, to divest holding in the brokerage company. The IPO is filed under Regulation 26 (2) of SEBI (Issue of Capital and Disclosure Requirements) Regulations 2009 wherein if the IPO fails to get at least 75% of the net offer to public by Qualified Institutional Buyers (QIB), it has to refund full subscription money. ICICI Prudential AMC, through

five schemes, made a bid of Rs 400 crores on Day 1 and sensing the IPO could fail, made an additional bid for Rs 240 crores on the last day. If the last day ICICI Pru MF subscription is not counted, the QIB portion stands at 70.11% (less than 75%) and hence the IPO would have failed.

SEBI felt the AMC subscription on the last day was done to facilitate QIB portion subscription and to ensure that the IPO does not fail. SEBI sensed mischief by the AMC and that the CEO and fund managers have not worked in unit holders' interest and even violated code of conduct and due diligence. It directed ICICI Pru AMC to refund the full Rs 240 crore with interest per annum back to all the five schemes. MF scheme investors who sold their unit holders but had to suffer loss due to the IPO will also be compensated. ICICI Securities made a disastrous stock exchange listing and the share price fell heavily incurring loss to all investors, including to the MF investors. Media investigations reported that 54 mf schemes from different fund houses that subscribed the IPO completely exited in less than a month taking short-term losses showing their subscription is solely to bail out the IPO.

In April 2018, SEBI initiated adjudication proceedings against HDFC MF for alleged mf regulation violations (such as purchasing securities exceeding scheme maturity, differences in TER of direct and regular plans lower than distributor commission being paid in certain schemes, scheme NAV data not being published on website for certain period and error in unlisted equity share valuation of a company) done between April 1, 2014 to March 31, 2016. HDFC MF and HDFC Trustee Company submitted separate applications for settlement which SEBI approved after collecting a fine and taking approvals.

In May 2018, SEBI issued a show cause notice to SBI MF for concealing essential details about an investment in Padmini Applied Sciences / Technology shares thereby violating Prohibition of Fraudulent and Unfair Commerce Practices (PFTUP) guidelines. The MF also failed to preserve records, books of accounts or documents for eight year. SBI MF settled the issue without admitting or denying the findings of fact and conclusion of law by paying Rs.14.05 crore for settlement and Rs.62.04 lakh towards investor protection and education fund. The regulator said it will not take up any enforcement proceedings against the MF for the alleged default.

FINDINGS

Despite stringent rules & regulations, violations and deviations continue to surface in newer forms. A deeper investigation (such as 2003 MF scandal in US and 2010 front-running in India) often unearths a bundle of worms. Governance and Independence of MF company board is hardly checked. Consent order route is the most preferred way of settling a regulatory investigation. Regulatory adjudication process is found to be *ad hoc* and arbitrary in some cases.

RECOMMENDATIONS

Proactive sharing of best practises and experiences with other regulators, perhaps from other countries, will help regulators to get to know of newer ways of bypassing the system and fix regulations before they get violated. MF Board should have more independent members, perhaps nominated by SEBI or Government in similar lines to banks. Vibrant and encouraging whistle blower policies are necessary. SEBI should form a dedicated team / committee to monitor violations. Consent order route should be allowed on case-by-case basis only

CONCLUSION

Many mf issues such as late trading, market timing, breakpoints and front-running got unearthed in the past. Despite stringent regulations, mutual fund companies, at times, are found to be deviating the rules. Regulators need to be proactive at updating security laws, rules and regulations based on new experiences obtained as quickly as possible instead of entering after the damage is already over. In almost all cases, consent order route has become the easiest way of cleaning hands without accepting or denying any wrongdoing and regulators should curtail this casual usage and restrict it to lengthy or complex cases only.

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