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INVESTOR PROTECTION AND MUTUAL FUNDS REGULATION: AN ASSESSMENT

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ABSTRACT

The economic policy of India and the role of the state in managing the financial services of the country are undergoing a change impelled by a near- unanimous opinion that freedom of individual economic action is more effective for economic growth and the development of a country than an interventionist policy. It is being increasingly believed that the role of the government in the financial sector should be restricted, and that the liberalisation of this sector is necessary for allocative efficiency. Countries the world over have, during the past two decades, witnessed a process of dismantling of regulations and restrictions, and the removal of controls in the financial market. However, the process of liberalisation has not always ensured optimum allocation of resources or been able to protect investors from market failures. This has raised doubts regarding uncontrolled liberalisation and its impact on the economy in general, and investors in particular. The debate about the utility, extent and quality of regulations in a free-market economy is an ongoing one. The paper seeks to critically examine the pros and cons of regulating financial sector with special reference to mutual fund industry. It also analyses the present system of regulations in India and suggest a solution which can be beneficial to both industry in terms of autonomy and free competition as well as investors in terms of transparency and protection.

Keywords: Liberalisation, interventionist policy, allocative efficiency, market failure.

INTRODUCTION:

Regulation is considered unnecessary in a free market economy, yet it is pursued to achieve certain economic goals. The Posener-Stigler theory (Stigler, 1971) argues against regulation in view of its dangers and cost-moral hazards cost (meaning change of behaviour of agents due to regulations), compliance cost, cost due to loss of economic welfare and the cost which arises from the fact that regulation normally works against public interest. However, the Chicago school justifies regulation in the public interest. “Regulation is considered fundamental to safeguarding the interest of investors/consumers in a volatile, imperfect market.”

The liberalisation of the financial market ensures competition in the marketplace. But the most important condition for a competitive market is the free flow of correct information. In a perfect market, the buyers and sellers of any financial service should be able to receive the same information, at the same time and at the same cost. However, in reality, this does not happen because although 'information' is considered to be public goods, a competitive market does not provide a sufficient quantity of the goods. Moreover, financial information is a high-value-added good and its cost is often beyond the reach of individual investor. Therefore, there is always the chance of market collapse in a free economy due to the flow of imperfect information. Mutual funds, or any other investment management business, operating in such a market are exposed to this imperfection of the market and carry great risks in transacting their business.

OBJECTIVE:

1. To critically analyse the need to regulate financial sector with greater emphasis on Mutual Fund industry.
2. To analyse the present system of regulations and suggest a suitable system of regulation.

ANALYSIS:

All types of investment activity, whether undertaken by individual or institutional investors, involve considerable risk. These risks are associated with losing capital or receiving returns which are lower than expected. There are several factors which increase the element of risk. These can be broadly classified into the following three categories:

- Economic-performance-related risks: These include the risks of changes in the economy, money supply, inflation, interest rates and international and trade relations.

- Securities-related risks: These are related to the nature, efficiency and performance of the organisations issuing securities.

- Other risks; These include the marketability of securities (in secondary market), changes in tax laws,etc.

While the above-mentioned risks are common to all investors- individuals as well as institutions- when an investor invests through an investment management firm (e.g., a mutual fund), faces fourimportant classes of risk, namely: -

1. **Portfolio selection risk:** Portfolio selection risk arises out of adverse portfolio selection. It couldoccur if the investment manager of an investment firm/mutual fund, who selects the portfolio on behalf of the investors, is incapable of judging future market conditions, or intentionally selects securities despite the possibility of negative returns, or indiscriminately selects high- risk securities.
2. **Organisational risk:** Organisational risk or failure of a firm can arise from several factors related to the firm. The important factors noted by Franks and Mayer (1998) are:

- “Fraud committed by employees,
- theft or misuse of clients' funds, and
- reckless dealing of funds, including non-contractual transfer of funds, portfolio manipulation,reckless churning of funds, etc.”

Failure of the firm may also occur due to a general collapse of the market. A stock market crash may lead to a bank crash, which may cause the breakdown of the transaction machinery. These factors may put an investment management firm on the path of insolvency. Unless an investment manager is sufficiently alert to the situation and can take action to reverse the process, the investors may suffer huge losses.

3. Management process risk: The management-process risk is related to errors in the execution of transactions, delays in settlement and losses due to counter-party default. These risks are often associated with the financial transactions of the investment manager. “The risks associated with management activities relate to intangible assets (capitalised value of future fee, income); those associated with the value of the firm's fixed assets or its own security portfolio relate to tangible assets.” (Franks & Mayer, 1998)

4. Market Failure Risk: While mutual funds, as organised and well-regulated institutions, do notface undue problems of transaction, delays in settlement, or risks related to intangible and tangible assets, a major source of risk confronted by them is market failure, which occurs when prices and incentives do not fully reflect the costs and benefits of the goods and services provided. A market failure may occur when the failure of one kind of institution jeopardises the smooth functioning of the other (systematic risk). For example, a bank strike may jeopardise the operations of the securities market, or disturbances in the clearing system may affect market liquidity.

Market failure may also result from asymmetric information. There are three types of risks to whichuninformed investors are exposed: uncompensated wealth transfers (in particular, fraud and theft), incompetence and negligence. Risks arising out of asymmetric information have a greater bearing on mutual funds and are a matter of serious concern for those investing in mutual funds.

THE NEED FOR REGULATION:

The existence of risk, whether in the form of not achievement of expected returns commensurate with assumed risk or loss of capital itself, associated with investment activity is the basis and reason for legislative control of the financial market in general, and the operations of investment management and advisory firms in particular. The varied legislative and regulatory controls, irrespective of their scope, form or structure, are designed to mitigate and control these risks and achieve the twin objectives of preferably preventing or the very least correcting market failures and also protecting susceptible investors from potential loss. The view has been seconded by various prior researches on the need and rationale for regulating an economy. According to Subrahmanyam, (Subrahmanyam, N; 2008) "The principles of regulation are based on the following premises:

- To correct identified market imperfections and failures in order to improve the market and enhance competition;
- To increase the benefit to investors from economies of scale; and
- To improve the confidence of investors in the market by introducing minimum standardsof quality."

There are broadly five categories of regulatory measures that are adopted by Governments the world over:

(1) Imposing capital requirements for investment management firms:

Though capital requirement is considered an important pre-requisite for the healthy operation of a financial institution, this form of control cannot effectively check the failure of investment management firms. Because the problem of investment management relates to asymmetric information, the capital structure of such firms cannot prevent potential failures. This form of regulation does not appreciably enhance investor protection in the investment management business.

(2) Monitoring and auditing the operations of investment management firms:

Screening, monitoring and auditing are considered very effective systems of control and have been adopted by many countries, including the US, the UK and Japan. Screening is an *ex-post* assessment, conducted before the firm is allowed to start operation, while monitoring the performance of a firm is an *ex-post* evaluation. While screening through a 'fit and proper' test is given more importance in the UK, US regulations attach greater importance to *ex- post* evaluation. Auditing is also an *ex-post* assessment, and helps detect fraud and judge the quality of the management. Auditing is often done by a public agency.

(3) Disclosure and rating of management firms:

The disclosure of material facts is considered an important method of regulation to prevent market failure, and reduce the risks of adverse selection and moral hazards. Full disclosure is effective in dealing with problems arising out of asymmetric information. Two important methods are:

- Compulsory dissemination of information by investment management firms; and
- rating by acredit rating agency.

(4) Providing insurance:
The provision of insurance against financial loss is effective in the case of firm-specific risks, but may not cover losses arising out of general market failure. However, Rothchild and Stiglitz (1976) suggest that for systematic risks, insurance can be available to the extent that risks can be internationally diversified. Insurance is considered an incomplete form of protection, effective in the case of fraud due to wealth transfer.

(5) Setting up minimum standards for investment management firms*:*
Since management professionals play a very important role in providing investment services, the integrity of managers is very vital for preventing fraud. Therefore, the regulation of the 'profession' is considered very important for ensuring protection to investors. The formulation of minimum standards for professionals would compel managers to undergo professional training to enhance their efficiency and integrity.

PRESENT SYSTEM OF REGULATIONS:
At present, the mutual fund industry is governed by the SEBI (Mutual Funds) Regulations, 1996. Apart from these guidelines the present system of regulation of mutual funds also includes the provisions of the Indian Trusts Act 1882, relevant provisions of the Companies Act, 1956 and the Income Tax Act, 1961. Though the Unit Trust of India continues to be governed by the Unit Trust of India, Act 1963; it also has to adhere to the SEBI (Mutual Funds) Regulations,1996.

The SEBI (Mutual Funds) Regulations, 1996 is an attempt to remove many of the restrictions and rigidities, which were found in the 1993 regulations. Moreover, these guidelines brought into its fold new provisions with regards to disclosures, transparency and obligations on the part of mutual funds, asset management companies (AMCs), trustees and key personnel associated with them. Theexisting regulations are quite comprehensive and are covered in 10 chapters and 12 schedules. The rationale for such comprehensive guidelines is that even in the freest of the free markets, the mutual funds are governed by strict regulations by the capital markets regulator(s) and even a small non- compliance attracts heavy penalty both in terms of monetary fine and suspension of business. The market regulators, world over, take the mutual fund business very seriously and rightly so as it concerns the savings of the investors (at times lifetime as in case of pension funds).

The existing regulations, inter-alia, cover the following aspects: (1) constitution and management of mutual funds, (2) constitution and management of asset management companies, (3) launching of mutual fund schemes, (4) investment restrictions and valuation of assets, (5) general obligations, (6) inspection and investigation, and (7) procedure for action in case of default.

SUGGESTIONS:
There is considerable debate about the **appropriate structure of regulation** to be adopted by a country to regulate its financial services in general, and investment business in particular. However, no one solution can be suggested. The most suitable solution can be arrived at through trial and error. The regulatory structure, however, can be classified as either statutory (or legislative as in the US), or self-regulatory (as in the UK). Each of these forms of regulation has some limitation or other. For example, self-regulation may not create enough public confidence, although it is a less bureaucratic and more collective and practitioner-oriented mechanism. Statutory regulation may create greater public confidence, but it is bureaucratic and may be unrealistic and costly. A suitable regulatory structure would be one

which is backed by legislative action and supported by industry practitioners. In order to formulate a workable and acceptable regulatory structure, the following points must be noted.

- A close inter linkage must be established between the industry and regulatory body.
- Though the basis of such a structure may be legislative, it should be flexible, adaptive andless bureaucratic.
- The regulators should possess a high degree of perception and market experience.
- The regulators should have enough authority to enforce the regulatory measures.
- The regulators should not indiscriminately change their views as this may create instability inthe market and loss of public confidence.
- An effective regulatory structure should promote a respected Self-Regulatory Organisation(SRO) along with a legislative regulatory body.
- The SRO should be managed by persons of vision, knowledge and experience.
- The SRO should function to protect and enhance the economic interest of the members and investors, and should steer clear of group or individual interest.
- The structure of regulation should create enough space for investors, for whom the regulatory system has been developed. The regulators should treat the investors as facilitators in the smooth functioning of the system.

To enact an effective regulation, the regulatory bodies must perform cost-benefit analysis, in terms of cost of regulation and subsequent value addition arising from such regulation so as for it to be acceptable to all sections of society. Any regulatory measure involves two types of costs: direct and indirect. “The direct cost is the cost of administration and implementation, while the indirect cost is the loss of welfare due to restrictions on competition.” (Subrahmanyam, N; 2008) In order to ensure voluntary compliance, prospective regulation must consider both total costs and implied benefits. This is especially relevant in the context of developing and emerging economy like India, with ever increasing fiscal deficit year after year. “Any regulatory expenditure is an additional burden on the public exchequer and incurred at the cost of development expenditure. Moreover, in an emerging and semi-efficient market like India, investors are exposed to greater volatility and risks. Therefore, in order to be effective, regulation should be able to protect the investors' interests, and the direct benefits must be more than the indirect benefits and costs of regulation” (Subrahmanyam, N; 2008)

CONCLUSION:

The present system of regulations as governed by SEBI (Mutual Funds) Regulations, 1996, Companies Act, 1956 and Income Tax Act, 1961 have no doubt ensured a well-defined regulatory framework for mutual funds in India. Today, it has become one of the most stringently monitored industries in the Indian financial sector. Critics have often termed it as ‘policing by the regulator’. However, given the fact that Indian markets are still not matured, lacks depth and is dominated by gullible and vulnerable retail investor class, the basic thrust of legislation in India is regulation through control. Because of peculiar circumstances prevalent in Indian markets, implementation and compliance of UK model of regulation through SROs seems difficult and far-fetched. India has to adopt the US model of regulation and at the same time ensure voluntary compliance either by inclusion of mutual fund investors, managers and other stakeholders, like registrars, bankers, brokers etc. at the time of policy making or by providing monetary and non- monetary incentives to ensure compliance or a combination thereof. Effective regulation coupled with voluntary and active involvement by the Mutual Fund industry will not only enable the managers to achieve the fund’s objectives and create value for it but will also go a long way in securing customer confidence and patronage.

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