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Distribution Spectrum and the Changing Business Environment

Indian Mutual Fund Industry

7th CII Mutual Fund Summit

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Confederation of Indian Industry

pwc

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Message

Message

The mutual fund industry, today presents a picture of opportunity and challenges: Amidst a globally changing business and regulatory environment, Asset Management Companies and all service providers, including distributors, have to re-examine their business models and embrace the changing business landscapes with an open mind, without the baggage of past practices.

Notwithstanding the recent growth challenges, Mutual Funds continues to be the most low cost investment product for housholds to participate in the long term growth prospects for our economy.

This report by PwC titled "Distribution Spectrum and the Changing Business Environment" seeks to focus on the challenge of distribution, exploring possible solutions to some of the aspects of the distribution model.

We would like to thank PwC for their efforts in preparing this report and hope that you find it useful and interesting. We would welcome any comments and observations, to help us prepare better for the next summit.

Milind Barve
Chairman - CII Mutual Fund Summit 2011 and
Managing Director
HDFC Asset Management Co. Ltd.

Foreword

Foreword

As we step into the seventh year of the CII Mutual Fund Summit, it gives us immense pleasure to be a part of this prestigious event and share our thoughts and perspectives by way of this background paper.

This year, our report "Distribution Spectrum and the Changing Business Environment" revolves around the key challenge of distribution that plagues the industry and the evolving business landscape.

The mutual fund industry is focused on achieving greater penetration levels and strengthening its channels of distribution. Other concerns in terms of product innovation, investor awareness, lack of regulations specific to distributors, governance, risk management practices in the industry, mis-selling of mutual funds and limited use of technology, have also been discussed in some detail.

The prospects emerging on the global scene have been deliberated upon, taking into account the regulations, which will impact the way the industry moves ahead.

Preparation of this background paper has involved extensive meetings with leading fund houses in India, and we have incorporated their perspectives, along with our points of view.

We hope you will find this report insightful and useful.

We welcome your suggestions to help us improve our next report.

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Leader - Financial Services
PwC India

Gautam Mehra
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PwC India

Introduction

The past year has been a defining period for the mutual fund industry, as lack of incentivisation has made it increasingly cumbersome for the distributor to reach out to the retail investor. The number of folios in the equity segment has shown a decline from 409 lakh as of March 2010 to 392 lakh as of March 2011. As the industry strives to reach out to the smaller towns and cities, the regulatory landscape is also changing.

The macro-economic environment, with high savings and investment rates, is conducive for further development. To channelise these increased savings into mutual fund products, fund managers need to assure retail investors of a sufficient (inflation-adjusted) yield. Asset management companies are focusing on enhancing their investments in product development, customer relationship management and upgrading their customer-profiling.

Technology will play the role of a competitive differentiator, providing asset management companies with an edge to cost containment, improving efficiency and responding to increasing investor demands.

Emerging markets are geared to lead the growth of the asset management industry. A recent Global CEO survey by PwC suggested that more than 30% of asset management CEOs were looking to make cross-border acquisitions to support their growth plans over the coming year. Emerging markets featured strongly in the target regions for acquisitions, with 40% planning an acquisition in Eastern Europe and 30% looking to buy a business in Asia or Latin America.

As per the survey, a number of Asian asset management firms have established Europe-based Undertakings for Collective Investment in Transferable Securities (UCITS) funds for distribution not only into Europe, but also into Asia. Driving this trend are four major factors:

- A growing demand for emerging market products from European investors,
- The inability of Asian funds to access the European investor markets,
- The strong global brand of the UCITS funds and reputation means that multiple markets, both in and out of Europe, can be targeted with these products,
- The growing fund management expertise in the Asian region.

Transparency in transactions and products is a critical factor in attracting investors and building their confidence in mutual funds as an investment vehicle. Transparency provides a clear indication of the strategy, risk appetite and performance of the funds, helping to assure investors that businesses are properly controlled and governed.

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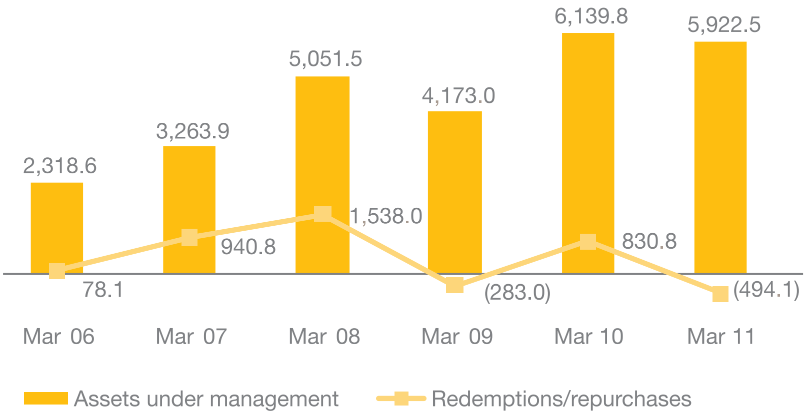
How we fared in 2010-2011: A snapshot

Growth levels in the industry have stumbled in the past year, with assets under management declining by four per cent as of March 2011 as compared to the fantastic growth of 47% in March 2010. As of March 2011, assets under management stand at Rs 5922.50 billion. Net inflows for the year ended March 2010 were high at Rs 830.81 billion. However, the year ended March 2011 faced tremendous redemption pressures and recorded a net outflow of Rs 494.06 billion.

Assets under management and net redemption/repurchases (in Rs billion)



Source: Association of Mutual Funds in India

At the end of March 2011, total funds mobilised were lower at Rs 88,595.15 billion as compared to Rs 100,190.23 billion, in March 2010, reporting a decline of 12%.

However, the number of schemes launched during the year was higher at 518 as against only 174 schemes launched in 2010.

Going forward, in this report, we explore the challenges that the industry is facing, especially focussing on the critical issue of distribution. The impact on distribution due to the restriction on entry load has been under the scanner for the whole of 2010, and in this report we discuss the impact and seek solutions to deal with this development. We have also reviewed the viability and sustainability of other channels of distribution, while discussing in detail the critical role played by technology in increasing the scale of distribution.

The case of

The case of distribution unveiled

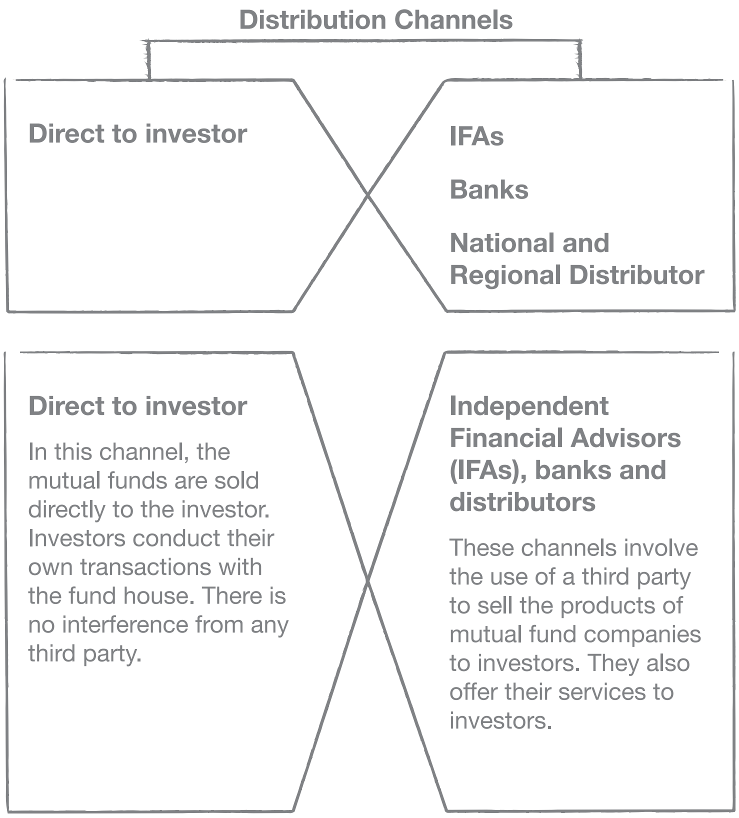
Background

It is a widely accepted fact in the asset management industry that mutual funds in India are 'sold' and not 'bought'. These products need a severe 'push' to reach investors. This is because the Indian mutual fund industry is not only in a nascent stage but is also going through a transitory phase with multiple developments in the areas of distribution, taxation and other regulations and compliance standards.

The main aim of fund houses is to continuously increase participation from investors. To do this, it is imperative to strengthen the distribution network beyond the obvious Tier 1 and Tier 2 cities. There are many aspects to distribution which fund house need to keep in mind, along with parallel changes in regulations and shifts in investor demands.

In today's age, new technologies help address the challenges of distribution. These technology solutions need to be aligned to a well-planned strategy, and integrated into the business model, for optimum results.

The channels of distribution in the current scenario



distribution

Distribution: Facilitators and challenges

Building and scaling up any distribution channel depends heavily on the confidence of the investor. It is therefore important for the asset management company to ensure transparency in business and focus on post-sales services. Some factors that strengthen the distribution channels and make them sustainable are ease of access, robust infrastructure in terms of a technology-oriented platform and prompt service to clients.

Although technology can go a long way in providing convenience to investors and helping distributors increase reach in Tier 2 and Tier 3 cities, it is not the only thing that needs to be revved up in order to increase penetration levels. A degree of innovation needs to be brought into existing distribution models. Unless the industry responds to the changing business environment, the mutual fund industry will lag behind.

Products need to address investor needs and fulfil short-term as well as long-term financial goals. Product complexities need to be reduced and different customer segments need to be targeted with variety.

However, the plethora of products will prove beneficial to the investor only if he/she is aware of his/her long-term financial goals.

Efforts in investor education and awareness further help the distributor community who, through their expertise and network, connect with the investor, gain their trust, explain the risks and benefits of the various fund schemes and in the process, sell the scheme to the investor.

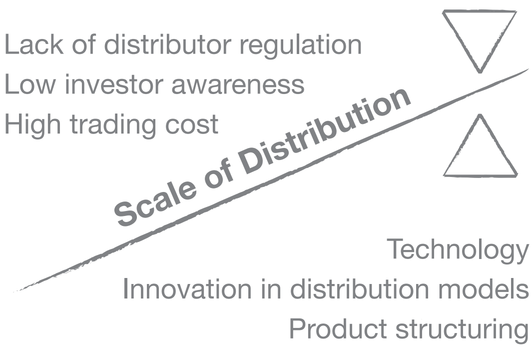
Thus, the importance of the distributor can in no way be undermined by the industry.

After a background of the key features required in creating a viable distribution model, it will be useful to also analyse the challenges that distribution is facing today.

On the regulations front, a key change has been the restriction on entry load. This has created havoc in the distribution of mutual funds. Working around this is by far one of the key concerns of the industry today.

There is a need to understand what the fund houses are doing differently in this scenario and how they plan to scale up their distribution in the future, in the backdrop of the no-load regime.

Around *80%* *of the resource mobilisation of mutual funds is from the top 10 cities, leaving the Tier 2 and Tier 3 cities unexplored.*



Impact of the no-load regime

The regulator's step to restrict entry load was implemented solely with the investor in mind. Almost a year has passed since, and it is interesting to note the key developments and the way fund houses and the distributor fraternity have responded to this regulatory directive.

Key observations

- Impact on the IFA channel resulted in smaller IFAs dropping out and larger IFAs focussing on the big ticket.
- Minimal incentives for intermediaries to sell mutual funds led to investors losing out on investment opportunities.
- No significant innovation in distribution; the distributor community is risk averse
- The objectives of reducing churn and focussing on long-term investments have not been met.

Note: Compiled from interviews

The most obvious observation was that there was a decline in the number of IFAs selling mutual funds. Currently, there is a lack of incentive to sell mutual fund products. Distributor focus is shifting to other structured products which actually hurt the growth of the industry, where commissions are higher.

Lack of adequate compensation has resulted in the disappearance of small distributors who would have otherwise serviced small retail investors. Only consolidated and integrated distributors can afford to stay in the market. However, these large distributors have the power to command a higher price from investors.

Another impact of this regulation is that banks have cued in more aggressively to the opportunity in the mutual fund space and are trying to leverage distribution networks to increase reach and awareness of such products.

Another fall-out of the no-load announcement is the decline in new fund offers (NFOs) by fund houses. Asset management companies (AMCs) have not been able to mobilise adequate resources through NFOs, affecting the remuneration and incentivisation of distributors. Resources mobilised between January and December 2010 were low at Rs 46.59 billion and Rs 641.49 billion through existing schemes.

Prior to the no-load regime, the distributor could earn a commission between three to four per cent on NFOs and two to 2.5 per cent on existing schemes. Post the restriction on entry loads, this has been reduced to a range of 0.75% to one per cent. Earlier, distributors capitalised on the opportunity to sell an NFO over an existing scheme, which does not exist any longer.

Business models to be explored

The murmurs in the industry suggest that there should be a shift from the transaction-based model to an advisory-based model. The advisory model will strengthen the investor-advisor relationship, add value to the portfolio and enable the investor to meet his/her long-term financial goals. In such cases, the investor will have the prerogative to decide the fees he/she wants to pay to the advisor. Advisor fees should be apportioned to the amount of time the investor stays in the fund, instead of as an upfront commission, which is generally high.

If the role of the advisor is elevated in importance, there rests huge responsibility on his/her shoulders to help the investor plan and achieve his/her investment goals

Industry comment

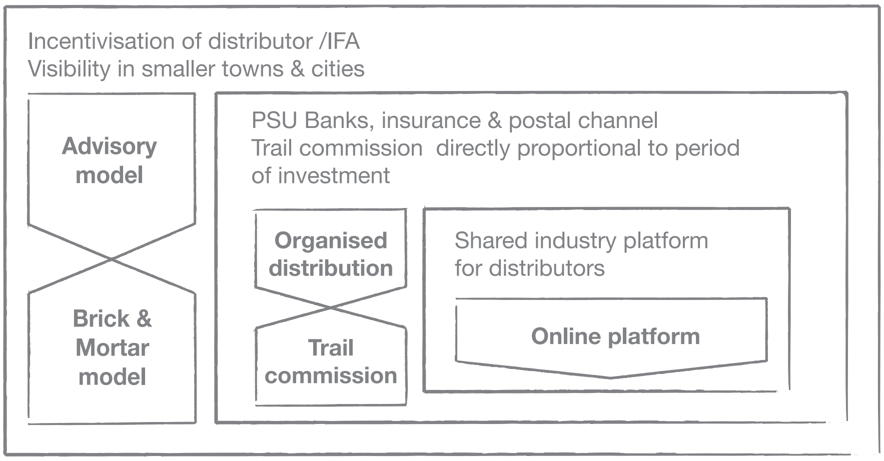
Expertise needs to be built in managing funds.

over time. The advisor should gain a detailed understanding of the needs and requirements of the investor and undertake his/her risk profiling before suggesting products to the investor.

CEO Speak

Open-architecture distribution model is the key to growth.

Exploring various business models



Although the industry takes cognizance of the need to shift towards an advisory-based model, the importance of the brick-and-mortar model can in no way be undermined. The brick-and-mortar model has immense powers to spread access in the smaller towns and cities. The concept of an institution and the presence of an office also helps create confidence in the mind of the investor. It provides visibility and is a key channel for reaching out to a larger number of investors. It is the most successful way of increasing awareness and a step towards investor education.

The banking industry in India has got a headstart, as a result of which their channels of distribution are much more widespread and deep-rooted. It would be wise for the mutual fund industry to leverage the public sector banking channels and cross-sell their products to the same set of clients. This channel holds huge potential and remains under-utilised to a great extent. If used adequately, this channel could yield great volumes for the mutual fund industry. Another channel with immense reach in the rural areas is the postal channel which can be used by the industry to establish a foothold in far-flung regions. The insurance industry can also be leveraged to sell mutual fund products, making use of the same platform.

Going forward, the organised distribution network will prove to be more sustainable.

Pushing sales in the industry boils down to incentivising the distributor to sell these products. A possible measure that could be looked at is increasing the trail commission paid to the distributor. This trail commission can be increased with each year that the investor stays invested in the fund. For eg, the trail commission can be higher in the second and third year as compared to what is paid out in the first year. This will actually lead to fulfilling two objectives. First, the investor stays invested in the fund over a long time, benefiting the fund and relieving it of any redemption pressure. Second, the distributor is encouraged to earn a higher commission with longevity of the investor remaining in the fund.

CEO Comment

The concept of a graded trail commission can be implemented, with the commission increasing over time.

A trail commission model will work better than an upfront commission model.

Another possible concept that has worked well in some countries is that of a tied agent. Although this concept has some disadvantages of leading to a closed-architecture distribution, minimising choice of the investor, the feasibility needs a detailed analysis.

An interesting sentiment which has unfolded with respect to enhancing distribution is that of having a shared platform of distribution for financial products. For eg, insurance, mutual funds, pension funds can have a common distribution platform.

Having an industry platform equipped with the latest technology will be beneficial to several aspects of transactions as well as to service delivery. For eg, updates on account statements and other client transactions will be hugely facilitated with the help of technology tools.

Other challenges

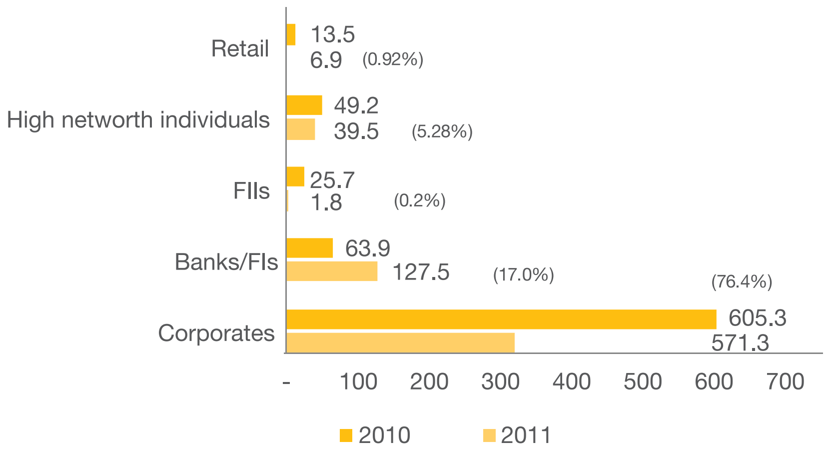
Apart from the challenges of distribution and limited use of technology, there exist other issues within the industry. It is equally important to dwell on these challenges to see how they can be overcome.

Investments in liquid funds

Most mutual funds have a large portfolio in liquid funds. Mostly, institutional investors such as banks, hold a large part of their investments in liquid mutual funds, as it is the most convenient avenue to park their surplus funds. The assets under management (AUM) in liquid funds are seen to be dominated by corporates and banks, as they historically took advantage of the tax arbitrage while parking their funds with fund houses. The contribution of banks to AUM under liquid funds has increased to 17% as of March 2011 as compared to eight per cent in March 2010.

However, with RBI putting a cap of 10% on the amount that banks can invest in liquid funds, the liquidity of these funds will be reigned in considerably, as inflows to mutual funds get restricted. The banks that have more than 10% of their net worth invested in these liquid schemes have been given an additional six months to withdraw their funds. As a result of this, the industry is likely to face an outflow of funds over the next six months, till October 2011.

Assets under management in liquid funds (in Rs billion)



Note: Figures in brackets indicate % to total AUM for the year 2011

Source: AMFI

Heavy dependence on institutional investors only increases the burden of redemption for the mutual fund industry, as redemption may occur simultaneously and may be of a large quantity. Dependence on institutional investors also leads to volatility in funds. Moreover, with a short-term view, these funds do not really contribute to a growth in assets under management.

This cyclical flow of funds between the fund house and the banks actually builds up a systemic risk in the industry, posing a challenge to asset liability management.

Recommendation

Mutual funds should therefore lay stronger emphasis to grow the retail investor base.

Governance and risk management

Governance is critical to the efficient functioning of the financial system and is thereby of prime importance even in the mutual fund industry. The element of disclosure needs to be integrated into the operations of the asset management companies. The policies and procedures of exercising voting rights with respect to shares held by mutual funds should be disclosed on the website of the AMC and in the annual report. The voting policies should also be regularly updated on the website. This measure needs to be implemented to bring in more transparency into the system. Transparency needs to be introduced at the operational level as well as at the portfolio level. To encourage and boost investor confidence, the transparency factor must be given importance by fund houses and distributors alike.

Corporate governance should be nurtured at the grassroot level, with the regulator and industry players working together.

There should be a strong mechanism to devise fair practices for the investor.

Risk management needs to be applied to fund management to identify inherent risks and gaps in the process. Systemic risk should be identified and avoided, with leading practices being established to avoid malpractice.

Recommendation

There needs to be an itemised disclosure on the website of the AMC for all payouts. Even the distributor should make a disclosure to this extent.

Corporate governance should evolve with increased disclosure.

CEO Speak

Risk management practices need to be upgraded. AMCs are not investing as much as they should in risk management.

Mis-selling of mutual funds

The industry needs to guard against the mis-selling of mutual funds, and take suitable preventive measures. Sometimes, mis-selling may happen inadvertently, if the distributor does not have the relevant expertise and knowledge, to guide the investor. On other accounts, mis-selling may happen as a result of fraudulent activities on the part of the distributor or IFA, especially now that the commissions have been impacted in the no-load regime. If the incentive to sell is missing, then it may lead fund managers to indulge in fraud and mis-selling practices.

Recommendation

Improve accountability of the distributor and fund manager

Scale up expertise of the fund manager to manage funds better

Investor awareness and confidence

Investor awareness is an area of concern for the industry. It is being dealt with in multiple ways. To have sustainable growth, it is critical that the investor understands the product, has a long-term financial plan in mind and is equipped with the right kind of products that fulfils his/her requirements. Investor education programmes have been a step towards educating the investor, but the industry still has a long way to go.

Subsequently, the industry also needs to garner the confidence of the investor.

As per the J.P. Morgan Asset Management – ValueNotes Investment Confidence Index (ICI), which captures the confidence of the retail and corporate investor sectors as well as financial advisors on the Indian economic and investment environment, some of the key findings are as follows–

- Retail investment activity between stock and mutual funds continued to move inversely as stocks declined to 68% while mutual funds increased to 66%.
- IFA confidence has seen the maximum volatility over 2010. Confidence among IFAs (146.9) in the last quarter of 2010 declined 10 points from September 2010 (156.9)
- The Corporate ICI has been range-bound in the last four quarters and remained unchanged for December 2010 (as compared to September 2010) at 132 points.
- A significant percentage of retail investors (47%) and their advisors (44%) indicate interest in investing in markets outside India.
- A higher percentage of retail investors (19%) and advisors (14%) are optimistic about growing corporate profitability.

Customer data: KYC

The availability of customer data and capturing it poses a huge challenge to the industry. The industry does not have a centralised database with its investor profiles regularly updated. As a result, there are discrepancies in KYC norms, which does not allow the industry to meet the regulatory standards of fund management and risk management.

Recommendation

The advent of the Unique Identification programme (UID) is expected to help resolve most of these problems.

Collaborat

Collaborating with Technology

With the advent of technology, much has changed in the industry, on the operational side as well as from the investor point of view. In today's scenario where the investor is demanding and has varied needs, technology can make the transaction process more efficient for the customer. From the distribution perspective, the presence of an online platform helps reach out to investors in smaller towns and cities.

The online channel is a preferred solution for most distributors today, as it equips IFAs and distributors with a variety of services from research, training and education to details of products. The link between the asset management company and the IFA is strengthened, adding more value with the help of technology. It offers investment management solutions, administration solutions as well as back-office support.

CEO Speak

It is essential that the online platform be collaborative rather than restrictive.

The use of online platforms has picked up pace in the no-load regime, where distributors are struggling to sustain themselves. The online channel has succeeded in reducing the overall cost for the distributor, as they save on the cost of collection and filling up of forms. There is also a huge saving in time, which is a big advantage to distributors and investors alike.

Online platforms earn their revenues from fund houses paying an upfront or trail commission to these platforms.

However, the start-up costs for setting up the online platforms are a deterrent for distributors. Although these platforms promise huge benefits and have the potential to increase access to investors, distributors and IFAs are hesitant to establish a web-based platform on their own.

Collation of customer data and maintenance of client records are critical to the industry. Customer data should be available with a centralised database, so that the investor does not need to fill his/her details with every investment. Technology has the ability to run such a database, regularly updating and upgrading it to comply with standards of quality.

For investors, the online platform outlines benefits, providing detailed research on products and markets. It recommends portfolios and funds for the investor suited to varied risk profiles.

What are the services offered by the online platform?

Online platforms tie up with various banks to facilitate transactions for investors. Facilitating online payments for investors provides a boost to online trading volumes. There is also an 'online SIP' facility for investors. The entire process of buying, selling and redeeming mutual funds is facilitated by the online platform, adding both speed and efficiency to the transactions.

Distributors who have invested in online platforms also benefit because it helps the clients of brokerage houses to link their current bank accounts to the brokerage account to make payments and receive redemptions smoothly.

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The concept of an online industry platform, if it is rolled out in the future, say, by AMFI, will be a boon to investors, providing them with information and the ease of trading. For distributors too, this will result in a huge cost saving.

But, even laden with so many benefits, we cannot expect the industry to jump to the next level of growth with the use of technology. The process of evolving with technology will be slow and will conform to a steady pace of awareness and acceptance. Confidence will come only with time and increased usage. The first step is to raise awareness among investors.

Evolving with technology

AMC	Distributor	Investor
Shift towards a paper-less online model Maintain and update customer data through KYC	Design customer - friendly portals Create awareness among investor class Industry platform - likely to emerge - Use of vernacular	Improved service delivery mechanism Time-bound complaint redressal system Extensive use of the internet

Industry Comment

Evolving with technology needs to be phased. It will be a step-by-step process. Eventually, online platforms will emerge in a big way.

As suggested above, the integration of technology needs to be a gradual process, with the fund house, distributor and investor working together to implement new measures and adapting to its use. The roadmap indicates some of the initiatives that could help ease technology into the mutual fund transaction process.

For the fund houses, it is imperative to align operations to a paperless model, as much as possible. Improving efficiency and saving time in daily operational work will be a big step in the use of technology. Maintaining the KYC records of customers in a centralised database is a huge challenge in today's times. If technology is used to create and maintain this database, it will prove very useful not only for the industry but for the entire financial services industry. Moreover, records need to be updated continuously to capture changes in KYC over time.

A complex portal embedded with intricate functionalities is likely to deter investors from making use of the online portals. Therefore, distributors when investing in mutual fund platforms need to emphasise on the investor-friendliness of the portal, to attract investors.

Once the investor becomes adept at using the online transaction system, he/she is sure to realise increased convenience, time savings and ease of addressing complaints which arise in the process.

Opportuni

Global frontiers: How much of an opportunity

The Budget 2011-12 announced that regulations would be amended to permit SEBI-registered mutual funds to accept subscriptions from foreign investors, who comply with KYC requirements. This move has been suggested with a view to capitalise on the huge potential in international markets. With increased access to foreign clients, the mutual fund industry has another option to compete in the international arena. However, industry players are 'cautiously optimistic' about the proposal, amid other tax and regulatory constraints.

The announcement

Foreign investors in the past were permitted to invest in mutual fund units under the Portfolio Investment Scheme through the Foreign Institutional Investors and Sub-Account routes. In addition, Non-Resident Indians were allowed to invest in mutual fund units.

The finance minister made some announcements in his Budget speech this year. The government is soon to liberalise the portfolio investment scheme. This will allow foreign investors to subscribe in equity schemes, provided these investors meet KYC norms. The draft guidelines for these schemes are to be released soon.

Where does the opportunity lie?

The growing expertise of Indian asset managers has encouraged them to advise offshore investors interested in India as an investment destination. Additionally, the finance minister's announcement could open a new window for established Indian players in the business who may want to venture into international markets and target investors (other than those eligible to invest currently through the FII/sub-account route). However, it is unlikely that Indian mutual funds will be immediately flooded with applications from international investors. The offshore regulatory and tax challenges remain to be addressed.

Most of the offshore jurisdictions with significant investor population have their own set of regulations for registration of offshore asset managers/investment products. Indian asset managers would need to comply with such regulations which may entail higher compliances and costs. It may be easier for offshore investors to invest into a locally regulated fund in their jurisdiction as compared to investing in a SEBI registered Indian mutual fund.

The industry perspective…

Currently, the excitement regarding the opening-up of the investment route for FII investments is pretty muted. The industry does acknowledge that the move will precipitate greater business opportunities for domestic fund houses, but in the same breath there is some apprehension on the regulatory front about the awaited guidelines. As of now, there is limited clarity on the issue of KYC norms and tax guidelines.

Long-term capital gains earned by ordinary investors in equity-oriented funds are currently exempt from tax (provided applicable securities transaction tax has been paid). Short-term capital gains are subject to tax at the rate of 15% (excluding applicable surcharge and education cess).

For funds in India which have a global presence, this investment route will elicit an opportunity to leverage, as these fund houses can tap the already existing client base in international markets.

From a long-term perspective, the large players may also find it worthwhile to establish and/ or increase their physical presence in the overseas jurisdiction with a view to tap into the foreign investor base.

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CEO Comment

It is a good opportunity for foreign investors to de-risk their portfolio. It has been observed however, that regional funds such as Europe, the Middle East and Africa (EMEA) funds, find favour over single-country funds.

The success of this initiative is contingent on how simple would be the 'path to purchase' for the offshore investors.

** New vistas with UCITS*

A strong emerging trend which has surfaced in 2010 and is still continuing in 2011 is the creation of 'sophisticated' cross-border funds (mainly UCITS). This is despite the fact that today such funds represent only three per cent of the entire cross-border UCITS market. Approximately 30% of all cross-border UCITS established in 2010 were of the more 'sophisticated' variety. We believe this trend will continue, leading to continuing discussions within the industry and at the European Commission about the appropriateness of the UCITS brand for such strategies.

The UCITS directive provides opportunities for managers to make their fund range and management company structures more efficient.

The UCITS IV Directive will be implemented in all European Union Member States on 1 July 2011, and will apply to all UCITS domiciled in Europe. Its sole optional transitional provision will be the 'grandfathering' of the Key Investor Information Document (KIID) requirements, which must be observed by 1 July 2012.

Increasing opportunities arise from the directive possibility of achieving greater efficiency through fund mergers, master-feeder pooling funds and the management company passport. Looking beyond the compulsory and seeking to improve efficiency, a minority of fund promoters are now also planning to rationalise their European UCITS ranges.

They are doing so for cost, tax and regulatory reasons. A small number are also considering introducing master-feeder strategies, although many operational and tax questions remain unanswered.

A number of Asian asset management firms have established Europe-based UCITS funds for distribution not only into Europe, but also into Asia.

**Establishment of an Asian fund passport*

After the release in November 2010 of a report prepared jointly by PwC and the Financial Services Council of Australia outlining the case for establishing an Asian fund passport (a cross-border vehicle which would recognise registered funds within the Asia-Pacific market in much the same way as UCITS does in Europe), we understand that work has started between countries which are interested in developing a single market for Asia's investment funds.

Currently, it is expensive and inefficient, and in some cases impossible, for fund managers to operate across Asia. Operating in a similar way to Europe's UCITS vehicles, an Asian fund passport would allow a complying fund or other collective investment vehicle in a nation that signed up to the passport framework to offer that product in each of the other signatory nations. Some 86% of our survey participants endorsed the development of a passport.

*Reference from PwC 14th Annual Global CEO Survey and PwC and FSC Asia Region Funds Passport

As per the report, some benefits are as follows:

- Increased investor choice
  A passport would provide broader investor choice arising from direct access to otherwise inaccessible markets, instruments and offshore expertise. Concentration in domestic equities is very high across the region. Greater product variety would provide retail investors with greater diversification, and the ability to participate in the growth of offshore markets.
- Access to capital
  Regionally, economies are at varying stages of development. Emerging markets are undergoing significant expansion and have intensive capital requirements. Mature economies with well-established pension systems have the assets and capital to help fund this demand.
- Improved efficiency and cost reductions
  Cross-border capital flows will allow fund managers to access larger client savings pools and achieve economies of scale. Greater fund size will help drive competition and exert downward pressure on the fees paid by investors. Direct access to offshore funds rather than through an intermediary will help eliminate the extra layers of fees and commissions.
- Regional retention of fund management positions
  Growth in the region's funds management industry will lead to employment opportunities and retention of expertise in Asia.

Regulatory frameworks

While there are diverse legislative and taxation requirements across the region, it was encouraging to note that most jurisdictions are similar in their regulatory frameworks. For example, each jurisdiction requires the licensing of the promoter or issuer of the fund, the registration or approval of the fund itself and the registration or vetting of the offer documents.

The way forward

The Asian fund passport will require support to ensure that it remains competitive and relevant and the passport framework will need to embed such a function.

However, the industry needs to be patient. UCITS' success that we see today took two decades. While we hope that an Asia region funds passport can be achieved more quickly, the industry must give it time to achieve success.

The UCITS framework may be a good starting point but the region will need to make some key decisions to tailor it for itself. For example, should the passport be fully competitive with UCITS IV (inclusive of a fund manager passport) or would this require too much change to be an attainable goal in the foreseeable future? Would the passport seek to differentiate itself from UCITS, other than through the markets available? If so, how?

While complex challenges will need to be overcome as we move forward, they are not insurmountable and the benefits will be substantial. An Asian fund passport will transform the way funds are distributed in the region.

Regulations

Defining the asset management industry: Regulations

Regulatory developments in India[1]

Certification programme for distributors

Distributors of mutual fund units were required to obtain certification from the AMFI. The SEBI decided that with effect from 1 June, 2010, distributors, agents or any other person engaged in the sale of mutual fund products would be required to have a valid certificate from the National Institute of Securities Markets (NISM) except for such persons who have passed and hold the AMFI Mutual Fund (Advisors) Module before 1 June, 2010.

Empowering Mutual Fund Trustees

Recently, SEBI has started interacting directly with mutual fund trustees in a bid to empower them and make them more aware of their responsibilities. It is engaging with trustees in two ways - by conducting workshops and by holding more personalized one-on-one meetings, or collegiums.

Usage of Load Accounts[2]

Prior to August 2009 mutual funds charged both entry and exit load from investors. However, post August 2009, mutual funds could charge only exit loads. In March, 2011, SEBI has issued instructions on the utilisation of balances in these load accounts in order to bring about uniformity in the usage of these accounts. SEBI's instructions which are as under:

- The load balance will be segregated into two accounts in the books of accounts of the scheme-one to reflect the balance as on 31 July, 2009 and the other to reflect accretions since 1 August, 2009.
- The load balances may be used for marketing and selling expenses including distributor's/ agent's commission.
- However, not more than one-third of the load balance as on 31 July 31, 2009 will be used in any financial year including financial year 2010-11. Though the unutilised balance can be carried forward, in no financial year can the total spending be more than one-third of the load balance on 31 July, 2009.
- The accretions after 31 July, 2009 can be used by the mutual funds for marketing and selling expenses including distributor's/ agent's commission without any restrictions

Know Your Distributor

Market regulator SEBI in September, 2010 ushered in a major overhaul of the way mutual funds were sold with the introduction of biometric cards and stringent licencing norms for distributors to weed out agents indulging in frauds. The Know Your Distributor ('KYD') norms, devised on the lines of Know Your Customer ('KYC') norms followed by banks and other financial service providers, now require distributors to submit identity and address proofs, PAN and bank account details.

Option to hold units in demat account[3]

SEBI has recently asked mutual fund houses to provide investors the option to hold their units under open-ended schemes in demat account, which would help manage their portfolio better. Such option is required to be provided to the investors in both existing and new schemes from October 1, 2011.

Direct Tax Code, 2010

After considering the representation made by various stakeholders, the Government presented the Direct Taxes Code, 2010 ('DTC') Bill in the Parliament on 30 August, 2010 for enactment. The Bill was subsequently referred to the standing committee of the Parliament for its recommendation. The committee held meetings with various stakeholders across different cities and is likely to provide its comments shortly.
At a recent meeting with the revenue authorities, the finance minister indicated the intent of the government to introduce the DTC with effect from 1 April, 2012.

1 Notification No LAD-NRO/GN/2010-11/09/6422
2 Circular No. CIR/IMD/DF/4/2011 dated March 9, 2011
3 Circular No. CIR/IMD/DF/9/2011

The tax proposals in the DTC could significantly influence the mutual fund industry. A comparison of the existing tax regime with the DTC is tabulated below:

Items	Current regime	Under the DTC
Dividend income in the hands of investors	Exempt	Units of EOF liable to distribution tax-exempt units other than units of EOF-Taxable
Income distribution tax payable by the Mutual Funds	Distribution tax payable by the mutual fund only on distributions made in case of other than EOF	Distribution tax payable by the mutual fund only on distributions made in case of EOF
Taxability of gains on sale/ redemption of units by investors - Units of EOF	LTCG: Exempt STCG: 15%	LTCG: 100% deduction; effectively not taxable STCG: Fifty per cent deduction; likely effective tax rate five to 15%
- Others	LTCG: 20% with indexation/10% without indexation STCG: Ordinary rates	LTCG: Ordinary rates with indexation STCG: Ordinary rates
- Long-term capital asset	Twelve months from date of acquisition	EOF: Twelve months from date of acquisition Others: One year from the end of the financial year in which the unit is acquired
Equity-linked savings scheme	Deduction available upto Rs. 100,000 for individuals and Hindu Undivided Families	No deduction available

Tax rates exclude surcharge and education cess, where applicable.

LTCG: Long-term capital gains

CTCG: Short-term capital gains

EOF: Equity-oriented schemes

Regulatory developments in the US

FATCA

The Foreign Account Tax Compliance Act (FATCA) is intended to reduce tax evasion by Americans who use foreign financial institutions (FFIs), foreign trusts and foreign corporations to shield their identities and US tax status from the Internal Revenue Service (IRS). FATCA introduces new compliance rules that aim at payments made for the benefit of non-US entities, creating a new withholding-and-reporting regime designed to provide the IRS with additional tools. The law requires FFIs, including funds and hedge funds which invest in the US, to enter into agreement with the IRS to identify and report on Americans annually.

Beginning 1 January, 2013, the provisions of the FATCA will generally require a 30% US withholding tax on any 'withholdable payment'–E.g., US-source dividends, interest, rents, royalties, etc., as well as the gross proceeds from the sale of investments that produce US-source interest or dividends, received by any offshore fund or other FFI. However, this withholding tax will not apply if the FFI enters into an agreement with the US government and agrees to comply with new documentation requirements, due diligence procedures and reporting obligations. The 30% tax withheld against payments to FFIs under FATCA is generally non-refundable. FATCA withholding and reporting requirements apply before current US withholding tax rules (e.g., the US-recipient, NRA and QI withholding and reporting rules).

Dodd Frank Legislation

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) significantly reshapes financial regulation in the US by creating new regulators, regulating new markets, bringing new firms into the regulatory arena and providing new rulemaking and enforcement powers to regulators. The legislation is comprehensive and complex. Political compromises led to a 2300-page act with 16 titles, which will become volumes of regulations going forward. Many titles directly impact the banking industry, and several titles and many provisions have general applicability to all public companies. Several provisions have absolutely nothing to do with the banking and finance industries.

This legislation could have a significant impact on non-US asset managers who have clients in the US. Dodd-Frank will for the first time bring private equity fund advisers under the oversight of the Securities & Exchange Commission (SEC). Managers who were formerly exempt from registration under the Investment Advisers Act of 1940 may now need to register as investment advisers with the SEC by the first quarter of 2012. For private equity firms, the impact of new regulation and oversight will be significant, requiring changes to controls, staffing, recordkeeping and disclosures to fund investors, as well as establishing new compliance programmes under the Investment Advisers Act of 1940.

Dodd-Frank also created new exemptions from SEC registration, which may apply to some advisers to private equity funds. For example, foreign private fund advisers may be exempt if they do not have a place of business in the US, have fewer than 15 clients in the US, and have less than $25 million in assets under management in private funds for US clients and investors.

Regulatory developments in UK

Introduction of retail distribution review (RDR)

The RDR, which is due to come into force on 1 January 2013, is a radical set of regulatory changes designed to enhance consumer confidence in the retail investment market by bolstering choice, improving the quality of advice and ensuring that products match customer needs more closely. The key change that will drive such improvements is that product manufacturers will no longer be permitted to pay a distributor or fund adviser a fee to actively market or sell the fund to their clients (investors) but rather clients (investors) will need to pay the adviser for the service (advice) they receive. After 2012, fund distribution into the UK market will be very different from that of other European countries.

In a nutshell, the UK changes will include the following:

- Differentiation between two types of advice: independent or restricted;
- Stricter definition of independence;

- Elimination of adviser commissions to ensure recommendations are not influenced by product providers;
- A negotiated fee for advice ('customer agreed remuneration') for advisers ;
- Requirement for advisers to meet tougher competence standards.

Regulatory updates in the European Union

Alternative Investment Funds Directive

Two recent announcements serve as timely reminders that the Alternative Investment Fund Managers Directive (AIFMD) continues its legislative progress and that alternative asset managers and service providers need to now be analysing its impact on their businesses and start preparing for impact as they plan for the next few years. The European Commission (EC) has pushed back the response date for the advice from the European Securities and Markets Authority (ESMA) to November 2011. In addition, Switzerland's Federal Council has urged legislators and regulators to begin preparing for the AIFM Directive.

These two recent announcements are timely reminders that the AIFM Directive continues its legislative progress. Alternative asset managers and service providers now need to analyse its impact on their businesses and start preparing for implementation as they plan for the next few years.

Within the EU, regulators have acknowledged that readiness for the directive is a major task and that preparing the detailed Level 2 Directives and Regulations will stretch available resources.

The financial services regulators of France, Germany, Ireland and the UK chair four working groups dealing respectively with the following:

- Depository issues (the AMF in France);
- Authorisation and general operational requirements, including delegation (BaFIN in Germany);
- Scope, defining categories of managers and strategies and defining opt-in and opt-out conditions (the Central Bank of Ireland); and
- Transparency, risk, leverage and liquidity (the FSA in the UK).

Their primary goal is to assist ESMA in defining its recommendations to the EC, which will shape Level 2 legislation to be appropriately responsive to the Level 1 text. They must also ensure that the measures are capable of implementation at a practical level across the great diversity of fund structures and asset management business models (including both EU and offshore arrangements). Each of the four committees has a spread of participants from other EU regulators, and is working hard to complete its work in the allocated time, with each already having held several meetings. However, they all recognise that they have an immense amount of work to do to provide clear advice to ESMA.

UCITS IV

The recent recast UCITS IV introduces five key modifications in the UCITS regulatory landscape, three of which offer fund managers the opportunity to undertake a strategic reflection on their product range and management structure, whilst the other two are compulsory measures to enhance speed-to-market and investor protection. The key investor information document, one of the two compulsory measures, contains important investor information, the content, form and presentation of which is harmonised so as to facilitate its understanding and direct comparisons between UCITS. The second compulsory measure is related to the simplified notification procedure which will decrease the time-to-market within the EU. Strategic opportunities are available for fund managers on account of modifications such as management company passport and merger of UCITS and master-feeder structure.

Packaged retail investment products

The European Commission's initiative on packaged retail investment products (PRIPs), forms part of the 'financial package' announced by the EU Commissioner in early 2009. PRIPs combine exposure to multiple underlying assets and are marketed directly to retail investors. However, approval from the EU Commission is awaited.

Regulatory updates in Australia

Foreign Accumulation Fund

Australia is undergoing a period of significant tax reform in response to the Johnson Report 1. The Johnson Report makes a series of recommendations that seek to promote Australia as a financial services centre.

The proposed Foreign Accumulation Fund (FAF) provisions (which replace the now repealed Foreign Investment Fund (FIF) rules) are narrowly defined anti-avoidance provisions designed to prevent Australian residents from accumulating passive income in certain offshore vehicles. These rules are a significant improvement on the FIF rules, which were overly complex and created onerous administrative compliance.

In broad terms, a foreign entity is a FAF if it is a foreign company or a fixed trust, that is not a CFC and meets both the 'Investment Test' (80% or more of the market value of all assets held at the entity's year-end comprise 'debt interests' (as defined for Australian tax purposes)) and the 'Accumulation Test' (less than 80% of the direct and indirect realised profits and gains of the entity for its accounting period are distributed within a designated timeframe (or in the case of a trust, included in the assessable income of its beneficiaries)).

The FAF provisions have not yet been passed by Parliament, and with the repeal of the FIF rules from 1 July 2010, there remains uncertainty for Australian funds with years ended 30 June 2011.

Whilst the proposed FAF rules are a positive development, the simplification of the rules does not necessarily reduce the rigour required in determining the FAF status of offshore investments and product structures. Fund managers will still need to diligently consider product development opportunities and practicalities in relation to foreign investments.

Outsourcing of activities

SEBI's discussion paper on outsourcing of activities related to the intermediation services proposes certain principles for outsourcing along with suggested activities to not be outsourced by intermediaries. As mentioned in the paper, in case of mutual funds, all key investment-related activities including trading will not be permitted to be outsourced. Similarly, for portfolio managers, fund management/ portfolio management activities should not be outsourced as per the discussion paper.

Infra debt funds

The Finance Act, 2011 has introduced the concept of the infrastructure debt fund. Taking a cue from the Budget announcements and in an attempt to boost infra financing in the country, SEBI is exploring options to come out with an infra debt fund for fund houses. This proposed infra debt fund is still in its conceptualisation phases. It is expected that funds invested in the scheme will be used to invest in various infrastructure projects across the country.

Recent press reports, based on an interview with the SEBI chairman, suggest that SEBI has sent a detailed scheme to the government in this regard. It is expected that the same will be made operational post-discussion with stakeholders.

Regulation of distributors

A recent media report stated that the finance ministry has set up a high-level committee on financial investor awareness initiatives proposing a common set of rules for financial product sellers. The report also suggests that those violating the rules would be subject to penal action.

Pension Bill

As part of the ongoing reforms in the financial sector, the government has tabled the Pension Fund Regulatory and Development Authority Bill, 2011 in Parliament to provide for the establishment of an authority to promote and regulate pension funds in the country. Significant growth is expected in the industry in case these pension funds are permitted to invest there. This will enable Indian workers to access Indian capital markets.

New SEBI committee

U K Sinha, the new chairman of SEBI, in a recent press report, has indicated a three-pronged strategy for handling the securities market--intensification of investor education, simplification of processes and strong deterrents, with effective surveillance mechanisms, for manipulators.

Further, SEBI has recently set up a seven-member committee in order to address the problems faced by the industry. Few of the major issues that will be considered by the committee are as under the following:

- Impact on account of the no-load regime, such as lack of distributor initiative to sell mutual fund products due to lack of incentives, lack of distributors to service the small investors, etc
- Generation of common account statement to reflect all investments across mutual fund houses, etc.

Recommend

Recommendations for the industry

> ### *CEO Comment*
> *Asset management' rather than 'asset gathering' should be the focus area.*

- **Level playing field for all products**
  A level playing field is needed for all investment products in the financial services domain. Securing it is critical for distributor compensation, as this will ensure that investors make decisions based on their requirements. This could be created either in the same category or across various investment products.
- **Conducive regulatory environment**
  There should be regular and constructive dialogue between the regulator and industry stakeholders. As and when new regulations are introduced, there should be a formal process where these guidelines should be interpreted uniformly so that there is ease of implementation. More importantly, the implementation of any new regulation should be phased out, so that stakeholders get time to adapt to the changes and strategise the road ahead.
  Regulatory changes, moreover should be 'lab-tested' (analysing possible impact on current business model), if only to avoid diluting the focus of the industry. Progressive reforms in the financial services industry as a whole are required to take the industry to the next level of growth.
- **Product structuring**
  Complex mutual fund products, their benefits and risks are difficult for the customer to understand. Manufacturers need to design products keeping in mind the varying needs of the customer and with the aim of flexibility and simplicity. Bundling of products could be a suitable option.

  It is essential to assess product structuring and ensure that the investor stays invested for a long time. In Tier 2 and Tier 3 cities, the SIP option is gaining focus for the industry, as it meets the needs of the small investor and is simple in nature.
- **Building mutual funds as a long-term product**
  Currently, there is a fundamental mismatch where investing in mutual fund products is concerned. It has been observed that investors invest in fund products only for the short term. The period of holding of fund units ranges between a day to two years. There is a need to re-focus on the brand funds to change the investor's outlook towards funds as a long-term product.
- **Tapping the insurance network**
  The insurance infrastructure should be leveraged to the maximum extent possible, for their deep-rooted distribution network. The aim should be to sell both risk and investment products to the customer.
- **Training of the distributor fraternity**
  Distributors are the point of contact for investors, and it is their responsibility to ensure that the right product is sold to the investors, as per their financial goals and requirements. Distributors should be equipped with the knowledge and experience to respond adequately to the queries of the investor. Developing domain knowledge is of immense importance in today's scenario.
- **Confidence in technology**
  Technology yields huge benefits, if used appropriately. However, for end-users (investors) to become adept at using the available technology tools, they need to develop enough confidence in the medium itself. Investors should be sufficiently encouraged by the multiple benefits rendered by technology, so that there is ease and convenience of usage.
- **Customer segmentation**
  It has been observed that customers have different aspirations with a need to fulfil different aims over a long-term horizon. The pyramid below shows that it is the middle

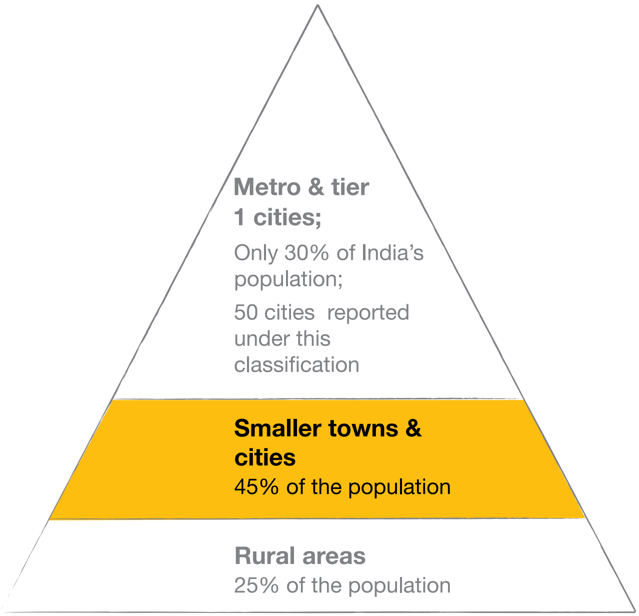
which holds the maximum potential, offering huge opportunity to the industry. The population in smaller towns and cities offer immense potential to move into the bracket of metro and Tier 1 cities.

However, the urbanisation process in India has been slow, with only 30% of India's population classified as 'urban', as compared to other developing economies like China where urbanisation is 45%, Indonesia 54%, Mexico 78% and Brazil 87%.

There has been a steady rise in the savings and investment rates in the economy at 33.7% and 36.5%, respectively. This has been coupled with an increase in the disposable income, with an emerging HNI segment in the Tier 2 and Tier 3 cities gaining ground.

As per a paper by NCAER, the expected annual increase in the average Indian household income will be about Rs 11,000 between 2011 and 2015. The top 20% in both rural and urban India will gain Rs 24,000 and Rs 75,000, respectively.

Mutual fund companies need to tap the retail investors in this segment, to garner increased volumes. Segmenting the customer base will make it easier for the industry to address the requirements of investors with efficiency.



- **Financial planning for investors**
  Apart from focusing on investor education, there needs to be a clear and defined emphasis on the need for financial planning. Investors need to be educated about the need to have long-term financial goals. They also need to be aware of their risk appetite so as to invest in the right schemes. Fulfilment of their financial goals will ultimately help investors stay invested in the fund over a long-term horizon.

Some CEO opinions

- **Distributor regulation**
  There has surfaced a great need for distributor regulation, especially in an era when there is no incentive and limited remuneration for the distributor. Regulations including best practices, penalties for mis-selling, should be introduced with expansion plans being regulated by a regulator like SEBI.

- **Class of shares**
  The concept of having a 'class of shares' is doing the rounds among industry players. In this format, a class of shares will carry a certain amount of load. Additionally there will also be a category of shares without load. This will leave the choice to the investor to decide the category to invest in.

  This however, will need great effort in educating the investor and also, if implemented, will imply a reversal of the current guideline on entry load.

- **Tied-agent concept**
  The concept of a tied agent has also been conceptualised, but may not really work in the domestic environment. In this case, the agent is tied to a particular institution, and thereby reflects a closed architecture model, limiting the choice of the investor. Also, there rests huge responsibility on the part of the investor to take informed decisions. He/she should be aware of fund performance when approaching agents. This could eventually turn out to be an irritant for the industry.

- **Separation of institutional and retail investors**
  It has been a common sentiment that institutional and retail investors should be separated, because their behavioural patterns are completely different. The portfolio of large institutional investors should be kept separate so that they do not impact the small retail investor.

  There should also be separate disclosures for a separate class of shares. Liquid funds should be accounted for separately.

- **Pension funds**
  The Pension Fund Regulatory and Development Authority Bill, 2011 has been tabled in Parliament. If implemented, it will boost the growth of the Indian industry, by opening up avenues for investments in the equity markets. Pension funds are likely to yield a reasonable risk-adjusted return over a long-term horizon.

- **Need for a Self-Regulatory Organisation (SRO)**
  Some industry players feel that establishing a self-regulatory organisation may be the solution to many concerns that the industry is currently facing.

Conclusion

Conclusion

This report reflects PwC's views and recommendations for the mutual fund industry going forward, drawing from perspectives of some of the top asset management companies in India.

We believe the industry is in a state of development and although hugely under-penetrated, carries much potential. It will take relentless effort on the part of all industry stakeholders to work towards attaining an increased scale of distribution. It is imperative to therefore focus on reaching out to investors especially in the smaller towns and cities, providing them with a choice of products, ease of transaction through technology, instilling confidence in their minds through efficient risk management, ultimately aiming to help investors fulfil their financial goals.

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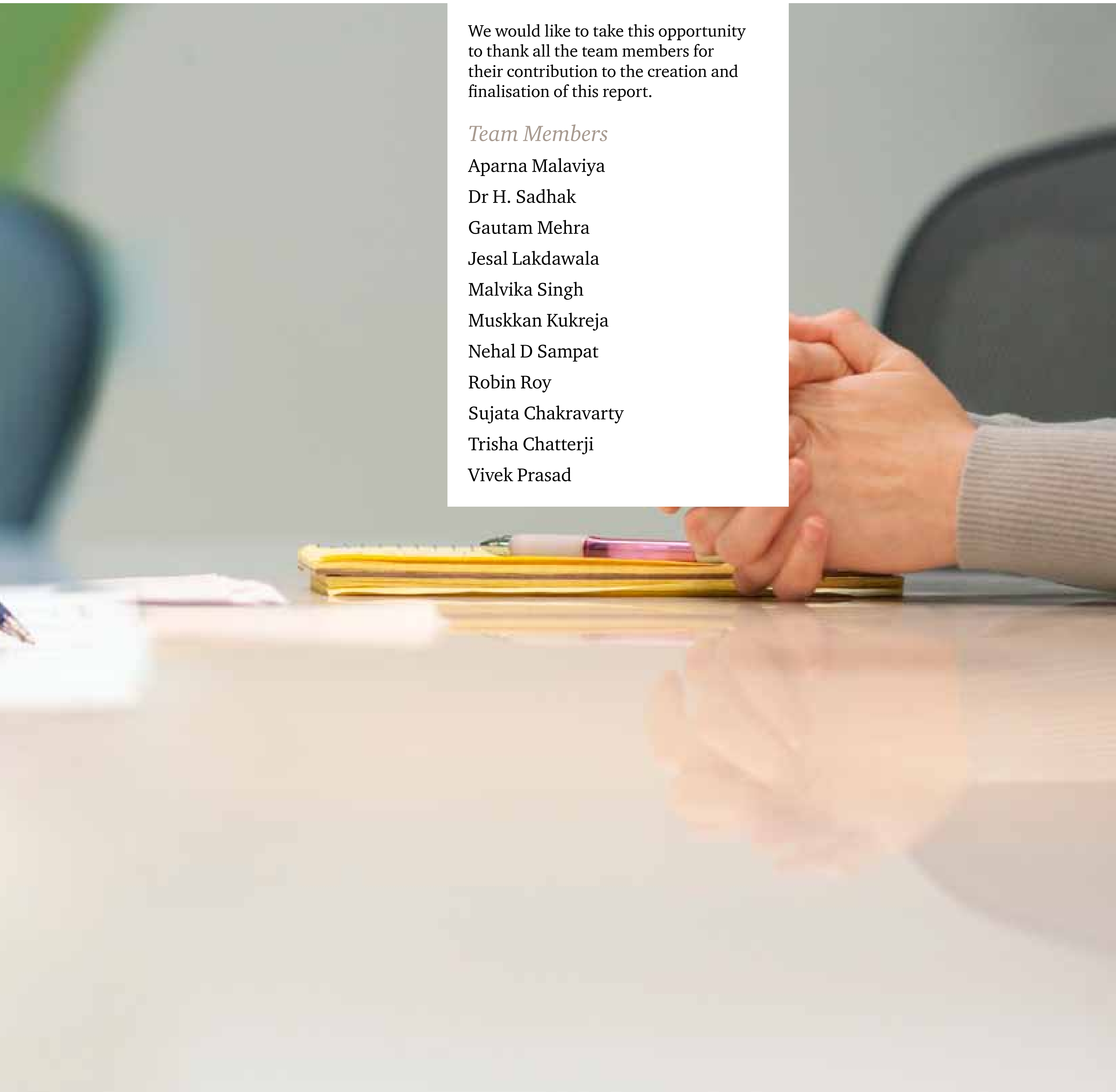

Notes

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CII

About CII

The Confederation of Indian Industry (CII) works to create and sustain an environment conducive to the growth of industry in India, partnering industry and government alike through advisory and consultative processes.

CII is a non-government, not-for-profit, industry led and industry managed organisation, playing a proactive role in India's development process. Founded over 116 years ago, it is India's premier business association, with a direct membership of over 8100 organisations from the private as well as public sectors, including SMEs and MNCs, and an indirect membership of over 90,000 companies from around 400 national and regional sectoral associations.

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CII has taken up the agenda of "Business for Livelihood" for the year 2011-12. This converges the fundamental themes of spreading growth to disadvantaged sections of society, building skills for meeting emerging economic compulsions, and fostering a climate of good governance. In line with this, CII is placing increased focus on Affirmative Action, Skills Development and Governance during the year.

With 64 offices and 7 Centres of Excellence in India, and 7 overseas offices in Australia, China, France, Singapore, South Africa, UK, and USA, as well as institutional partnerships with 223 counterpart organisations in 90 countries, CII serves as a reference point for Indian industry and the international business community.

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