GNLU CENTRE FOR LAW & ECONOMICS

Policy Recommendations

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Comments to the Securities and Exchange Board of India on Consultation Paper on Introduction of Mutual Funds Lite Regulations (MF LITE) for Passively Managed Mutual Funds Schemes

Comments on behalf of the Policy Inputs Research Group on SEBI, GNLU Centre for Law & Economics

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I. INTRODUCTION:

On 1st July 2024, the Securities Exchange Board of India ("SEBI") released a Consultation Paper for the introduction of Mutual Funds Lite Regulations (MF LITE) for passively managed Mutual Funds Schemes ("Consultation Paper"). The Consultation Paper focuses on creation of a relaxed regulatory framework to govern passive mutual fund schemes owing to their reduced risk as compared to active schemes. The Consultation Paper outlines inter alia reduced compliance requirements and eligibility criteria thresholds and introduces notably close-ended debt passive schemes and Hybrid ETFs / Index Funds.

With regards to the underlying purpose for which the Centre for Law and Economics was established at the Gujarat National Law University, the Centre constituted a special Research Group to look further into the proposed set of rules and regulations and research on the recommendations so as to suggest changes in order to ensure a robust regulatory framework for passively MF schemes.

This document proposes comments which would facilitate striking a balance between ease of doing business and promoting competition for passive mutual fund schemes, while also ensuring sufficient regulation for protection of investor interests.

II. GENERAL COMMENTS:

This section would provide an overview of the comments of the Centre as stated below.

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The proposal to hive off active and passive MF must be reconsidered, those having both active and passive schemes should under existing MF regulations and only the passive schemes be under MF lite, the proposal goes against the objectives of creating ease of compliance and may prompt large players to stop their passive schemes. Secondly, the proposal to further limit the scope of an AMC under the MF lite regulations, should also be reconsidered, the proposal goes against the explicit provisions of Regulation 24 of MF regulation and AMFI's proposals that required that AMCs be allowed to settle their trades in repo. Additionally, the proposal to lift the applicability of the 6th schedule on passive MFs also goes against the very intention of the advertisement code.

The proposal to lower the TER of passive funds and accordingly relax the investor education fund requirements helps ensure that passive funds remain viable and competitive. Introduction of Hybrid passive funds that would replicate composite indices would allow investors to gain exposure to both equity and debt instruments while managing risks of the performance of debt and equity markets.

The proposal to update SIDs for passive schemes within 2 months from the financial year-end simplifies the process but may delay the availability of updated information. It is hence recommended that quarterly updates would ensure better, timely and accurate data while maintaining a streamlined process.

The proposal to relax portfolio disclosure norms for passive funds simplifies reporting but may reduce transparency. It is, therefore, recommended to consider monthly disclosures for passive schemes to balance efficiency and transparency. Additionally, allowing well-regulated debt derivatives or standardized debt securities and excluding provisions for Interval schemes, Capital Protection oriented schemes, for passive schemes would increase flexibility and enhance portfolio diversification while simplifying regulation.

While some of the proposals aim to make schemes affordable and offer new options, others might have unintended effects. Positive aspects include relaxing investor education fund requirements and simplifying updates to key investor documents. Additionally, allowing well-regulated debt instruments and excluding specific scheme types (interval and capital protection) could enhance flexibility and better reflect the nature of passive funds. Overall, while the proposals aim to streamline regulations and make passive funds more attractive, carefully considering the potential impact on all market participants is crucial.

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III. SPECIFIC COMMENTS: -

SL. NO.	ISSUE	SUMMARY OF PROPOSAL	COMMENTS/ SUGGESTION	RATIONALE
1.	**Proposal No.2** **Shareholding and governance in Mutual Funds**	Existing MFs having both active and passive schemes are required to hive off the passive schemes to a separate AMC having separate technology, infrastructure, staff etc. Each AMC will be required to meet the regulatory requirements like net worth criteria independently. In case the sponsor hives off passive schemes to an AMC within the same group, it shall not be permitted to launch any passive schemes.	This requirement to hive off passive schemes for existing MF providing both active and passive schemes must be reconsidered. Those having both active and passive schemes should be regulated under the MF Regulations while those having only passive schemes regulated under the MF Lite regulations. Separate registration should not be mandated.	- This mandate of separation deviates from the objective of creating ease of compliance and increased players in the market. - Existing MF having both categories of schemes would require setting up additional infrastructure and place increased investment to meet the net worth criteria separately which will increase cost of compliance and reduce ease of doing business. - Mandating such separation might prompt existing larger players to stop passive schemes if there are insufficient AMCs to hive off the operations to and potentially be detrimental to their business model. - Since passive funds account for 17% of the

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				AUM of the mutual fund sector[1] MF may choose to close the passive fund option if the increased cost of compliance for passive funds through a separate AMC reduces the ROI to make it non-profitable.
2.	**Proposal No.6** **Restrictions on business activities of AMCs**	It is proposed to limit the scope of activities an AMC registered under MF Lite can carry to managing passive MF schemes only.	The proposal is not a welcomed one. It further narrows down the already narrow and segregated functions allowed. Activities of AMC were in 2011 restricted to 2 buckets: (i) *management of funds of other broad-based entities* and (ii) *other activities like PMS and advisory services.*[2]	This proposal excessively limits the scope of an AMC's functions. This goes against the express provisions of regulation 24 of MF regulation that states "*.AMC may, itself or through its subsidiaries, undertake portfolio management services and advisory services for other than broad based Fund.*" The proposal goes against SEBI vide circular no. SEBI/HO/IMD/DF2/CIR/ P/2019/155, dated December 16, 2019, which had specified certain categories of FPIs to which

[1] https://www.amfiindia.com/Themes/Theme1/downloads/AMFIMonthlyNote_June2024.pdf
[2] https://icmai.in/upload/pd/Discussion-Paper-SEBI.pdf

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				the AMCs can provide management & advisory services in terms of Regulation 24(b) of MF Regulations, 1996.[3] It permitted AMCs to provide management and advisory services to all FPIs operating from IFSCs. Additionally, the proposal goes against AMFI's proposal that AMCs of mutual funds may be allowed to clear and settle trades in repo on corporate bonds on behalf of mutual funds.[4] In order to enable AMCs to participate in repo transactions under the debt segment, AMCs must be permitted to become self-clearing members of recognized clearing corporations for clearing and settlement of trade for their schemes in the debt segment of recognized stock exchanges.

3 https://www.taxmann.com/post/blog/amcs-are-allowed-to-provide-management-advisory-services-to-all-fpis-operating-from-ifscs-sebi/

4 https://www.sebi.gov.in/sebi_data/meetingfiles/oct-2020/1602843463422_1.pdf

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3.	**Proposal No. 8** **Advertisement Code**	Content of 6th schedule advertisement code is not applicable for passive MFs ads, it is mandated that any advertisement of passive investment schemes shall not be misleading or lead to mis-selling of any such scheme.	The said proposal by easing the implementation of the advertisement code on passive MFs does not help but furthers the issues SEBI faces regarding advertisements/ presentations, which lead investors to believe that they would receive fixed returns on their investments in MF.	Even though passive schemes are rule-based in nature, it does not equate to it having less scope of misleading or mis-selling. (the WG made a fallacy in this logic) And does not guarantee that MFs come up with simpler advertisements. Hence, lifting 6th schedule's detailed code requirements is not justified, solving no purpose.
4.	**Proposal No. 13** **Investor education and awareness**	The Working Group (WG) suggested that due to the limited fees (TER) charged by passive funds, the requirement to set aside funds for investor education and awareness should be relaxed for "MF Lite." They propose that fund allocation for investor education in passive schemes and Fund of Funds	The proposal is appropriate as passive funds typically have lower TER compared to active funds. Therefore, imposing the same investor education requirements on both can disproportionately affect passive funds.	Passive funds are designed to replicate the performance of a specific index or benchmark, requiring less active management compared to actively managed funds. This lower level of management involvement translates to lower Total Expense Ratios. Since passive funds operate on tighter margins due to their low TER, imposing the same investor education requirements as active funds, which have higher

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		(FoFs) be as follows: 1. For Domestic FoFs investing more than 80% in domestic passive funds, no allocation is needed. 2. For ETFs, Index Funds, and Overseas FoFs investing in ETFs, no allocation is needed for assets up to INR 250 crore, 3. For assets above INR 250 crore, 5% of the TER charged to direct plans should be		TER and therefore more financial leeway, can strain the resources of passive funds. Investor education and awareness initiatives often represent a fixed cost, meaning it does not scale down proportionally with the fund's size or TER. For passive funds with already low TER, allocating a significant portion of their limited expense ratio to investor education can be disproportionately burdensome, which could put them at a competitive disadvantage. This may discourage the growth and development of passive investment funds. Therefore, by recognizing the lower TER of passive funds and accordingly relaxing the investor education fund requirements helps ensure that passive funds remain viable and competitive.

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		allocated, with a cap of 0.5 basis points of AUM.		
5.	<u>**Proposal No.14**</u> **Introduction of Hybrid ETFs/ Index Funds**	The proposal suggests introducing Hybrid passive funds that would replicate composite indices consisting of fixed proportions of equity and debt, offering investors a single product with exposure to both instruments.	The proposal is welcomed as Hybrid Passive Funds allow investors to gain exposure to both equity and debt instruments within a single product, enhancing diversification. This can help in risk management as the performance of equity and debt markets often differ, balancing the overall portfolio risk.	The alignment with existing regulatory frameworks for debt and equity ETFs/Index Funds ensures that the hybrid funds will adhere to established standards, providing assurance to investors and regulators alike. The requirement for the ETF/Index Fund issuer to ensure compliance with the asset allocation every calendar quarter ensures that the funds adhere to their investment strategies. Disclosing the tracking error (TE) and tracking difference (TD) for both equity and debt components ensures transparency and helps investors understand the fund's performance relative to its benchmark.

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				However, the minimum subscription amount of INR 10 Crore at the time of New Fund Offer (NFO) may be prohibitive for smaller investors and could limit participation and accessibility of these funds, and therefore, should be reduced.
6.	**<u>Proposal No. 15</u>** **Investment and trading in securities by the employees of the AMC(s) and Trustee(s)**	The proposal suggests replacing the prior approval for AMC and trustee employees' investments and trades with a prior intimation of at least 3 working days before the transaction within 7 working days remain unchanged.	The proposal to replace prior approval with prior intimation of at least 3 working days for AMC and trustee employees' transaction recognizes the limited scope for active management in passive schemes. However, this change could potentially increase the risk of conflicts of interest or market abuse due to less thorough view as prior approval involves a review process. While prior intimation simplifies	- Streamlined approval for significant transactions minimizes conflicts of interest and market abuse, ensuring critical trades are scrutinized - The3- day prior intimation reduces administrative burden, simplifying processes without compromising oversight. - Periodic audits and stronger monitoring ensure compliance and detect any irregularities,

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			the process it may not provide sufficient scrutiny. A balanced approach could involve maintaining a streamlined approval process for significant transactions or those involving sensitive securities, alongside the 3- day prior intimation for routine trades. Additionally, enhancing monitoring mechanisms and conducting periodic audits of employee transactions can further mitigate risks while ensuring regulatory compliance. This process retains the regulatory scrutiny while providing operational flexibility by ensuring significant transactions are reviewed while	maintaining a robust compliance framework. - This balances operational flexibility with regulatory control, upholding investment integrity while adapting to passive fund management.

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			simplifying routine trades and enhancing monitoring.	
8.	**<u>Proposal No. 16</u>** **Compliance and disclosure.** **15.1- Updation of SID and KIM**	The proposal suggests updating the Scheme Information Document (SID) for passive schemes within 2 months from the end of the financial year, instead of the current bi- annual updates within one month from the end of each half- year. The proposal suggests relaxing	The proposal to update SIDs for passive schemes within 2 months from the financial year-end simplifies the process but may delay the availability of updated information. A better way could be quarterly updates to ensure timely and accurate data while maintaining a streamlined process. This would balance the need for current information with operational efficiency.	- Quarterly updates ensure that the information in SIDs is more current and relevant, reducing the risk of stakeholders relying on outdated data. - Regular updates improve transparency and trust among investors, as they have access to the most recent and accurate data available. - This would strike a balance between the administrative burden of frequent updates and the need for accurate, time information. - Monthly disclosures for all

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	15.2- Portfolio Disclosure	the portfolio disclosure norms for passive funds as follows- Debt and hybrid passive schemes to disclose monthly within 10 days; equity passive schemes to disclose quarterly within 10 days. The half-yearly disclosure for passive funds would be eliminated, as monthly and quarterly disclosures already cover the necessary information.	The proposal to relax portfolio disclosure norms for passive funds simplifies reporting but may reduce transparency. To balance efficiency and transparency, it is prudent to consider monthly disclosures for all passive schemes. This ensures consistent and timely information for investors while maintaining a streamlined process, enhancing trust without significantly increasing the reporting burden.	passive schemes provide more up to date information for investors. - It ensures efficiency while maintaining investor trust through regular updates. - Aligning disclosure schedules across schemes simplifies compliance and improves clarity.
	15.3- Unaudited Half Yearly Financials	The proposal suggests discontinuing the requirement for passive schemes to publish unaudited half- yearly	Discontinuing unaudited half-yearly financials for passive schemes streamlines reporting	- Discontinuing half-yearly unaudited financials may reduce the frequency of updates, potentially

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		financials on the MF website, given their objective to replicate an index or benchmark. However, the annual report for these schemes will still provide the necessary financial details	but may reduce transparency. To maintain investor confidence, it is recommended to enhance the annual report with more detailed financial and performance information. This ensures that investors still receive comprehensive updates while simplifying compliance for passive schemes	affecting transparency. Enhancing the annual report with detailed financials ensures that investors still receive comprehensive and up-to-date information. - A more detailed annual report can help maintain investor confidence by providing clear and thorough information about the scheme's performance and financial health. - Simplifying reporting requirements for passive schemes reduces administrative burden while balancing efficiency with transparency.

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9.	**Proposal No. 17** **Investments by passive schemes** **16.2-**	The proposal suggests that the passive schemes can invest in equity, plain vanilla debt securities, physical commodities, and exchange- traded commodity derivatives. It also permits investment in equity derivatives of index securities if the underlying security is unavailable. However, investments in bespoke debt securities and debt derivatives are not allowed.	The proposal to allow passive schemes to invest in equity, plain vanilla debt securities, physical commodities, and exchange traded derivatives, while also permitting equity derivatives for unavailable index securities, is a practical approach. However, excluding bespoke debt securities and debt derivatives could limit investment opportunities. Thus, allowing well-regulated debt derivatives or standardized debt securities for increased flexibility must be considered,	- Allowing regulated debt derivatives could provide more investment opportunities and improve portfolio diversification while still maintaining passive investment principles. - Introducing standardized debt securities can enhance portfolio options for passive schemes, offering better risk management and alignment with index replication goals. - Ensuring that any new options are well- regulated and standardized maintains the

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			ensuring they align with the passive nature of the schemes. This can enhance portfolio diversification without deviating from the core objectives of passive investing	simplicity and transparency of passive investment strategies
	16.3 -	The proposal suggests that provisions for Interval schemes, Capital Protection oriented schemes, Real Estate MF schemes, and Infrastructure Debt Fund schemes may be deemed irrelevant under the MF Lite regime and thus not applicable. Similarly, stress testing for debt funds and liquidity risk management frameworks for debt funds will continue to be	The proposal to exclude provisions for Interval schemes, Capital Protection oriented schemes, Real Estate MF schemes, and Infrastructure Debt Fund schemes from the MF Lite regime is appropriate for simplifying regulations. However, continuing to exclude stress testing and liquidity risk management for passive funds might overlook evolving risks	- Excluding complex schemes from the MF Lite regime simplifies regulatory requirements and focuses on passive fund objectives. - A minimal, risk-based approach for stress testing and liquidity management ensures passive funds are resilient to market fluctuations without adding excessive regulatory burdens.

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		excluded for passive funds, as is currently the case.	Thus, a minimal, risk- based approach to stress testing and liquidity management must be considered for passive funds to ensure they remain resilient to market changes while keeping regulations streamlined	- Ensuring that passive funds have some level of stress testing and liquidity management maintains a balance between simplicity and adequate risk management
	16.4-	The proposal suggests that passive schemes should not invest in- - Unlisted debt instrument - Bespoke or complex debt products - Securities with special features	The proposal to restrict passive schemes from investing in unlisted debt instruments, bespoke products, special- feature securities, inter-scheme transactions, short- selling, and derivatives (except for rebalancing), while also limiting investments to rated debt and specific money market	- Allowing a broader range of high quality, standardized instruments can improve portfolio diversification while adhering to passive investment principles. - Expanding the scope for investing in top-rated standardized instruments can potentially enhance returns for passive schemes without

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		- Inter scheme transactions - Short selling - Derivatives (except for portfolio rebalancing) - Unrated debt and money market instruments (except Gsecs, T Bills and other money market instruments)	instruments, is well targeted for maintaining simplicity. Thus, allowing passive schemes to invest in a broader range of high quality, standardized financial instruments, if they meet strict regulatory criteria such as high credit ratings, transparency, liquidity and regulatory compliance must be considered. This could enhance portfolio diversification and performance without compromising the passive investment strategy.	deviating from their core objectives. - Introducing strict regulatory criteria for new investment opportunities maintains the simplicity and transparency of passive schemes while allowing for some flexibility in investment choices.
10.	<u>**Proposal No. 21**</u> **Introduction of close-ended debt passive schemes.**	The consultation paper proposes to enable an option for launching closed-ended debt passive schemes. Currently, there are	The introduction of closed-ended debt passive schemes is a welcome proposal as it provides investors with another investment option	- Closed-ended structure gives fund managers more flexibility to follow the investment objective without having to manage

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		target maturity debt passive schemes that are open-ended, where the index of the scheme matures on a particular date, and the fund also expires after that. The proposal suggests allowing closed-ended versions of such debt-passive schemes.	and increases product diversity in the mutual fund market. However, the regulator should provide clear guidelines on the eligible investment universe and maturity profile of these schemes to ensure consistency and investor understanding. Additionally, it is crucial to incorporate appropriate liquidity mechanisms, such as allowing periodic repurchase of units or providing for trading on stock exchanges, to address the inherent lack of liquidity in closed-ended structures and protect investor interests. Robust disclosures on investment strategy, risks, and total expense ratio, along with investor	redemptions, which can benefit investors. - Allowing closed-ended debt passive schemes provides investors with another investment option and increases product diversity in the mutual fund market. - Closed-ended debt passive schemes can potentially offer higher returns than open-ended versions by allowing fund managers to take on more risk and use leverage. - The closed-ended structure may appeal to investors with a defined investment horizon matching the scheme's maturity, providing them access to debt markets in a

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			education campaigns, will be essential to enable investors to make informed decisions and understand the differences between open-ended and closed-ended debt funds. Furthermore, the regulator may want to consider imposing reasonable limits on the use of leverage by closed-ended debt passive schemes to mitigate the higher risk profile and safeguard investor interests.	passive, cost-effective manner. - From an asset management company's perspective, closed-ended schemes can provide a stable asset base to manage, potentially improving the economics of scale and profitability.
11.	**<u>Proposal No. 22</u>** **Categories of schemes under MF Lite Regulations (Two different approaches)**	SEBI's Working Group has proposed two approaches for allowing passive schemes to be launched under the MF Lite Regulations. The approaches and their key points are as under:	Approach 2 appears to be more favorable as it provides a broader and more flexible framework for passive schemes under the MF Lite Regulations. Limiting the eligible indices in Approach 1 may restrict the growth and	- Approach 2 ensures that the MF Lite Regulations are uniformly applicable across the passive mutual fund industry, covering all existing ETFs, index funds, and fund-of-funds investing in a single

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		1. Approach 1 (Phased Implementation) - Phase 1: Only domestic equity passive indices with a minimum AUM threshold of ₹10,000 crore, ₹5,000 crore, or no threshold would be allowed. Overseas indices and certain debt passive schemes would also be permitted. - Phase 2: Schemes based on other indices may	diversification of the passive fund market.	ETF/index fund. This provides a level playing field and avoids creating a two-tier regulatory system, where only a limited set of passive schemes would be governed by the MF Lite Regulations under Approach 1. - Approach 2 allows for the inclusion of all existing passive schemes, providing investors with a broader range of diversified investment options. This approach aligns with the objective of the MF Lite Regulations to facilitate investment diversification and increase market liquidity. - Under Approach 2, new equity passive schemes with

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		be considered. - The list of eligible indices would be prescribed by AMFI in consultation with SEBI 2. Approach 2 (non-phased implementation) - All existing ETFs, index funds, and fund-of-funds investing in a single ETF/index fund would be included under MF Lite. - New equity passive schemes with underlying indices not covered by existing		underlying indices not covered by existing schemes can be launched, subject to a list prescribed by AMFI in consultation with SEBI. This flexibility allows fund providers to introduce innovative passive products, fostering competition and meeting the evolving needs of investors. - For debt passive schemes, Approach 2 proposes to continue with the existing requirement for AMFI to prescribe a list of eligible indices, as specified in the Master Circular on Mutual Funds. This ensures consistency and familiarity in the selection of debt

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		schemes may be launched subject to a list prescribed by AMFI in consultation with SEBI. - For debt passive schemes, the existing requirement for AMFI to prescribe a list of eligible indices would apply.		indices, building on the established industry framework. Approach 2 ensures that the MF Lite Regulations are uniformly applicable across the passive mutual fund industry, covering all existing ETFs, index funds, and fund-of-funds investing in a single ETF/index fund. This provides a level playing field and avoids creating a two-tier regulatory system, where only a limited set of passive schemes would be governed by the MF Lite Regulations under Approach 1. - Approach 2 allows for the inclusion of all existing passive schemes, providing

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				investors with a broader range of diversified investment options. This approach aligns with the objective of the MF Lite Regulations to facilitate investment diversification and increase market liquidity. - Under Approach 2, new equity passive schemes with underlying indices not covered by existing schemes can be launched, subject to a list prescribed by AMFI in consultation with SEBI. This flexibility allows fund providers to introduce innovative passive products, fostering competition and meeting the

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				evolving needs of investors.
12.	**<u>Proposal No. 22(part 2)</u>** **Categories of schemes under MF Lite Regulations (In respect of Approach 1, for domestic equity indices - whether an AUM threshold of minimum INR 10,000 Cr. or INR 5,000 Cr. would be appropriate OR no threshold should be provided.)**		A lower AUM threshold of ₹5,000 crore or no threshold at all would be more appropriate.	- By reducing the barriers to entry, the regulatory framework encourages more players to participate in the market, fostering competition and innovation. This can lead to more efficient allocation of resources and better outcomes for investors. - By allowing a broader range of indices, the market will see increased competition, leading to better pricing and more innovative products. - A lower or no AUM threshold would reduce the compliance burden for new entrants, making it easier for

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				them to enter the market. This aligns with the objective of the MF Lite Regulations to simplify the regulatory framework for passively managed mutual funds
13.	**<u>Proposal No .23</u>** **Categories of schemes under MF Lite Regulations (selection of debt indices to be considered under the proposed MF Lite Regulation.)**		For debt passive schemes, the existing requirement for AMFI to prescribe a list of eligible indices, as mentioned in the Master Circular on Mutual Funds, seems reasonable. This would ensure a standardized and transparent process for selecting appropriate debt indices.	- AMFI, as the industry association, has great expertise and experience in evaluating and prescribing appropriate debt indices for mutual fund schemes. They are better equipped to assess the suitability of debt indices based on factors such as liquidity, diversification, and passive replicability. - The existing AMFI framework for selecting debt

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				indices has been developed and refined over time, based on extensive industry feedback and regulatory oversight. Continuing this approach ensures consistency and familiarity for both fund providers and investors. - Leveraging the existing AMFI framework eliminates the need for SEBI to develop a new, parallel process for index selection. This allows for efficient utilization of regulatory resources and avoids duplication of efforts.

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