

SEBI IS ON THE WAR PATH TO LOWER MUTUAL FUND COSTS

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Capital Market & SEBI

Starting soon your [mutual fund will cost less](#). The capital market regulator, the Securities and Exchange Board of India (Sebi), has put out rules that further tighten the mutual fund industry norms to take care of the loopholes found and misused by the industry. You can read the circular [here](#). There are four changes that impact you.

One, for costs related to the scheme, mutual funds will now pay only out of the scheme account and not from any other source or account. What was happening was this: some of the bigger fund houses were using their profits to pay commissions to distributors to kick up sales. Remember that after a certain scale, it does not cost much more to run a fund house; so as the fund size grows, costs should actually come down.

But the [total expense ratio for equity mutual funds](#) have remained at the maximum limits allowed by the regulator. The costs came down for plans like the liquid and bond funds that are used primarily by institutions and high net worth investors, that is for those with higher bargaining power. But they stayed high for retail investors. It does look as if the retail is subsidizing the corporate and HNI. The higher profits could have led to lowering of costs, but were instead used to pay distributors upfront commissions totally ignoring the industry association (Association of Mutual Funds in India, or Amfi) norm to keep up fronting of commissions at 1% only.

Some fund houses were paying as much as 5-6% as upfronts dipping into their profits. By specifying that commissions can only be paid from the scheme and no other head, Sebi is plugging a loophole that was causing misselling and churning.

But funds can keep all the profit, no? No, because in addition to this, the costs will come down because of the new cost structure that was announced last month which shaves the total expense ratio down across the various slabs of assets. You can read more on this [here](#).

Two, Sebi is banning all upfronts except for a small carve out for the systematic investment plans (SIPs). Front commissions incentivise sharp sales of financial products. There is enough evidence globally of this practice and Sebi's step to ban all incentives for making the first sale, other than a transaction cost (that already exists), is a step in the right direction.

Three, the circular says that all fees and expenses in a direct plan under various heads, including the investment and advisory fees, should not be higher than the same expenses in a regular plan. What this means is this: those investing directly into mutual funds will benefit from lower costs.

Remember [mutual fund direct plans](#) are the route taken by do-it-yourself investors or fee paying investors who go direct to save on the commission costs. Direct plans should be cheaper than regular plans by the amount of the trail commission being paid. But certain fund houses did some clever interpretation of the rules and began to pad up direct plan costs, narrowing the gap between the costs of a regular and a direct plan. Sebi's intervention will force direct plans to cost less. One difference between a direct and regular plan is the commission, now the direct plans will have to reflect this difference.

Four, it seems that Sebi found that the additional cost of 30 basis points being allowed for the

smaller towns and cities (called B30, or beyond the top 30 cities) ,was being misused by institutional and high net worth investors. Routing an application through the suburb that fell in the category for higher cost would allow the distributor to earn more and then share a part of that with the investor. Sebi is curbing this practice by removing all upfronts from the B30 costs and the commissions will be trail only. Sebi is prohibiting corporate and institutions from buying via the B30 route. The B30 higher cost was being paid by all investors. The closing of this loophole will mean lower costs finally for an average investor.

These changes come into effect immediately and the lower cost circular should be out once the regulations are amended.

It does look like a cat and mouse game: firms continue to find loopholes and the regulator continues to modify. I have been following the mutual fund related-regulatory changes in Sebi for over a decade. All I can say is that the effort and intelligence that some fund houses spend on gaming the system could be spent on better fund management. It is a pity that it is the largest fund houses that twist the rules. There is a new Sebi out there right now that is focused on the rule book. Good news for investors and what is good for the consumer cannot be bad for the industry and the intermediaries finally.

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