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REPORT OF THE
COMMITTEE ON
COLLECTIVE
INVESTMENT
SCHEMES

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CHAPTER 1



1.1 INTRODUCTION AND BACKGROUND

The last few years have witnessed initiative by private entrepreneurs to undertake plantation activities on a commercial scale. The effort per se is commendable as it supplements the Governments efforts to prevent erosion of forest base and also channelises private investments towards agro plantation activities. However, it was noticed that the promoters themselves invested a minimal amount in such ventures and sourced a majority of the funds from ordinary investors. The high returns promised by these schemes coupled with questionable claims of fiscal incentives and effective rural marketing helped many of these companies to mobilise large amounts over a period of time. The initial success in mobilising funds by some of these companies lead to a mushrooming of such schemes throughout the country.

The Government, after detailed consultations with the regulatory bodies, decided that an appropriate regulatory framework for regulating entities which issue instruments like Agro Bonds, Plantation Bonds etc. has to be put in place. A press release was issued by the Government on November 18, 1997, conveying that such schemes should be treated as Collective Investment Schemes coming under the SEBI Act, 1992. In order to regulate such collective investment schemes, both from

the point of view of investor protection as well as promotion of legitimate investment activity, SEBI was asked to formulate the draft regulations for them. These draft regulations were to be made available for public discussion. The investors who have invested in these schemes as well as entities running such schemes will be requested to give their comments on pertinent matters to SEBI for enabling it to formulate appropriate regulations for the collective investment schemes. The press release further states that once these regulations come into force, it is expected that they will promote legitimate investment activity in plantation and other agriculture based business, while at the same time giving investors an adequate degree of protection for their investments.

In order to examine and finalize the draft regulations for Collective Investment schemes, SEBI appointed this committee under the Chairmanship of Dr. S. A. Dave. The committee contains representation from the Government Ministries, Regulatory Bodies, Consumer forum, Professional Bodies and Plantation Industry. The following were the committee members: Shri A.P. Kurian, Shri I.C. Jain, Shri V.S.N. Murthy, Shri M.M. Chitale, Shri Vivek N. Pai, Shri S.B. Mathur, Shri Manubhai Shah, Dr. Jayalakshmi Jayaraman, Shri Atul Chadha, Ms. D.N. Raval and Shri Vijay Ranjan (member secretary). As Shri Ranjan left SEBI his place on the committee was taken up by Shri Ashok Kacker.

The committee held its first meeting on January 28, 1998 and began its task by reviewing the information submitted by the existing schemes to gather an insight into the structuring of the offerings by some of the larger Collective Investment Schemes. The data submitted by the existing schemes and its analysis provided by SEBI helped the committee in analysing the aspects relating to scheme features, disclosures, background of promoters etc. The members also conducted site visits of some of the plantations.

As per the data available, it was noticed that large sums of monies had been collected by entities which did not necessarily have sufficient experience in agro based activities. The schemes were typically open ended and the disclosures made to the investors were not adequate to enable informed decisions. There were high risks associated with these ventures due to the long gestation period involved coupled with crop risks. The committee members felt that some interim measures of investors protection must be notified pending finalisation of regulations.

Accordingly, the committee made a recommendation for mandatory credit rating for existing schemes desiring to mobilise further funds. This provision was expected to provide a degree of risk assessment of the future cash flows by independent and accredited agencies.

1.2 INVESTMENT FEATURES

The plantation schemes were able to attract a considerable degree of investor interest over the last few years. It may be pertinent to examine the features in these schemes which made these investments attractive from the point of view of investors.

1.2.1 High Returns Assured

Invariably, all the schemes have assured or indicated high yields (in the region of 18% to 30%) per annum on the investments. These yields have been worked out on the basis of projected growth and estimated price of the plantations. These estimates vary from company to company and scheme to scheme. The projected yield estimates have been disputed by forestry experts. An independent study into the Economics of Growth of Teak Plantations conducted by the Ministry of Forestry (Gangopadhyaya Committee) concluded that the yields promised by many of these schemes were optimistic and not achievable. The Industry representatives, however, feel that the study had relied more on the experience and data available with various Forest Departments and that Privately managed commercial plantations provide for scientific and technology inputs which facilitate higher growth and quality superior to rained forestry situation. In the opinion of the

Industry representatives, the yields projected by the Gangopadhy Committee are conservative. The committee is not in a position to comment on these studies as they involve technical simulations by Forestry experts, and are not yet proven.

Quite often the schemes come up with Novel Products for which there is no ready market to compare the forecasts. The promise of returns higher than any conventional debt instrument was a major attraction for the investors investing in these schemes.

1.2.2 Distribution Channels

The schemes were aggressively marketed in the rural and semi urban areas directly and through a network of Agents who were offered attractive commissions to sell these products. The commissions offered were at times as high as 10 to 15% of the amount mobilised.

1.2.3. Advertising and Marketing

The companies used focused media campaigns to advertise their schemes. Colorful brochures, newspaper insertions and Television Campaigns were used by some of them to attract investments. By and Large, these advertisements did not indicate the risk factors associated with these schemes.

1.2.4. Tax Implications

The Income tax act exempts income from agriculture activities from taxable income of the assesses. The scheme operators have interpreted the provisions of the Income Tax Act to be applicable to the incomes received by the investors in these plantation schemes. It was observed that the scheme operators were not deducting any tax at source from the returns paid to the investors regardless of the fact whether these returns accrued from genuine investment activity in agriculture or whether these were infact being paid from other sources including fresh collections.

Promises of tax free returns were a major attraction for investors investing in plantation schemes. These tax free returns were conspicuously advertised by the scheme operators.

1.2.5. Land Ownership

Many schemes have been structured in a way which offers ownership of a piece of land or property to the investors. In a way, this feature was used to create a sense of security which arises from owning a real asset. A comfort level was sought to be created in the minds of the investors notwithstanding the fact that most of the times the piece of land allocated to each investor was not distinctly identifiable.

CHAPTER 2

RECOMMENDATIONS OF THE COMMITTEE

2.1. DEFINITION OF COLLECTIVE INVESTMENT SCHEMES

As per the mandate given by the Government of India, the schemes which issue instruments like agro bonds, plantation bonds etc. were to be treated as "Collective Investment Schemes" coming under the purview of the SEBI Act.

The committee recognises that "Collective investment Scheme" is a generic term, and would therefore encapsulate within its fold various activities which have been found to have certain specific characteristics. It may further be added that these characteristics have been adopted by various countries including United Kingdom, Australia and New Zealand. At the same time, it may be pertinent to note that while defining "Investment Contracts", the Securities and Exchange Commission of United States delved into the characteristics of 'securities' as laid down by the U.S. Supreme Court, in what is now commonly known as the 'Howey's Test'. The Howey's Test lays down that contracts can be construed to be Securities if they cumulatively satisfy the following characteristics, irrespective of the legal terminology in which these contracts may be clothed:

- a. The contract denotes an interest or participation in any profit sharing agreement.
- b. The Management of the arrangement is by a separate entity.
- c. There is an absence of day to day control on the arrangement by the investors.
- d. The resources of the investors, in whatever form, are pooled.

While finalising the definition of Collective Investment Schemes, the committee, therefore, adopted the above characteristics, which are also in consonance with the norms adopted internationally. The definition finalised by the Committee is as under:

“collective investment scheme” means any scheme or arrangement:-

- (i) with respect to property of any description, the purpose of which is to enable the investors to participate in the arrangements by way of contributions and to receive profits or income or produce arising from the management of such property or investments made thereof; and
- (ii) the contributions of the investors, by whatever name they are called, are pooled, and are utilised solely for the purposes of the scheme or the arrangement; and

- (iii) the property or such contributions is managed as a whole on behalf of the investors, whether or not such properties or contributions and the investments made thereof are evidenced by identifiable properties or otherwise; and
- (iv) the investors do not have day to day control over the management/operation of the property/scheme.

The following arrangements are not collective investment schemes:-

- (i) Acceptance of deposits by companies under Section 58A of the Companies Act, 1956 and Non Banking Financial Companies (NBFCs) as defined under Section 45-I of the RBI Act, 1934;
- (ii) Acceptance of fund by Chit Funds in terms of Chit Funds Act, 1982;
- (iii) Acceptance of fund by Nidhi companies from its members as per direction of the Central Government issued under Section 637A of the Companies Act;
- (iv) Contracts of insurance under the Insurance Act, 1938;
- (v) Any scheme of the employer for the benefit of its employees under the Provident Fund Scheme as per Employees' Provident Fund and Miscellaneous Provision Act, 1952;
- (vi) Arrangements of building societies or co-operative societies under Co-operative Societies Act, 1912 including Co-operative Societies under State legislation;

(vii) Any other schemes as may be declared as such by Securities and Exchange Board of India including Mutual Funds registered under the SEBI (Mutual Funds) Regulations, 1996.

The committee is, however, aware that there may be arrangements wherein funds have been pooled from the investors, by issuing instruments like agro bonds, plantation bonds etc., clothed in the legal terminology akin to the common understanding of the term 'Securities'. But, in essence, these arrangements denote a borrower/lender relationship offering a fixed/pre-determined returns totally exorcised from the profits accruing out of the venture and therefore the regulation of such arrangements by a Securities regulator may lead to unnecessary distortions in regulations.

The committee has observed that some of the schemes filed with SEBI to come under its purview of Collective Investment Schemes have been inspected by the Department of Company Affairs and by Independent Chartered Accountants and the schemes, on account of promising a fixed return have been classified as 'Deposits' as defined under Rule 2 of the Companies (Acceptance of Deposit) Rules, 1975.

2.2. COLLECTIVE INVESTMENT SCHEMES-STRUCTURE AND CONSTITUTION

The committee reviewed the information filed with SEBI by the existing collective investment schemes. It was noted that most

of the schemes are being operated by companies registered under the provisions of the Companies Act, 1956. Some of the schemes were also launched by non corporate entities like Association of Persons. Though all of the existing schemes have been managing investors funds, there is no distinction between the management and trustee function. In most of the cases there is an intermingling of the schemes accounts with those of the company's accounts. Consequently, it becomes difficult to ensure investor protection through this structure of operations. Due to the inherent nature of collective investment schemes, where assets are managed for and on behalf of the investors, these schemes must declare a trust in favour of the members over the scheme properties.

The committee feels that a sound structuring of these schemes is of prime importance towards investor protection. For a better understanding, the Committee undertook a comparative study of the regulatory position in Australia and New Zealand. Australia has recently amended its regulations under the Management Investment Act, 1998. Prior to notification of this act, the managed investment schemes were operating in a trust structure whereby a trustee company was required to monitor the interest of the investors. During the late 1980's and the early 90's, there were instances of scheme failures in Australia. There was a significant

difference in the perceived responsibility of the trustees viz a viz the actual responsibility assumed by these institutions. The trustees refused to be responsible for the poor investment decisions of the managers to the schemes and contended that investment function is the prerogative of the scheme managers and the trustees could not be held responsible for scheme failures on account of these decisions. A review commission was set up to examine these issues and it was decided to combine the role of the trustee and the manager in a Single Responsible Entity. The activities of this entity are monitored by a compliance committee which consists of at least 50% external representatives. New Zealand, on the other hand, has been following the trustee structure in its regulations.

As the new laws in Australia were made applicable from July 1, 1998, the experience with the single entity concept is insufficient and it is difficult at this juncture to conceive a similar structure for the Indian conditions. Moreover, the Australian regulator, unlike the Indian Regulator, monitors and implements the company law which gives it far reaching powers in regulating the single responsible entity. A significant point to note is that the concept of the trust has not been done away with and only the functions of trust and management have been realigned in a Single Responsible Entity. The committee feels that it would be imperative to

specify a trust structure under which these schemes would have to operate. Apart from the aforementioned reasons in favour of this structure, the trustee structure has been in operation for the Mutual Funds in India and SEBI has sufficient experience in handling the complexities involved in such a structure.

The committee recommends that a collective investment scheme shall be constituted in the form of a trust and the instrument of the trust shall be in the form of a deed registered under the provisions of the Indian Registration Act, 1908 and executed by the Collective Investment Management Company (CIMC) in favour of the trustees named in such an instrument.

2.3. COLLECTIVE INVESTMENT MANAGEMENT COMPANIES- REGISTRATION, CONSTITUTION AND OBLIGATIONS.

As the Collective Investment schemes, in general, accept monies from ordinary investors, the committee feels that these investments would be better protected if they are managed by persons who have the capability to ensure that the desired activities are carried out efficiently, honestly and fairly. Keeping in mind this underlying principle, the committee recommends that any entity seeking registration with SEBI, to operate collective investment schemes, must possess adequate organisational capacity to meet the current and

future operational demands in addition to necessary skill and experience required to operate such schemes.

The following conditions must be satisfied before an entity is licensed to carry out the activities of a collective investment management company:

2.3.1. Adequate Management structure

The Board of Directors of the CIMC should possess adequate professional experience in related fields and should satisfy the fit and proper criterion laid down by SEBI. They should have high integrity and must not have been found guilty of moral turpitude or convicted of any economic offense or violation of any security laws. The composition of the Board should be such that at least 50% of the directors must be independent persons, who are neither directly nor indirectly associated with the persons who are in control of the collective investment management company. At least one of the directors would be representative of the trustee. The management team of the CIMC must also comprise of responsible officers who have not been found guilty of moral turpitude or convicted of any economic offense or violation of any securities laws.

2.3.2. Financial Requirements

The committee had initially felt that the CIMC should have a minimum net worth of not less than Rs. 10 Crores, but, after considering the views of the Industry, recommends that the minimum net worth may be pared down to Rs. 5 Crores . This is to ensure that the Collective Investment Management company has sufficient financial resources to ensure ongoing scheme related cash requirements. The minimum net worth requirement has also been specified in the mutual funds regulations and it acts as a filter and allows only the serious and committed players to enter the markets.

2.3.3. CONDITIONS UPON WHICH THE REGISTRATION WOULD BE GRANTED

Upon satisfying the basic requirements, the CIMC would be granted a licence/registration to operate collective investment schemes. The registration would be subject to the following conditions:

- a) Any non independent director in the registered CIMC shall not hold the office of the director in another CIMC. This provision is to ensure avoidance of conflict of interest in business activities of separate entities.
- b) The CIMC must inform SEBI about any material change in the information or particulars which may have a bearing on the approval granted it.

- c) The CIMC would undertake to comply with the regulations notified by SEBI from time to time.
- d) Any change in the controlling interest of the CIMC shall be subject to prior approval of the trustee, the Board and the unit holders.
- e) The CIMC shall furnish such information and documents to the Trustee as and when required.
- f) The prescribed fees shall have to be paid to the Board.
- g) It is recommended that the registration fee payable by the CIMC be brought down to Rs. 10 Lacs from Rs. 25 Lacs.

2.3.4. RESTRICTION ON BUSINESS ACTIVITIES

As per the information available with SEBI on the existing collective investment schemes, many instances of diversion of funds to unrelated activities by persons operating collective investment schemes have been noticed. To prevent such undesirable practices, the committee feels it would be prudent to restrict the activities of CIMC. The registered CIMC would be permitted to undertake only the business of managing collective investment schemes. CIMC would also not be permitted to invest in any of the schemes floated by it unless a disclosure of its intention to do so has been made up front in the offer document.

2.3.5. OBLIGATIONS OF CIMC

As has been mentioned earlier, CIMC would be responsible for managing the investors funds. The CIMC should ensure:

- a) The interest of the CIMC or its related parties are not placed above the interest of the scheme investors. Towards this end, the CIMC should ensure meticulous compliance with regulations governing related party transactions.
- b) There is strict adherence to the scheme's investment policy, offer document and the trust deed.
- c) Participants are given regular feedback and told of all the information pertinent to their investments.
- d) Participants do not suffer losses because the CIMC or its employees do not act with reasonable care and diligence or otherwise fail in their duties to the scheme.
- e) Regular reporting to the trustees on the activities of the schemes and the compliance with the regulations.
- f) Compliance with the code of conduct prescribed in the regulations.
- g) It should be ensured that the CIMC and its officers and employees, do not benefit from unfair use of information.

2.3.6. APPOINTMENT AS TRUSTEES

To ensure that the interest of the investors are looked after by trustees of high repute and track record, the committee has laid down eligibility criterion for appointment of trustees for

collective investment schemes. The following persons, registered with SEBI under the SEBI (Debenture Trustee) Regulations, shall be eligible to be appointed as trustees:-

- a) A scheduled bank carrying on commercial activity; or
- b) A public financial institution within the meaning of section 4A of the Companies Act, 1956; or
- c) An insurance company; or
- d) Any other company which may be approved by the Board for this purpose.

It would have to be ensured that no person shall become eligible to be appointed as trustee of a collective investment scheme if he is directly or indirectly associated with the persons who have control over the collective investment management company.

2.3.7. RIGHTS AND OBLIGATIONS OF THE TRUSTEE

The Trustees have been vested with a great deal of fiduciary responsibility in ensuring that the managers of the schemes exercise due diligence while managing the investors funds in the interest of investors. The committee has specified the rights and obligations of the trustees which inter alia would include the following:

- a) The trustees have been given the responsibility to ensure that before launching any scheme the CIMC has taken steps to comply with the pre launch requirements specified in the regulations including existence of necessary office infrastructure, appointment of key managerial personnel, auditors to audit the accounts of the schemes, a compliance officer to comply with the regulatory requirements and to redress investor grievances etc.
- b) The trustees shall ensure that the contracts entered into and the activities carried out by the CIMC are in accordance with the provisions of the regulations and the offer document of the schemes.
- c) The trustees shall be accountable for, and be custodian of, the funds and property of the respective schemes and shall hold the same in trust for the benefit of the unit holders in accordance with these regulations and the provisions of the trust deed.
- d) The trustees shall act as a link between the unit holders and the scheme operators. They would have the responsibility of convening a meeting of the unit holders whenever required to do so in terms of the regulations.
- e) The trustee shall monitor and review, on a quarterly basis, all activities carried out by the CIMC on behalf of the scheme.
- f) The trustee shall monitor and review the net worth of the CIMC and in case of any shortfall ensure that the same is made up by the CIMC.

- g) The trustees shall periodically review all service contracts related to the scheme.
- h) The trustees shall also ensure that there is no conflict of interest between the manner of deployment of networth by CIMC and the interest of the unit holders.
- i) A quarterly report to SEBI should be submitted by the trustees to report on the activities of the scheme and also for other purposes specified in the regulations.
- j) The trustees shall cause the accounts of the scheme to be audited at the end of each financial year. Further, they would also have to ensure that the scheme is appraised at the end of each financial year.

2.3.8. SCHEMES AND DISCLOSURES

The committee has recommended the procedure for launching of collective investment schemes and the disclosures which are required to be made in the offer documents. The registered CIMC would be eligible to launch a scheme subject to the following requirements:

- a) The scheme must be approved by the trustee and a copy of the offer document shall be filed with the Board.
- b) All schemes must be rated by an approved credit rating agency.
- c) No scheme shall be launched without appraisal by an empanelled appraising agency competent to conduct

technical and / or financial appraisal of the project of the scheme.

- d) The schemes would have to be close ended and must have a minimum duration of 3 years.
- e) No scheme shall be open for subscription for more than 90 days.
- f) The units of Collective Investment Schemes shall be listed on the recognised stock exchanges.
- g) No guaranteed returns shall be provided in the scheme. Indicative returns, if assessed by the appraising agency, may be indicated in the offer document in monetary terms only.
- h) Adequate insurance covers for protection of scheme assets against loss or damage must be taken.

The offer document for the schemes must contain complete and adequate disclosures. The offer document must also specify the minimum and maximum subscription amount which is sought to be raised. The offer document should also specify the procedure with regard to allotment and refunds of moneys to the investors, listing on stock exchanges, utilisation of funds, winding up of schemes etc.

2.3.9 ACCOUNTING AND VALUATION NORMS

The Committee had suggested to SEBI to undertake inspection of the existing companies who had collected funds for Collective Investment Schemes. It was noticed that the accounting practices followed by many of these companies did not disclose the financial statements in a proper manner.

The Committee, therefore, decided to lay down the accounting / valuation norms for such Collective Investment Schemes including the disclosure requirements for such schemes. Accordingly, a sub-committee of reputed Chartered Accountants headed by Shri M.M. Chitale was constituted. The other members of the accounting committee were - Shri Ketan Dalal, Shri R. Subramanian, Shri Neeraj Golas and Shri S.C. Loonkar. The sub-committee has broadly suggested the following:-

- a) The nature of activities which can be undertaken in Collective Investment Schemes are so varied in nature that it is not considered practicable to outline norms for each type of Collective Investment Scheme separately at this stage. The Committee, therefore, recommends that a Standing Committee of Chartered Accountants be formed by SEBI to lay down accounting/ valuation norms for new type of schemes or situations that may arise in future.

- b) The basic accounting principals and the various standards and statements issued by the Institute of Chartered Accountants of India which were considered as the basis of information of accounting practices for Collective Investment Scheme were summarised in brief. These would form the basis of which the accounting practices and disclosure requirements have been laid down.
- c) The amounts collected from investors were to be shown as unit capital and no part of such amount was to be apportioned as income.
- d) In case of Collective Investment Scheme undertaking plantation activities the expenditure on crop development are to be accumulated in a separate account called Crop Development Expense account and carried forward to the subsequent years. The net realisable value of such crops at the year end was to be ascertained and disclosed and accounted for.
- e) The investments as well as the inventory was to be valued at cost or net realisable value whichever is lower.
- f) The interim returns to investors can be paid only out of the distributable surplus of the Collective Investment Scheme.
- g) The financial statements of Collective Investment Scheme were to be prepared according to the format given in the report.
- h) It is recommended that the initial issue expenses for schemes of duration of upto 8 years (instead of the earlier

10 years) shall not exceed 7% of the corpus mobilised and for schemes of duration exceeding 8 years it shall not exceed 9% of the corpus mobilised.

2.3.10. General obligations

The committee has specified certain general obligations which are required to be followed by every Collective Investment Management Company such as the following:

- a) Every CIMC must maintain proper books of accounts, records and documents. These documents should explain the transactions and disclose the financial position of the scheme at any point of time. The intention is to ensure that the true and fair position of the state of affairs of the scheme is disclosed.
- b) Every CIS shall have its annual statement of accounts audited by an auditor chosen from the list of auditors approved by SEBI. It should be ensured that the auditor of the scheme is not in any way associated with the auditor of the CIMC. The auditor shall be appointed by the trustee and shall forward its report to the trustees and such report shall form part of the Annual Report of the collective investment scheme. The auditors report (or an abridged summary thereof) shall be published through an advertisement.

- c) CIMC shall have to follow the regime of continuous disclosures on a quarterly basis.

2.3.10.1 Inspection and audit

The committee has recommended powers for SEBI to appoint one or more persons as inspecting officers to undertake the inspection of the books of accounts, records, documents and infrastructure, systems and procedures or to investigate the affairs of the trustee and collective investment management company of a collective investment scheme. This inspection can be undertaken by SEBI to ascertain necessary compliances by the CIMC / Trustees and to investigate complaints received from the investors or any other persons on any matter having a bearing on the activities of the trustee and CIMC.

2.3.10.2 Procedure for action in case of default

In the event of contravention of any of the provisions of these regulations, failure to submit any information or submission of wrong information relating to its activities or for any other matters to be specified in the regulations, SEBI may suspend a certificate granted to any CIMC / Trustees. Further the board would be empowered to cancel the certificate of registration granted to a CIMC if it is found guilty of fraud or has been convicted of an economic offense, has been guilty of repeated defaults or if its financial position deteriorates to

an extent that the Board is of the opinion that its continuance is not in the interest of the unit holders.

2.3.11.RECOMMENDATIONS FOR PROMOTING AGRO BASED COLLECTIVE INVESTMENT SCHEMES

As per the mandate given by the Government, the objective of the regulations would be to protect the interest of the investors and to ensure that legitimate investment activity in plantation and other agriculture based business is promoted.

It is expected that the regulations which have been recommended by the committee would go a long way in addressing the issues of investor protection and at the same time a framework has been created to promote genuine agro based investments to take place on commercial and industry scale. The committee feels that certain legislative and fiscal changes may be considered by the government to further encourage investments in these areas. The recommendations of the committee in this regard are:

2.3.11.1.Relaxation of land ceiling laws.

The Collective Investment Schemes mainly involve plantation activities which are carried out on large areas of agriculture land. As per the various state legislations on land holdings, there are restrictions on the aggregate holdings which a person can have.

Consequently, many of the schemes resort to practices which, while they satisfy the letter of the law, do not provide adequate and clear security to investors. In order to channelise resources towards agro plantation activities as a matter of priority, the government may like to consider exempting these activities from the purview of land ceiling acts. This would also ensure that the properties created out of these schemes are identifiable and a trust can be created in the favour of the investors. Alternatively, Government may like to declare all plantation schemes registered with SEBI as industry so that land related issues can be sorted out for better investor protection.

2.3.11.2. Clarification on Taxation Issues involving incomes earned by Collective Investment Schemes.

There has been a great deal of debate on the matters relating to treatment of Incomes earned by the investors investing in collective investment schemes and conflicting opinions have been expressed on the taxability of such income. Many of the schemes have claimed that the income would be exempt from tax under Section 10(1) of the Income tax act since it is income earned from agriculture sources. However, the individuals investing in these schemes may not be genuine agriculturists, and therefore, it would be better if appropriate clarifications in this regard are issued by the government especially since tax

exemption is an important feature guiding investment decisions of the investors in these schemes.

The committee has also observed that the Governments in Australia and New Zealand offer tax exemptions to encourage these schemes. A proportion of the amount invested by the investors in these countries is eligible for deduction from their taxable incomes.

It is recommended that in order to encourage investments in these areas, particularly, long duration plantation schemes, government may like to consider suitable tax deductions for investors investing in these schemes on similar lines as those given to infrastructure projects.

CHAPTER 3

EXISTING COLLECTIVE INVESTMENT SCHEMES AND TRANSITORY PROVISIONS

Upon being mandated to regulate collective investment schemes, SEBI had directed all the existing entities which were operating such schemes, to file information about their schemes with SEBI. In response to these directions, 643 entities filed the information with SEBI. The amount mobilised, as declared by these entities, was approximately Rs. 2,500 Crores. An analysis of the information received reveals that the top 50 entities account for approximately 80% of the total amount raised. A substantially large number (over 50%) of these entities have mobilised less than Rs. 1 Crore from the public.

The schemes which are in existence on the date of notification of the SEBI regulations would be treated as Existing Collective Investment Schemes. These schemes would have to seek registration from SEBI within a period of two months from the date of notification of these regulations. The existing schemes can continue to operate their schemes until a certificate of registration is granted to it or rejection of application is communicated. Existing Schemes, including those which may have obtained rating in compliance of the directions of SEBI dated February 24, 1998, shall not be

permitted to raise fresh funds from the investors under their existing schemes, after the date of notification of the regulations. However, till the certificate of registration is granted or the application is rejected, the CIMC shall continue to operate their schemes which shall be construed to mean management of their schemes and the obligations arising out of its management.

As per information filed with SEBI, a substantially large number of schemes are operating on a small level and it is possible that they would not be in a position to comply with the regulatory requirement and restructure their operations in accordance with these regulations. The committee, therefore, recommends that from the date of notification of the regulations, a maximum time period of three years may be given to enable the existing schemes to restructure themselves to comply with the norms of the regulations. It is also recommended that during these three years, graded norms of compliance with the various provisions of regulation may be prescribed to be complied by the existing schemes in phases.

These graded norms of compliance shall be as under:

a. At the time of making an application for registration, the CIMC of an existing scheme should have a minimum net worth of Rs. 1 Crore. The net worth shall be gradually raised

by Rs. 1 Crore each at the end of 12 months and 24 months and by Rs. 2 Crores at the end of 36 months from the date of filing of the application so as to reach the minimum net worth of Rs. 5 Crores at the end of 3 years from the date of filing of the application.

b. At the time of making an application, the CIMC shall have to satisfy the requirement with regard to adequate manpower and managerial personnel and restructure the Composition of its Board of Directors to include at least 50% independent directors.

c. Within a period of one year, the CIMC shall have to get its schemes appraised by an approved appraising agency.

d. Within a period of two years, the CIMC shall have to create a trust and appoint trustees.

e. Within a period of three years, the CIMC shall comply with the accounting and valuation norms.

f. The CIMC shall have to comply with various other requirements as may be laid down by the Board from time to time.

The CIMC of the existing schemes which comply with the initial requirements shall be given an in principle approval to continue to operate their schemes except raising fresh funds from the investors under the existing schemes. This in principle would be conditional upon the compliance with the graded norms of regulations as suggested above.

The CIMC of existing schemes which are not able to comply with the initial requirements shall not be granted in principle approval and shall be required to wind up the schemes after obtaining suitable consent of the investors. While seeking the consent, it shall be made clear to the investors that the CIMC has not obtained the in principle approval of SEBI to continue to operate the scheme and hence investors consenting to remain with the schemes would not be under the regulatory protection of the Board.

CONCLUSION:

In accordance with the press release issued by the Central Government on 18th November, 1997 the draft Report as well as the draft Regulations were made public by SEBI on December 31, 1998. After incorporating the suggestions received from the investors who have invested in such schemes as well as entities running such schemes, the Report and the Regulations have been finalised and is being submitted to SEBI.

(S.A. DAVE)

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April 5, 1999.