BACKGROUND

At present various financial investment products have varying incentive structure regulated by different financial sector regulators. There is a plethora of incentives /charges cap imposed by different regulators across financial products making the incentive structure skewed. The Government set up a Committee under the Chairmanship of Shri Sumit Bose, former Union Finance Secretary to go into this question in detail.

The terms of reference for the Committee were as follows:

1. The Committee would study the prevailing incentive structure among various financial investment products taking into account the historical evolution of such structure in India and globally and also the differential nature of the product itself,
2. The Committee would suggest policy measures such that differential regulatory norms do not favour any particular financial product and prevent mis-selling. The study would also address issues with respect to hidden costs and identical financial products under different regulatory jurisdiction'
3. Suggest measures to rationalize the incentive structure across financial products.

The said committee has submitted its report on 10th August ,2015. The government has clarified that the views and recommendations contained in the report are those of the committee and not of the government. Government will take a view of the same only after public consultation.

The government has request all stakeholders to forward their comments/suggestions that they wish to submit on the report by 5th October 2015.

The Foundation of Independent Financial Advisors,(FIFA) a pan India body of Independent Financial Advisors (IFAs) being a stakeholder gratefully acknowledges the opportunity provided by the government to submit its comments/suggestions.

The Foundation has been invited earlier by the Ministry of Finance in 2013 to discuss the steps needed to be taken to re-energise the Mutual Fund Industry. We had submitted our submissions in writing to Ministry of Finance in 2013.

The Foundation has joined hands with a number of other local/regional associations of IFAs to form an United Forum to represent IFAs across the country and submitted their consolidated feedback.

We give below our comments on the measures recommended by the committee for curbing mis-selling and rationalizing distribution incentives in financial products.

Overview

At the outset, we would like to congratulate the Committee in studying the market for household savings, focusing on the retail financial products namely Mutual Funds, Insurance and Pensions, the distribution of financial products, the different commission structures, the policy responses so far, the regulatory arbitrage, the policy choices and finally its recommendations.

Before we go into the comments on the report we would like to humbly submit that:

1) As the committee was set up to suggest measures to rationalize incentive structure across financial products representatives from the product providers/ distributors should have been included in the committee as they could have provided valuable inputs on the likely impact of the proposed measures .

2) The financial distribution industry is made up of 3 distinct segments namely Banks, Brokers and IFAs (Independent Financial Advisor/Agent). IFAs channelize more than 35% of the retail saving in Mutual Funds, maybe more than banks and brokers especially in the retail segment and smaller towns. Their business model is very different from banks. The committee would have benefited from consultations with representatives of an IFA body.

We thank the government, for inviting comments from all stakeholders and request that views of the product providers/distributors and especially of IFAs are considered before finalizing its views.

The business model and sales processes adopted by each channel is very different and we therefore recommend that government should prescribe regulations separately for each channel. The growth of the individual IFA across the length and breadth of the country will be the most cost effective method to spread financial literacy and providing awareness and access to financial products. The committee's recommendation does not take note of the different distribution channels and we request the government to consider the same and prescribe segment wise regulations.

We agree with the need to remove any regulatory arbitrage and support the IFC recommendation of a Unified Financial Sector Regulator. The Report covers three areas of Financial Distribution viz. NPS, Insurance and Mutual Funds (MF) and the consumer needs of risk coverage, investments and income replacement. Currently we have 3 separate regulators, with separate product providers and distributors. Thus restricting one provider/distributor providing holistic advise to a consumer on all his financial needs. The consumer should have the choice of getting all his needs fulfilled by one distributor and thus we support the need for a common distributor licensing. We believe that the government should establish a Unified Regulator first and then entrust that body to forms regulations which would remove the regulatory arbitrage rather than attempting to do so under different regulators.

It would lead to Product Providers / distributors being able to offer products suitable to the consumer need across risk coverage, investment and income replacement and the ability for stronger regulatory oversight. This would also lead to consumers suitable products across his various needs and level playing field across various products. We suggest that government first sets up a Unified Regulator.

Our biggest concern is that the committee's recommendation is based on a belief of widespread mis-selling across various financial products. We vehemently oppose this belief and have addressed it in a separate section Mis-selling Fallacies in this feedback. Unfortunately it seems that the committee has proceeded with the sole objective of preventing mis-selling (pg.21). Despite noting the reduction in the number of MF distributors, the economics of a distributor has not even been mentioned let alone analyzed. Nonetheless, the measures proposed must keep the viability of the distributor in mind. Besides, as the report itself notes, they must not be so tight as to stifle innovation, or too micro to affect operational flexibility. We believe there is a need for a more Balanced view which is discussed subsequently.

We believe the more appropriate framework for developing an incentive structure involves:

(a) First enunciate the industry wide goals and objectives

(b) Align the incentive structures of the distributors/agents with these goals

(c) Ask Product providers to review their remuneration arrangements to ensure that they support

    a. good-quality outcomes for consumers and

    b. better manage the conflicts of interest within those arrangements.

    c. support good-quality advice that prioritises the needs of the client;

(d) Review their business models to provide incentives for providing suitable advice;

(e) Review the training and competency of distributors and

(f) Increase the monitoring and supervision of distributors/agents for compliance.

The adoption of the above approach is would lead to a new paradigm appropriate for the possible explosive growth of household savings into financial products, eliminate the likelihood of systematic mis-selling and lead to favourable outcomes for the consumer.

The new paradigm would be based on Customer Centricity, Onus on Manufacturer and Rating of Distributors.

We have created such a framework for the Mutual Fund Industry on the above lines and are attaching the same herewith.

The committee seems to favour the adoption of a seller –beware market as proposed in the Indian Financial Code. We would like to point out our apprehension to the same and would suggest the need for a balance between Buyer Beware and Seller Beware approaches. Research on Behavioral Finance has shown that consumers decisions are significantly affected by greed and fear, leading them to make wrong/ inappropriate decisions. Hence the move for regulations to move to a seller - beware market will be dangerous in India's context. We would urge that the consumers must be made responsible for their decisions along with responsible sales by distributors; a skewed structure will kill the intermediation industry.

Need for a Balanced Approach

We concur with the Committee's observation that "One of the biggest challenges in the Indian context has been the weaning of the Household from real asset such as gold and real estate , both of which are used as insurance and investment vehicle towards formal sector finance." (Page 9). In 2012-13 real assets accounted for more than two-thirds of household savings (pg.20). Low penetration of financial savings continues in spite of the opening up of the economy in the 90s more than 3 decades ago.

We would urge the government to seriously examine whether a tight regulatory regime especially compared to regulations for non-financial sectors such as gold and real estate has constrained the deepening of the financial markets in the economy.

Financial assets may be categorized into two sets of products : pull products and push products. Pull products have been long available, are well understood and widely distributed. Their incremental potential to rise to the challenge would therefore be limited. In contrast, push products, especially mutual funds and pension are nascent.

The report states that only 3.4% of the gross financial savings were invested with mutual funds (pg.20). These products, therefore, have the highest potential to achieve the above objective.

The report further states that financial products are still sold than bought, and distributors play an important role (pg.25). It reiterates this by stating that agents play an important role in educating the customer about modern finance and financial products (pg.42).

Given the importance of agents / distributors a rise in their numbers is vital.

However, the reality has been the reverse. At the current stage of Indian market, we have seen a dramatic fall in the number of agents in the Life Insurance as well as the MF industry – as a fallout of the reduction in commission payouts in Mutual Fund and Insurance Industry. The number of MF distributors has, infact, declined from 92,500 in March 2010 to 40,000 in March 2014 (pg.20).

Instead of being a worthwhile vocation, for them, it has turned out to be unviable.

A further reduction is quite possible if a Seller beware approach is adopted - leading a drastic fall in the reach of financial product to households across the country and continued low penetration of financial products. It must be recognized that financial viability of agents / distributors is vital for meeting the above challenge.

The policy on distributor incentives, therefore, cannot proceed from a single objective of preventing mis-selling. It must be designed with twin criteria in mind – preventing mis-selling and ensuring the financial viability of the distributor.

The recommendations of the committee must be viewed against this fundamental shortcoming.

Fallacies on Mis-Selling :

Undoubtedly consumer protection in finance has taken centre stage post the 2008 global financial crisis. However the committee attributes the global financial crisis " was essentially a MIS-selling episode at a massive scale ." We would like to humbly differ.

A number of causes have been identified for the global financial crisis. Dr Raghuram Rajan, currently Governor, Reserve Bank of India, in his book "Fault Lines" shows how the individual choices - made by bankers , government officials and ordinary homeowners - that collectively brought about the economic meltdown. In fact to quote from his book "One set of fault lines stems from domestic political stresses especially in United States . The second set of fault lines emanates from the trade imbalances between countries stemming from prior patterns of growth. The final set of fault lines develops when different types of financial systems come into contact to finance the trade imbalances....”. He further states "We should resist the temptation to round up the most proximate suspects and pin blame on them".
Credit rating agencies have also been blamed for the role they played.

We would also very strongly like to rebut the committee’s observation that "The overwhelming evidence from the household finance points towards agents maximising their own income at the cost of selling unsuitable products to households"

No source or empirical evidence has been quoted for this statement.

Out of over 1 lakh distributors : (Source- http://tinyurl.com/nmtnutl)
Only 19 have been suspended and Only 12 have been terminated (as per AMFI data)

We believe the overwhelming majority of agents are focused on providing the appropriate product / solution for household and ensuring favourable outcomes.

In India we believe there is a tendency to blame all ills related to the financial savings industry to the distributor/agent and to Mis-selling.

The report contains a number of other fallacies and false impressions on mis-selling.

Para 1.2 states that “agents are remunerated directly by the product provider and this could often lead them to represent the interest of the product provider.”

Para 2.1 states, “This means that agents do not have to focus on serving the customer, but on meeting volume based targets. In the olden days, the agent may have lost her reputation, but in this new world order, the agent does not have much to lose if the trust with the customer gets broken.”

It further states, “The customer also does not pay the distributor directly, the distributor therefore has no incentive to service the customer. The distributor’s incentive is to maximize her income by selling the product that provides the highest commission regardless of whether it is in the interest of the customer.”

The above fallacies are apparent.

The reality before the distributor is simple : the producer will pay provided there is a customer who buys. A customer will buy provided he trusts the distributor.

For a distributor, a satisfied customer not a satisfied producer is the key to sustainable business.

The report presents evidence of its own fallacies. On pg.19 it states that in the case of mutual funds "the direct channel now accounts for more than 30 percent of the AUM." Surely, if mis-selling were the norm the reverse should have been the case. It further adds, "However, it (direct channel) seems to be more popular with corporate and institutional clients, than with retail investors who still seem to prefer to invest through distributors." The continued reliance of the retail investor on the distributor is a mark of the level of trust and satisfaction that he has in the distributor.

The report, thus, presumes mis-selling and ignores the contrary evidence it itself contains.

Not only are there false presumptions but also false deductions – convenient inferences.

In para 1.3 it talks about the low percentage of household savings in the MF, insurance and provident and pension funds. To explain it states, "Low access to finance cannot have one simple answer. And yet, one factor that can potentially explain the reluctance of households to engage in the financial markets is low trust."

It conveniently ignores the regulatory hindrances to invest in these product compared to investing in gold/real estate namely the KYC requirements; compulsory investment in Cheque (versus Cash) ; requirement of PAN card , caps on investment, restrictions on withdrawals, etc . Additionally the low levels of financial literacy also have limited the penetration of these products. We would therefore like to humbly submit that blaming low penetration on lack of trust is inappropriate.

The fact that established distributors have long standing clients indicates high levels of client satisfaction and trust. In Mutual Funds the fact that Institutional investors accounted for 51.5% of MF AUM (pg.16) but only 30% of MF AUM was invested through the direct channel (pg.19) clearly shows that even sophisticated investors trust distributors and believe that distributors add value. The report itself adds that retail investors still seem to prefer to invest through distributors clearly indicating the trust they have in distributors.

The report refers to consumer surveys and anecdotal "evidence" of mis-selling.

Anecdotal "evidence" lacks scientific rigor and cannot be the basis for policy making. It may also be mentioned that the results of consumer surveys on the subject always refer to perceived mis-selling rather than actual mis-selling. Consumers have a tendency to perceive an honest sale to be mis-selling if the outcome is adverse. **The government/regulators need to study independently the extent of mis-selling in India which could than form the basis of the need for making any changes**.

Measures Already in Place :

Prior to the committee's report a number of measures with a view to prevent mis-selling in MFs were already in place :

a. Ban on entry loads
b. Introduction of the Direct Channel
c. Restriction of upfront commission to 1%
d. Clawback mechanism for upfront
e. Agent – advisor differentiation.

Also in Insurance industry changes in ULIP commissions / structures were put in place.

The "evidence" of mis-selling in respect MFs/ULIPs in the report is of the period before these measures were put in place. No "evidence" of mis-selling post the introduction of these steps has been presented in the report. This raises the fundamental question whether any changes in incentive structure for MFs/ULIPs are warranted today.

More importantly another inbuilt check is competition amongst agents and entry of new players.

We concur with the committee's view that " In a competitive environment the agents who recommend better products would get more customers, and the market would weed out those who are either not able to provide good advice or willfully provide bad advice. Even though market forces would replace community ties, competition would ensure that good behavior will prevail." (Page 25)

But we strongly disagree with its view "The logic begins to fail when the customer is ignorant about financial products and does not see the outcome for many years to give feedback .' In fact in case of Mutual funds/ULIPs the outcome is available on a daily basis. The customer's ignorance about financial products in fact reinforces the view that in case of an adverse outcome; an honest sale maybe perceived as Mis-selling.

In the report the committee views low persistency of Insurance policies in India as a manifestation of unsuitable products sold to customers. (Page 35).

Whereas the report itself lists the following factors causing low persistency :

1. Income Disruption for various reasons including failure of monsoon
2. Intermittent Incomes which impact persistency
3. Mis-selling and Poor service by agents
4. Rural Mandates
5. High rates of inflation

There are thus multiple factors which result in low persistency. Before taking any policy action a detailed study needs to be carried out to determine the extent to which Mis-selling causes low persistency

Comments on Costs and Benefits and Alignment of Interests

It observes that "Modern financial products should be such that costs and benefits are clearly visible to the buyer. Costs should sit in one place under a common head and that cost head must have a regulatory cap. Within that the firms to manage costs and profits." (Page 10)

We would like to point out that benefits which depend on investment performance in the future cannot be quantified exactly and can only be probabilistic and thus need to specify likely outcomes.

We also suggest that it is not that important that costs sit in one place, as long as the total cost of the product is quantified and has a regulatory cap. We agree that within the cap the firm should be free to manage the cost and profits.

The committee observes that one way to reduce the regulatory cost and the potential of Mis-selling by ensuring clean product structures, clear benchmarks, and by aligning incentives of the manufacturer, seller and buyer to the outcomes that householders derive from the purchase of the financial product.

Alignment of interests should begin with aligning interest of Manufacturer and Consumer and then put onus on Manufacturer to see that the distributors/agents incentive are aligned to the same.

In Mutual Funds the manufacturer earns based on AUM whereas consumer wants either an absolute return or return above benchmark. In Mutual funds can manufacturer / seller be paid only when consumer earns a return or a return higher than benchmark? To align interest an incentive could be paid to Manufacturer/Seller in term of higher costs he can charge consumer if he beats the benchmark. In Insurance, can incentives be paid, when consumer dies and nominee receives benefit? In Pension can manufacture and seller be paid only when annuity start? Clearly a complete alignment is not possible in the real world but incentives to product providers can be structured so that it leads to favourable outcomes for the consumer. Market economics teach that consumer is king, only by providing value to the customer will one have a sustainable earning model.

Consumer needs of Risk Coverage, Investment, Income Replacement are varied and he needs to have a choice of doing it through individual products separately or via combination product. As the needs and benefits vary having uniform structures would be difficult.

Distributors' efforts to acquire and retain customers will vary depending on whether it is an insurance, mutual fund or pension product.

Efforts and costs would be higher in in some geographies – Rural mandates in Insurance and case of B15 areas in Mutual Funds

Insurance contracts being long term ensure stability of the incentive structure. In insurance products, the incentive structure fixed at the time of taking the policy does not change over the period of the policy. However in case of mutual fund products, being open ended the incentive structure is subjected more frequent changes.

Appropriateness/Rationale of Commission

The appropriateness of the commission to be paid for distributing financial products should be judged keeping in mind the differences between push and pull products in terms of the following :

Education and Qualification requirement of the Agent
Effort required to sell and service
Cost of infrastructure and support systems required
Value Added to Client

It is evident that push products (Insurance / Mutual Funds/Annuities) require better quality trained agents, who need to put in greater effort supported by better infrastructure and systems. These products provide higher value add compared to traditional pull products.

The efforts required for insurance, mutual fund and pension products are different the incentive structures may be rationalized but there cannot be a case of "one size fits all

The commission structure should be such that it provides an attractive career opportunity to draw and retain a large army of well qualified professionals. Thus care should be taken that the measures taken to curb mis-selling and rationalize incentives do not impact the viability and attractiveness of distributing financial products.

Upfront versus Trail

Commission on mobilisation of financial savings can broadly be divided in 2 categories

1) Upfront : commission paid immediately when the product is sold
2) Trail : commission is paid regularly over the term of product

An upfront commission is paid for customer acquisition and making the sale of a product.

A trail commission is paid for retaining the consumer and for maintaining and servicing his account.

The sale of financial product, involves education of the customer understanding his needs and then suggesting the appropriate solution / product. The longer the time horizon needed to meet the client need and or objectives, greater is the effort required to make the sale. Customers need more information and time for making a long term commitment.

It was natural and logical that for insurance contracts typically covering a term of 20 years, that a large component of commission was paid in the first year as the acquisition cost would be much higher and maintenance cost much lower. Also the risk covered could happen technically immediately after the policy was taken, the insured would get benefit but the agent would net get any compensation if it was a trail model.

For liquid funds where the funds could stay just for a day it had to be a trail model. And the logic could be extended to open ended funds.

An entry load (in MFs) and Allocation charge (in Insurance) allowed segregation of the acquisition cost from the recurring charge and payment of upfront commission and trail commission.

In the US till 1980 even in case of MF sales, upfront commission of 5% - 6% were paid on sales and even today there is no ban on upfront commissions .

To develop it is necessary that a fair compensation structure be developed keeping in mind the large no of distributors who follow best practices rather than the few who mis-sell.

We therefore believe that instead of banning upfront commissions the emphasis should be on making the right sale. We should give consumers to choose between alternative cost structures for example i.e allowing consumers to choose between : high upfront, low recurring cost or low upfront, high recurring costs.

The consumer will choose based on his perspective. For example a consumer who is confident of the product performance might prefer a higher upfront cost whereas one who is not will prefer to pay over-time rather than upfront even though it may cost more.

Evaluation of total cost of the product over the life of product is more important than whether is upfront or trail.

In case there are there are cap on total costs the consumer could be indifferent to how the distributor is paid upfront or trail as long as her cost does not change.

The product provider would like to choose to make upfront based on the length of time over which the product is going to generate revenue to him and the continuous servicing the agent needs to provide.

We believe that if multiple models are allowed the market forces; Consumer, Manufacturer and Agent; will arrive at an optimal solution that will be a win-win for all.

While a large upfront commission does galvanise sales efforts there is apprehension of it leading to mis-selling. We suggest that the emphasis should be whether it can galvanise the right sales effort. The regulators and industry should define what is mis-selling or rather what is right selling. This would require regulator/industry establish standards which indicate that right selling is done.

For example in case of Insurance:

Persistency: The level of persistency could indicate whether customers are satisfied with the product, and the right sales are happening then the desired levels of persistency need to be defined.

Level of Sum Assured: Whether consumer is sold the desirable level based on his medical and financial underwriting.If so the levels would have to be defined.

For example in Mutual Funds :

Holding Period: For retail products the longer the holding period better is the investor outcome . If so standards for desirable holding period could be set.

Penentration : If penetrations of financial products has to grow than goals need to be set on an yearly basis

A higher cost structure should be allowed based on meeting the standards, this will encourage manufactures to train agents to sell right and lead to better customer experience.

It will lead manufacturers to spend more on training agents with a view to get better outcomes.

Similarly incentives could be provided on achieving investment performance over benchmark this will ensure that maturity values meet the customer need over the long term

We believe incentives for right selling are more important than the penalties for mis-selling

We believe a combination of upfront and trail commissions are fair, logical and reasonable for the efforts that go into making the right sale. At the current levels of penetration their can hardly be systematic risks of mis-selling.

In the recent past we have seen abolition of entry load in MFs and reduction of commission in ULIP plans has led to a significant decline in the sales of these products.

This was accompanied by large flows into gold and real estate – completely unregulated and unproductive. The country and the households are paying a huge cost for the same. For the country huge drain of foreign currency (gold) and investment in non-productive assets (real estate). For households loss of financial stability on account of opportunity loss because of lower returns. Also the huge cost to society and dependents in case of death of an uninsured bread winner.

Has the abolition of upfront led the customer making right choices ? Clearly not – the diversion from financial assets to non-productive assets will cause a lot of misallocation of assets by households and small retail investors and who will be responsible for this.

Reduction in commissions while penalising the minority which mis-sell has turned people away from the profession of providing financial solutions in the right way, leading to concentration amongst the handful of practitioners leading to reduced access to the small retail investor who then turns to gold.

After a number of years of negative sales of equity funds by domestic mutual funds the markets have witnessed a return of positive sales in 2014 and 2015. We believed this was energised by the change in sentiment and the launch of a number of longer term product (Close ended for 3 - 5 years) versus the existing open ended schemes – leading lot of marketing efforts - along with manufactures providing incentives in advance knowing the money is coming for a defined period. Distributors who pushed these products to their customers at the appropriate time deserve a lot of credit as their customers have benefitted immensely.

As the nature of products – open ended and close ended are different, meeting different customer objectives, we should not be prescribing similar incentive structure. Flexibility in pricing of products is most important. Focus has mostly been on mis-selling by the agent whereas the focus should be on how to stop wrong buying by the customer as most of the time he is swayed fear and greed.

We therefore believe that enunciation of industry wide goals and benchmark need to be elucidated and adopted by firms and incentives linked to the achievement of the parameters. Structure should be such that all stakeholders benefit. Incentive structures should be linked to the longevity of the investments. See note in Annexure A

Accompanied by continuous training of distributors and setting up of self regulatory bodies

Comments on Specific Reccommendations related to Mutual Funds :
Product structure

1. The benchmarks should be made more relevant than they are today. Schemes should be periodically tested to see if the asset allocation is conforming to the benchmarks chosen.

We believe that relevant benchmarks are being used. We agree schemes should be periodically tested to check the relevance of the benchmark.

2. Similar schemes from the same fund house should be removed. Some of these were launched in the NFO boom to harvest the 6 per cent marketing cost. Such duplicate funds should be merged with others in the same fund house since they confuse investors.

Similar is an ambiguous term. A mutual fund may have two diversified equity funds with different investment strategy and philosophy. Considering that investment strategies and philosophies affect the performance of a fund over different time periods, mere name or investment objective cannot differentiate between different schemes. It should be left to the respective fund houses to take a call on this.

3. The regulator should ensure that the mutual funds are true to label. This means that the investment mandate in the information memorandum should be reflected in the active portfolio of the fund.

There is a need to explore the possibility of entities like Crisil, Value Research and Morning Star doing this

4. The regulator should consider measures to encourage retail participation in ETFs.
We don't believe regulator should be promoting any asset class/category

5. The regulator should put in place a free look policy and define the period for which it will hold.

A free look policy is not a good idea for an investment product. Investors, knowing that they can get out of the scheme, will take the investment process lightly. They need to be encouraged to do their homework well before investing in a product. The purpose of a free-look or trial period for mutual fund investments appears unclear. Most mutual funds are open-ended products that allow investors to exit any time unlike many insurance products where investors are locked in for longer periods.

Allowing investors to wait for a couple of weeks before confirming their investment may cause them to base their decision on short-term market fluctuations and prompt them to 'time' the markets. Besides, it may be misused by investors if there is a fall in the market immediately after making an investment.

On the process side too, the free-look period can throw up a number of problems. Units are allotted based on daily NAVs. So one question is on the NAV that should be taken to allot units. Investors may demand the NAV that prevailed when they first invested, before the free-look period, especially if the NAV rises. Another question pertains to where the investor's money will be invested during the free-look period.

Costs and commissions

1.The cost caps within a overall TER should not be fungible.

We believe that cap on total costs be set and within that manufacturer should manage costs and profits.

2. Upfronting of commissions should be totally removed. There is a current cap of 1 per cent that comes from the fund house capital or profits. This too should be removed.

While abolishing the upfront commission can be a populist measure, removing it altogether will serious affect the efforts to expand the base of the industry. Acquiring new clients, especially considering a low conversion rate on account of poor perception of mutual funds and aversion of investors to invest in market linked products, remains an expansive proposition. The service tax has already dented the margins. It needs to be realized that for distributors of mutual funds, it is not a mere acquisition of clients but about changing the mindset of investors who for long have got used to investing in guaranteed return products.

3. Distribution commissions should only be paid as level or reducing AUM based trail. In the case of lumpsum investment, or upon termination of a systematic investment plan, the trail commission should be declining (or nil after a specified period of time).

Once the investments are suggested in a particular scheme, they need to be continuously monitored for their effectiveness, performance and suitability of the client. Reducing Aum based trail may fail to motivate the distributor to put in the required time and effort for such analysis. This could certainly encourage churning of portfolio as well. Considering that a large number of investors have the tendency to redeem once they see healthy profits in equity or equity oriented funds, it requires a serious effort on the part of advisors to convince them to remain invested and maintain continuity. Besides, during the prolonged periods of market downturn (like 2008 to 2010) the trail commission gets reduced considerably. While investors get an opportunity to recoup the losses and eventually earn profits by remaining invested, for distributors it is a permanent loss. Hence, it is only fair that distributors get trail commission throughout the period during which an investor remains invested. “If the adviser is only remunerated for the initial few years and deprived of trail commission, as is proposed in the committee report, she has no incentive to make the investors stay in the fund for a long term, which is very much against the tenets of sound investing.”

4. The extra commission in B15 should be removed and a level playing field be created in the country. Manufacturers and distributors should on their own tap such unexplored markets to increase their sales and market share.

While extra incentives for achieving Industry goals one will have to explore whether burden should fall on the T-15 investors or a different mechanism is reuired.

5. No category of mutual funds should be exempt from the zero upfront (when it is put in place).

There should be flexibility. Products like ELSS and retirement funds will suffer in the absence of any upfront commission. If the committee feels that upfront commission should continue for pure risk products as it is very difficult to sell them, selling long-term equity based products is as, if not more, difficult.

6. Distributors should not be paid advance commissions by dipping into future expenses, their own profit or capital.

For the growth of the industry on a sustainable basis, it is necessary to allow mutual funds to do, if they so desire especially dipping into their capital but should be linked to achieving set goals as explained in our note in Annexure A

7. Competition has not reduced costs much below the expense ratio that was fixed when the AUM of the industry was much lower. The regulator should lower thecost caps as the AUM rises over time.

Competition has significantly reduced the cost of debt funds which are substantially lower than maximum TER prescribed by regulations. They account for about 60% of the total Industry AUM. So no need for regulator to lower cost caps. It is matter of scale and size

1) While the regulation is made, the regulator must see each distributor community with different lenses (Banks, NDs and IFAs) and have rules relevant to each segment, knowing the past trends.. One regulation for all category will be unfounded!!!

<u>Comments on Some other Recommendations :</u>

One page Distributor-Investor Form:
In disclosures, the committee has recommended getting a proposal form signed by the client to ensure that he/she has all the information and that a well-informed decision is taken by even mentioning the current asset allocation, time horizon, TER etc. A number of details might not be available with the distributor at the point of sale , as it is dependant on Manufacturer and Client. It will not be practical to have one more form. This to our mind is another sign of excessive regulation making investing in financial products cumbersome for the consumer as against buying gold. Again the focus is on mis-selling and not right selling.

Further in case of advice from a SEBI registered RIA, risk profiling is already mandatory and so requirement to match product suitability with the risk profile. These forms would only add to the paper work and a duplication in such cases. There are multiple documents which a client signs like an SLA, KYC over and above the forms for investment. An asset allocation is decided based on overall risk profile and the financial /investment plan of a client

At a time when the mutual fund industry is trying to minimise/move away from paper work, this proposed form is a step back from the paperless objective. Signing a one-page disclosure at every point of sale is more likely to exacerbate inconveniences for investors by increasing the amount of paperwork they have to deal with. As it is, investors already deal with extensive KYC requirements, which need to be updated from time to time. Also, investors invest several times, in several funds over the years and making them sign disclosures at each time will be cumbersome and can well put them off mutual fund investing altogether.

Such a process will be considered regressive, especially in online platforms that have come a long way to free investors from paper work.

Trail commission disclosure:

We suggest that the Manufactures be asked to disclose the total cap costs on website and the incentive structures segmentwise (Banks, Brokers and IFAs separately) rather than at the time of each sale. Such disclosure should be across all products.

Declarations of commissions at the time of sale will leads to consumer asking for rebate of commission . Regulations should be passed that forbid consumers from asking and receiving such rebates and strict penalties prescribed for the same Concrete steps on how such a practice would be identified should be laid down. Penalties too to be well defined. Awareness to be built through product brochures to ensure that clients are informed about this practice that could be detrimental to their interest.

Upfront for pure risk:

In our experience, helping an investor understand the role and important of equity and debt funds in their long-term wealth-building portfolio is not a simple task. This is made more challenging, in the midst of investors being influenced by immediate market movements, tax breaks, and news being discussed on various forums and in the media. herefore, in our experience, selling mutual funds is not easier than pure-risk products (insurance products).

Just like selling of pure risk products is not easy, clients do not easily get convinced about retirement solutions until a particular age, given the long term nature of the goal. The incentives to distributors should be encouraging enough on such products including NPS.

In such a scenario, we do not see why upfront commissions are allowed for these pure-risk products stating difficulty in selling them. Pure-risk products are also long-term in nature and require investors to stick with the product, just as most classes of mutual funds are. If any, pure risk products, coming as they do, with tax benefits and an emotional trigger tagged to it, can only be easier to sell than long-term market-linked wealth building products like mutual funds.

Segmentationwise Regulations

While the regulation is made, the regulator must see each distributor community with different lenses (Banks, NDs and IFAs) and have rules relevant to each segment, knowing the past trends.. One regulation for all category will be unfounded!!!

Other Points

There is a need for regulations to clearly define mis-selling.

As in any industry/profession you will have a small minority cases of MIS-selling and " the regulators should be able to catch the errant driver jumping the red signal"

The purpose of this report is to prevent mis-selling. As mentioned earlier, instances of 'mis-selling' in MFs referred to by the report have been before various measures were instituted. As such there is no evidence to warrant additional measures.

The principle of proportionality must be also be borne in mind. Thus a minor positive for one criterion should not be at the cost of a major negative for another.

The prevailing upfront in Mutual Funds is a constrained commission - within the TER, capped at 1% and subject to clawback. In its present form it is unlikely to cause mis-selling. An upfront is a fair reward for the time, effort and cost involved in any sale. Further, it enables upcoming distributors with low AUM to meet their running expenses. It must, therefore, be continued.

The other recommendations are either derived from the above or are too micro in nature and must be eschewed.

Advisor Plan: The ministry should consider an “advisor” plan open for RIA’s which has a lower cost structure. This will allow the RIA to price his fees based on value addition and encourage fee for advice. Commissions which could lead to mis-selling will thus be avoided.

Data sharing : Bank customers are the vulnerable lot here since their bank balances are bound to be known to the banks’ distribution division. Norms could be specified to avoid sharing of such data.

Insurance Distribution: The concept of one distributor selling only for one insurance company could be removed as this would enable a client in getting the best suited insurance product.

Other beneficial measures.

Disclosure of returns on the amount invested rather than any other parameter as well as the IRR, similarity in treatment of service tax, stamp duty, etc would make the products simpler to understand.

The checks should be stronger for vulnerable categories such as senior citizens. The product providers should add a second layer of in-house approval before a sale is concluded for such customers. The product providers should be required to provide details of the same to their regulator on a periodic basis. This is clearly defined and would certainly help reduce mis-selling.

Impact on IFAs

All the IFA associations are extremely appreciative of the Government's Policy of bringing in Investor Friendly Policies for the benefit of the Common Man. All IFAs are committed to this cause. Our fear is that the recommendations of the report, should not reduce the already small incentives, that IFAs earn out of selling of Mutual Fund Schemes. With effect from this year they have already been burdened with service tax @14% on their gross commissions which is deducted at source and are not being allowed to pass it on the receiver of the service.

With a poor 4-6 % penetration of any investors investable surplus, there is a long way to go for achieving more penetration and a bigger wallet share. More the Indian Investor invests in to India, the more the Indian Stock Markets will become Stronger and Lesser Dependent on FII Investments. Continuous lowering of the incentives has already caused many IFAs from discontinuing in this noble profession of Nation Building. We sincerely trust and hope that we IFAs will be given a fair opportunity to make a living, as also serve more and more investors. More importantly, the next generation will also have the thought of serving the nation and becoming a part of this Noble Profession if the long term vision is clear and properly incentivised enough