

Proposal on Variable Entry Load

Mutual funds are sold to investors through entities variously known as distributors / agents / brokers (referred to as 'distributors' hereafter). These distributors perform two functions. They act as agents of the Asset Management Companies (AMCs) in helping them sell their schemes. They also act as advisors to investors in helping the investors choose a scheme suited to their needs.

The distributors are compensated for their services in two ways. A fixed charge is deducted from the investor's subscription by the AMC (known as entry load) and is paid to the distributor. In equity schemes this is generally around 2.25% of the subscription. In addition, the AMC is free to pay the distributors amounts considered appropriate by them.

The practice of deducting a certain percentage from the investors' subscription has led to a criticism on one hand by the investors that they have no control over what they pay for the advice rendered to them. On the other hand, while, SEBI circular prohibits sharing of the distributor's commission with the investors, complaints regarding such practices are voiced without any evidence being available.

As a partial solution to this problem, SEBI mandated a zero entry load, in cases where investors apply directly for the schemes of mutual funds with effect from January 4, 2008. This has received a moderately good response with about 4%-5% mutual fund applications being made in this mode.

However, investors making investments other than through the direct mode are still not able to exercise control over the commission paid to the distributor as the charge (load) is levied by the AMC and collected by the distributor from the AMC. Additionally, the entry load which is utilized towards meeting the distributor commission is linked to the size of the investment and has no correlation to the service provided by the distributor.

We have received suggestions from various stakeholders that the commission paid to the distributor should be determined by the investor in consultation with the distributor depending on the service provided by the distributor i.e. to have a variable

entry load structure. Variable load structure would also bring in greater transparency with regard to the commission paid to the distributor/agent/broker.

The Advisory Committee of Mutual Funds deliberated on the issue and the following options emerged for consideration to operationalise the issue of implementing variable entry loads:

- a) **Separate section in the application form:** Within the application form itself, there could be a section where the investor could indicate the commission payable to the distributor which would be signed off jointly by the investor and the distributor. The AMC would then deduct the amount payable and pay the distributor.
- b) **Separate cheque issued by the investor towards commission:** In this mode the investor issues two cheques – one for his investment in the name of the scheme and the second one in the favour of distributor towards the commission agreed to be paid.

In both the above options, the process for making the investment application remains the same except for the entry load being decided in terms of the agreement between the investor and the distributor. However, the mode of payment of the commission differs. In option (a) the investor would indicate the commission payable in the application form and the AMC would pay the commission payable to the distributor from the amount received from the investor, whereas in option (b) the investor would be directly paying the distributor.

The downside of option (a) above could be that some complaints may come up between what the investor has indicated and what the distributor has agreed to. The probability of such a scenario would arise due to an oversight by either parties (investor and distributor) while filling up the form or due to any differences that may arise between them post the investment process.

In option (b) there is an element of inconvenience to the investor who has to write separate cheques every time he invests through a distributor. Concerns of the distributors regarding non receipt of payment from the investor have been expressed by some quarters.

As regards the payments made by AMCs to the distributors for the services rendered to the AMC, investors have raised issues regarding transparency. The question raised relates to varied commissions available on different schemes and by different AMCs. Due to such variations, the question arises as to whether the advice rendered is in the interest of the investor or whether it is influenced by the quantum of commissions. It has, therefore, been suggested that it should be mandatory for distributors to disclose the commission being paid to them for the different schemes which are being recommended to the investor. Transparency in this area will work to the benefit of the investors.

Comments / suggestions are invited on the best option for implementing the variable entry load structure as well as the issue of mandatory disclosure of commissions. Comments/suggestions may be emailed to mfcomments@sebi.gov.in or sent to the address mentioned below **before March 6, 2009** with the subject line indicating "Comments on Proposal on Variable Entry Load"

Investment Management Department – DoF2,
Securities and Exchange Board of India,
SEBI Bhavan, Plot No. C-4A, G Block,
Bandra Kurla Complex, Bandra (E),
Mumbai – 400051
