REPORT OF THE
COMMITTEE ON
COLLECTIVE
INVESTMENT
SCHEMES
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
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.

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.

1.2.2 Distribution Channels

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.

Industry representatives, the yields projected by the Gangopadhyya 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.

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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 in fact 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
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;

(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.
(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. APPOINTEMENT 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
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:

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) 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.
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
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.

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.
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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MUMBAI  April 5, 1999.
A note of dissent to the Report of the Dave Committee on "Collective Investment Schemes" by a Member of the Committee, Prof. Manubhai Shah, Managing Trustee, Consumer Education & Research Centre, Ahmedabad.

I have signed the report dated 5th April 1999, with which I am largely in agreement except the note of dissent as follows:

With due respect for Chairman, Dr. Dave and other members of the Committee, I am of the opinion that the purposes of development of increasing green cover in the country with the help of the private sector on commercial lines and also protecting interest of individual investors shall not be served by implementing the recommendations contained in the report unless and until the following measures are taken by the Government and/or SEBI for the rationale also spelled out in support thereof:

(1) The report makes a reference to Gangopadhyay Committee Recommendations and also the rating to be carried out by Rating Agencies for entitling CIMCs for mobilisation of deposits under the Collective Investment Schemes.

Credit Rating Agency obviously needs some bench mark in the context of which they can assess value and rate the Collective Investment Schemes.

So far as the Plantation Schemes are concerned, particularly Teakwood, there is a published report of the Ministry of Environment and Forests, Government of India, popularly known as "Gangopadhyay Committee Report".
Our Committee had occasion to look at and discuss the findings and recommendations of the said Report.

Some of the findings and recommendations were discussed with the experts of Sterling Magnum Tree Company when a number of Members of the Committee visited their plantation sites at and around Coimbatore.

Uneasy feelings were expressed by those experts on the Gangopadhyaya Committee’s findings on commercial viability and maturity period for adequate return on Teakwood Plantations. Their uneasy feelings on the findings were on the ground that they were largely influenced and arrived at by their experience of developmental approach followed by Governments, Central and State, and not on the commercial approach.

In any case it is true that unlike functioning of many other Committees, this report has not been finalised and published after adequate public participation and debate taking into account different points of view and more particularly modern agricultural techniques and inputs which may shorten the maturity period, and may lead to healthy and taller growth and larger yield.

It is difficult for non-technical members of the Committee and more so a person like me to evaluate the validity or otherwise the findings of Gangopadhyay Committee. In all fairness I suggest that Dave Committee should recommend to SEBI and SEBI in turn or on its own request the Ministry of Environment and Forests to invite views and comments on Gangopadhyay Committee.
Report and review its findings and recommendations if and to the extent called for and justified by additional inputs that the Committee may receive from experts and other members of the public.

Rating Agencies will need such technical inputs against whose benchmark they can carry out credit rating assignments. Collective Investment Schemes are not only for Teakwood or Plantations. Even right now there are Schemes in force dealing with goateries, horticulture and the like. It will therefore be necessary to have some benchmark under the regulations or separate chapters for separate schemes against which the rating agencies can rate the schemes and business also has a clarity as to what would be the basis of rating.

If this is not done, how will Credit Rating Agencies shall rate the Schemes or in case of Teakwood Schemes, they will have no choice but to follow conservative findings of Gangopadhyay Committee. It may probably adversely affect afforestation activities by private sector.

(2) INSURANCE COVER:

If insurance is required for protecting the investors or any property against unfortunate events, there is a larger need for insurance cover in case of activities under Collective Investment Schemes where such risks are larger and the Scheme period is for longer period from five to twenty years.
Risks may include but not limited to, absence, inadequacy of, or excessive, rains, disease or epidemic to the plants and live stock, cyclone, hurricane, floods or famine.

Incidentally to protect investor interest, Supreme Court of India in the case of Peerless Financial and Investment Company case had directed to Reserve Bank of India (RBI) and Government of India to have a Deposit Insurance Scheme, so as to protect the interest of the individual unsecured depositors with non-banking finance companies.

RBI has in the recent communication to CERC agreed in principle to the idea of Compulsory Deposit Insurance Scheme for a certain amount and for a certain period, if not on the same lines as Deposit Insurance cover for Banks. (Papers already submitted by me to the Committee earlier).

If there is a need for protecting depositors with Banking and non-Banking Finance companies, there is all the more need for insurance cover for investors under Collective Investment Schemes having regard to the larger risks involved.

Some of the members of the Committee could visit Australia and New Zealand which have a long record and experience of Collective Investment Schemes. The relevant point here is that such insurance cover has been made statutory under the laws for Australia and New Zealand. Interestingly, the regulations also provide that insurance cover for honesty and fidelity of key management personnel be also taken.
In the absence of such an insurance cover, no matter what the regulations may provide and no matter whatever penalty we may prescribe, investors are not likely to get back their money, which is their primary interest. Investors are not so much interested as to what penalty is recovered or punishment is inflicted for violations.

(3) **Ownership and transfer of Agricultural or Forest lands:**

The Committee has recommended an approach on the lines of Mutual Funds where assets are required to vest in the Trustees, and Collective Investment Management Company (CIMC) are subject to superintendence, direction and control of the Trustees like AMCs in case of Mutual Funds. Appointment, reappointment, termination of contract or taking legal action for negligence or non-compliance against CIMCs shall rest with Trustees.

The question that remains unanswered is that there are large number of Central and States laws whereunder there are one or more restrictions like size of the holding or the agricultural land to be held by an agriculturist.

Now the first barrier that comes up is that such agricultural land may not be transferred in the name of the Trustees. In the possible contingency of Trustees to sell the property, to realize assets value to distribute among the investors, how will the Trustees be able to do so if they cannot hold the property in their names much less they cannot sell and transfer the land and realise the money.
There are similar restrictions on the forest land.

If the Government is really keen to protect investors and increase the green cover by the private sector on commercial basis, Government of India may declare such Collective Investment Schemes as an industry like the tea, coffee and rubber plantations.

Once such Collective Investment Schemes are notified as industry, those restrictions on holding and transfer will not be there and trustees will be able to hold the assets in their names and if and when required, sell and transfer those assets and distribute the sale proceeds among the investors.

Role-relationship between Trustees and CIMCs.

The information that members of the Committee who visited Australia and New Zealand brought with them has important lessons for a country like India, more so for the points elaborated in this note of dissent.

There is a reference to Australian experience in the body of the report, para 2.2, page No. 11 to 14.

I understand that the new law based upon the recommendations of the Australian Law Commission has been recently brought into force.

The Report of the Committee is justified so far as the experience of the new law is concerned, since not adequate time has passed.
But the important lesson that Australia learnt, viz lack of clarity on role-relationship between Trustees and Asset Management Companies has to be taken note of. There were ambiguities as to who is responsible for mismanagement or poor management of funds, whether Trustees or AMCs.

The Committee is justified in expressing a view that the solution found in Australia of having a Single Responsible Entity (SRE) may not be recommended in the Indian context since Australia itself has to gain experience as to how the new system works.

However, under the present recommendation, Trustees are not as independent a body as it happens to be in the case of Mutual Funds. In the case of Mutual Funds, the Trustees are appointed by sponsorer and not by the Asset Management Company. In the case of Collective Investment Scheme, there is no sponsorer. Therefore, CIMCs which is like Asset Management Company, will appoint Trustees and also decide terms and conditions of their appointment.

I am aware of the fact that the Trustees have to be from the list of Debenture Trustees already recognised by SEBI.

Should the appointment of the Trustees and terms and conditions thereof can be dealt with by independent body like SEBI or investors themselves. It is true that there will be some time gap between proposing the scheme and mobilisation of funds on one hand and appointment of Trustees by investors unless initial appointment is done by SEBI and not CIMC.
It is true that this aspect can be taken care of by regulation. But the report can at least recommend that while drafting the regulations, the Australian experience may be taken note of and abundant clarity may be provided on real-relationship between trustees and CIMCs so as to avoid repetition of pre-1998 Australian experience.

In our country, since there has not been much of the litigation, in the case of Mutual Funds, not much light can be drawn from the principles of law which would have been enunciated in the event of litigation.

In any case, having regard to the experience of Mutual Funds in India, I would very much suggest that in the case of Collective Investment Scheme, it will be difficult, almost impossible, for investors to prove that CIMC or TRUSTEES had exercised due diligence or not. Therefore in the event of unsatisfactory performance, particularly investors losing whole or part of their capital, the onus of proof should lie on the CIMC and/or Trustees that they had exercised due diligence and it was for reasons beyond their control that they could not perform well, particularly when similar comparable schemes were floated in the Indian market around the same time and one which has performed poorly, viz. loss of whole or part of capital, compared to others who have done much better in terms of return on investments, besides their capital being intact.