COMPARATIVE ANALYSIS OF UNIT LIKED INVESTMENT PLANS AND MUTUAL FUNDS

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ABSTRACT

Unit Linked Insurance Plans (ULIPs) and Mutual Funds are both growth investment product but there is a fundamental difference between the two. While, ULIPs are a combination of insurance and growth investment, Mutual Funds are exclusive investment oriented. A fundamental regulatory question that arises herein is whether SEBI or IRDA would regulate EULIPS while Mutual Funds are regulated by SEBI under separate regulations, but this issue has been of bone of contention for regulators.

INTRODUCTION

Unit Linked Insurance Plan (ULIPs) and Mutual Funds (MFs) are forms of collective investment schemes defined under Sec. 2(b)(a) read with Sec. 11AA of SEBI Act, 1992. These are schemes or arrangements by a company other than schemes exempt under Section 11AA (3) which are related to contributions, or payments made by the investors which are pooled and utilized solely for the purposes of the scheme. Further in ULIPs or MFs, investors make contributions with a view to receive benefits in the form of profits, property, income etc. However, they do not exercise control over the management or functions of the scheme.

The law further leaves space for exemptions under Sec. 11AA(3) which excludes certain schemes from the ambit of collective investment schemes although they satisfy the conditions provided under Sec. 11AA(2) to be deemed as a collective investment scheme. Some of the schemes that are exempted from the ambit of collective investment scheme are schemes offered by co-operative societies, others such as contract of insurance, pension, insurance or other schemes under Employees Provident Fund and Miscellaneous Provisions Act, deposits under Sec. 58A of the Companies Act, Nidhi or Social benefit society under Sec. 620A of Companies Act, Chit fund business, and contributions to mutual funds.

All exempted forms of collective investment scheme are governed by separate regulations, but that is not the case with mutual funds which is governed by specific SEBI regulations and subsequently the question arises whether ULIPs which is a combination of insurance and growth investment will be governed under the IRDA or SEBI Act. The fundamental issue of dispute herein therefore is whether ULIPs are insurance products or collective investment schemes under SEBI Act.

1.1. MUTUAL FUNDS

"Mutual fund" means a fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities including money market instruments or gold or gold related instruments or real estate assets. However, it can also be described as "an entity which collects and pools investor funds for the purpose of collective investment and which issues shares that entitle the holder to receive on demand, or within a specified period after demand, an amount computed by reference to the value of a proportionate interest in the whole or in a part of the net assets of the entity."[259] According to the SEBI the essential features of mutual funds are that it should be in the form of a trust, the purpose of which is to raise money through sale of units to public under schemes of investing in securities.

Moreover, Sec. 12(1B) of the SEBI Act provides the definitions of registration of entities carrying on collective investment scheme which reads as "collective investment schemes including mutual funds". Thus, thereby making it clear that the definition of collective investment schemes in Section 11AA(2) was intended to exempt all those schemes and arrangement otherwise regulated under the Cooperative Societies Act, Reserve Bank of India, Insurance Regulatory & Development Authority of India (IRDA), Employees Provident Fund Organization, Registrar of Companies. For the purposes of Mutual Funds, SEBI had in place a separate set of regulations for mutual funds called Securities and Exchange Board of India (Mutual Funds) Regulations, 1996.

1.2. UNIT LINKED INSURANCE PLANS (ULIPS)

ULIPs products essential consists of two features which are insurance and investment. The company maintains various forms of funds as per guidelines of IRDA, and the customer has the option to choose between funds and interchange between them. The insurance part of the product should always be active for the product to give any returns. While, certain insurance companies permit withdrawal of funds partially before maturity, and in such a case the funds required for insurance is kept with the insurance company.

1.2.1. What is Contract of Insurance?

SEBI Act nor IRDA Act do not define what is a 'contract of insurance' and the Insurance Act, 1938 the term 'Contract of insurance' is not defined there in either. However, the Insurance Act also discusses different types of life insurance products and frequently refers to "contract of insurance". Therefore, we need to peruse cases laws to define the 'contract of insurance'.

In *Prudential Ins Co v Inland Revenue Commrs*260 defined a 'contract of insurance' as " a contract where by one party(insurer) promises in return for a money consideration(premium), to pay to the other party(insured) money or money's worth on the happening of an uncertain event more or less

[259] Regulation 2(q) of Securities and Exchange Board of India (Mutual Funds) Regulations, 1996.
[260] (1904)2KB658:73LJKB 734:91 LT 520:20 TLR 621.

adverse to the interest of the insured." In *Gould* v *Curtis*[261] the Kings Bench held that "in case of life insurance policies, it is not necessary to have a character more or less adverse to the interest of the insured in the case of life insurance since life insurance has an investment aspect as well, such as one providing for the uncertainty of life."

1.2.2. Whether ULIPs have components of 'contract of insurance'?

This issue was examined in *Fuji Finance Inc v. Aetna Life Insurance Co Ltd* where the 'capital investment bonds' (having features identical to ULIPs), were held to be 'contracts of insurance'.[262] The argument put forth by against this proposition was that a policy is not a contract of insurance in the case of a policy product issued by a life insurance company wherein policy benefits were the same whether on surrender or on death of the life assured. This is because principal object of this product and overall nature and intent of the contract was not to insure.

It was held that even though a policy is not a policy under the purview of Section 1 of the Life Assurance Act, 1774 it is not enforceable under Section 16 of Insurance Companies Act, 1982. The Court considered the argument that a contract offering mere surrender value would not constitute an insurance policy but there was no reason as to why a contract that offers benefits both on death and surrender could not constitute a 'contract of insurance'. Pursuant to the same logic as applied to 'capital investment bonds' in this case are equally applicable to ULIPs in India and hence ULIPs are 'contracts of insurance' which are exempt from the purview of SEBI regulations under S 11AA(3)(iii) of SEBI Act.

REGULATORY FRAMEWORK FOR ULIPS AND MUTUAL FUNDS

On 9th April 2010 SEBI prohibited 14 insurance companies from issuing an offer document under Section 11 and 11B of the SEBI Act read with Section 12(1B). So the question arose as to whether ULIPs offered by the said entities are a combination of insurance and investment features and if that's the case then are investment components are in the form of mutual funds which can only be offered upon obtaining registration from SEBI under Section 12(1B) of the SEBI Act? In pursuance of these provisions SEBI has drawn up several regulations such as the Securities Exchange Board of India (Collective Investment Scheme) Regulations, 1999 and Securities and

261 (1913) 3 KB84,95.
262 [1997] Ch 173, [1996] 4 All ER 608.

Exchange Board of India (Mutual Funds) Regulations, 1996. Under the auspices of Section 12(1B) of SEBI Act "no person" can sponsor a collective investment scheme including mutual funds unless he has prior registration with the SEBI under SEBI Act. Thus, for any entity to raise monies for any product including ULIPs having an investment component in the nature of a mutual fund, it has to obtain registration from SEBI.

However, the Insurance Regulatory and Development Authority (IRDA) categorically denounced the decision of SEBI as it would have an adverse impact on the insurance industry and would be detrimental to the interests of the policyholders and insurers alike. Therefore, in furtherance of the powers vested in IRDA under Section 34(1) (a) and (b) of the Insurance Act, 1938, and upon consultation with members of the Consultative Committee, it directed that all the 14 insurance companies notwithstanding the said Order of the SEBI, which are mentioned in the order of SEBI are to continue to carry out insurance business including ULIPs in accordance with the Insurance Act, 1938, Rules, Regulations and Guidelines issued there-under by the IRDA.

A comparison between ULIPs and Mutual Funds evidently brings out the issue of regulatory competition which was unknown hitherto. So, the question arises as to who shall be the adjudicator in such cases between regulators viz. SEBI and IRDA. It is important to address this issue because it is required both for good governance, in order to avoid regulatory conflicts and ensure proper functioning and growth of the financial sector.

If we need to establish which regulator is more appropriately suited to regulate ULIPs then we must analyze the terms 'collective investment scheme'. Section 11AA(2) of the SEBI Act encompass any scheme or arrangement which includes entities exempted under Section 11AA(3) of the said Act. The purpose of the exemption is ensuring that there are no regulatory conflicts. Subsequently, looking into ULIPs, it is a combination of insurance and investment products. Presently, both parts of the policy viz. investment and insurance are regulated by the IRDA, therefore, further regulation by SEBI makes the process cumbersome and complicated and it would be contrary to spirit of Section 11AA(3) of the SEBI Act. And referring to the based on the ruling in the case of Fuji Finance Inc v. Aetna Life Insurance Co Ltd[263], it can be clearly concluded that ULIPs are exempt from the jurisdiction of SEBI.

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[263] I.d at 5.

SUPER-REGULATOR IN INDIA

In United Kingdom, Financial Services Authority (FSA) which is an independent non-governmental body, quasi-judicial body and a limited guarantee company regulates the financial services industry. It has opted for a single super-regulatory model. Under this model, the ambit of FSA encompasses the entire finance industry which includes a wide range of organizations which deal with management of money. The entities so covered are banks, credit card companies, insurance companies, finance companies, stock brokerages, investment funds and government sponsored entities. A perusal of the powers of the FSA shows us that it performs the role of maintaining confidence in the financial system, promotion of public understanding, ensuring protection for consumers in reduction of financial crimes.

In a first, the regulator has taken over the responsibility of teaching the consumer about the products they are buying, and to protect them. It has powers to prevent money laundering and prosecute for noncompliance with regulations. In addition, seeks to control "market abuse", which can happen in three ways: misuse of information; creation of misleading impressions and, market distortion. The regulator can issue public censure or impose fines. Further, to counter-balance FSA's authority and to prevent it from unfair imposition of fines, an independent Lord Chancellor's Tribunal has to power to hear any disputed case. Moreover, it establishes a single compensation scheme and single ombudsman for consumer representation.

3.1. PROS OF SINGLE REGULATOR

Single regulator handles the financial sector as an integrated whole, moreover single regulator helps avoid possible conflicting regulations between different regulators. Since several players in the system are operating in multiple sectors which fall within the jurisdiction of more than one regulator, it is likely that problems will arise. For example, commercial banks are increasingly taking up roles which stretch its traditional boundaries which is making things more difficult for regulators. When customers want to raise funds from the market, banks now play a supportive role through activities such as underwriting of the issue.

Concerned banks must be in conformity with guidelines framed by SEBI otherwise the bank itself may be a listed company in which case it shall be subject to the listing guidelines. For instance, corporate governance principles require that a listing agreement be signed with the stock exchange and therefore be in conformity with relevant RBI.

If the regulations of SEBI and RBI are conflicting, then it will decrease the efficacy of banks. In addition to the RBI and SEBI, now we have one more regulator in the form of IRDA. Different regulators make their regulations according to the needs of the financial sector which leads to various areas of conflict. However, the single regulator solution may create new problems.

3.2. CONS OF SINGLE REGULATOR

There exist enough reasons as to why concentration of power in any single authority might not be prudent. One criticism levied on single regulator system is that it sometimes it might be blinded from viewing the problem from distinct dimensions and the viewpoint of diverse players in the financial system. Proponents of the single regulator mechanism argue that a super-regulator will allow us to avoid framing of conflicting regulations by separate regulators and to ensure mechanisms for adept resolution of disputes arising thereof. On the hand, Indian financial is sector being deregulated and is being opened to foreign players. Critics on the contrary suggest that a single monolithic regulatory organization may not be swift and prompt enough to respond to the evolving financial system. In order to achieve efficacy and precision in each area under its jurisdiction, the super-regulatory must ensure a high level of area-wise expertise.

Conflicts between two independent regulators are much more foreseeable, but the same cannot be equated to two deputy regulators. However, there is no proof either that a super-regulatory will be more effective in resolving problems that may need to be tackled by market players and institutions in circumstances in which regulations are framed for different and specialized activities viz. banking, insurance and the securities market. It also cannot be argued that problems arising because of egos of different independent regulators would be resolved if these different regulators are regulated by a single super-regulatory body. However, in certain matters independent regulators conflict with other regulators not because of ego rather as a result of overlapping jurisdiction in its regulations. Such differences in perceptions may be genuine and not necessarily due to ego problems.

SUGGESTIONS AND RECOMMENDATION

At present, the Association of Mutual funds of India (AMFI) assign AMFI Registration Number (ARN) number to distributors of mutual fund products which are registered with the AMFI. In turn, Asset Management Companies (AMCs) pay commission for their services in procuring business. The distributors are empanelled with AMCs hence, Mutual Funds/AMCs possess responsibility for the conduct of the distributors empanelled by them. However, diverse practices in the industry with respect to distributor and AMC relationship brought forth the need for a level of consistency in the practices of distributors. To address such issues, SEBI has issued a discussion paper putting forth proposal for a self-regulatory body for distributors and advisors of mutual funds. The self-regulatory organization shall have powers to expel, suspend and impose a non-monetary penalty on distributors and advisors in case of malpractices in mutual fund schemes. Therefore, the debate continues whether decentralization through Self-Regulatory Organizations are a better option.

To conclude, with reference to ULIPs creation of single super-regulator means as an amalgamation of separate regulators into a single organization. The imagined outcome of such an amalgamation on paper should drive value addition in the process. In this regard, it is important to understand that financial sector players come up against various issues of conflicts with other authorities because of conflicts between other laws and regulations and therefore, it is pertinent to ensure that such obstacles are cleared.

It is not convincing to argue in favor of bringing all such authorities and regulators under one roof merely because there are possibilities of avoidable frictions due to conflicting regulations of different regulators or laws administered by other authorities. At present 13 economies have opted for a single 'super' regulator however at the heart of the current debate is Germany's planned financial sector reforms which proposes for the creation of a single independent regulatory authority that would continue the tasks currently performed by three separate organizations, for stock markets, banks and insurance. Australia's Wallis Report also recommended a single authority.

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