

FAQs on Mutual Fund Distributors Due Diligence Process

1. What is Distributors' Due Diligence?

Due diligence, in the context of mutual fund distributors (MFDs), refers to appraisal of various activities and processes undertaken by the MFDs while conducting the mutual fund distribution business and servicing their mutual fund clients, with a view to evaluate that the MFDs are exercising reasonable care and control that a prudent business set-up or person is normally expected to have in place, considering the fiduciary nature of mutual fund investments.

2. Objective of the due diligence

The objective of the due diligence exercise is to review the efficacy and the effectiveness of the internal controls of the shortlisted distributors and their compliance with extant regulations and applicable AMFI guidelines, to enable the AMCs to satisfy themselves that the concerned distributors meet the 'fit and proper' criteria as required as per SEBI regulations.

3. What do the SEBI Regulations Stipulate ?

As per extant SEBI Regulations, AMCs are required to undertake a due diligence process of the Mutual Fund Distributors satisfying one or more of the following four criteria at the time of their empanelment and during the review period :

- 1) AUM raised over Rs. 100 Crore across industry in the non-institutional category but including high net worth individuals (HNIs)
- 2) Commission received of over Rs.1 Crore p.a. across industry
- 3) Commission received of over Rs.50 Lakh from a single Mutual Fund
- 4) Multiple point presence (More than 20 locations)

→ Clause 15.5.1 of SEBI Master Circular for Mutual Funds stipulates that the AMCs shall regulate the distributors by putting in place a due diligence process

→ Clause 15.5.1.3 stipulates that the AMCs shall undertake a due diligence process of the distributors (at the time of empanelling the distributors and during the subsequent periods to satisfy 'fit and proper' criteria that incorporate, inter-alia, the following factors:

- a. Business model, experience and proficiency in the business.
- b. Record of regulatory / statutory levies, fines and penalties, legal suits, customer compensations made; causes for these and resultant corrective actions taken.
- c. Review of associates and subsidiaries on above factors.
- d. Organizational controls to ensure that the following processes are delinked from sales and relationship management processes and personnel:
 - i. Customer risk / investment objective evaluation.
 - ii. MF scheme evaluation and defining its appropriateness to various customer risk categories.

Please refer to Section 15.5 of SEBI Master Circular for Mutual Funds dated 19-05-2023 relating to Distributors of Mutual Fund products

4. Why is AMFI Conducting the Due Diligence ?

While the AMCs are required to undertake a due diligence process of their MFDs, over the years, AMFI has been organizing a common/unified due diligence of the qualifying MFDs on behalf of the participating AMCs for convenience of the AMCs and the MFDs and to avoid duplication. The Due Diligence Reports (“DDR”) submitted by the firms engaged for the purpose are shared with the respective AMCs for taking necessary action on the observations therein as deemed appropriate.

5. SEBI Directive to AMFI to ensure uniformity in dealing with Due Diligence Observations

- With a view to bring in objectivity and uniformity in the action taken / to be taken in respect of DDR by all AMCs, SEBI had advised AMFI to formulate suitable policies and procedures and issue guidelines on the action to be taken by AMCs while dealing with the observations in the Due Diligence Reports uniformly, particularly while dealing with major observations, and to review the efficacy and the effectiveness of the internal controls of the distributors.
- Accordingly, AMFI, in consultation with AMFI ARN Committee and with the help of a professional law firm, has reviewed and revised the Due Diligence Questionnaire” (DDQ) suitably to align it with current SEBI Regulations and AMFI Code of Conduct incorporating risk ratings against various observations to make the evaluation very objective.
- The Risk rating and the severity of the observation shall be decided by the firm conducting the due diligence depending on no. of instances, whether it’s a systemic issue, amount involved, lack of appropriate infrastructure, non-compliance with Code of Conduct for MFDs and/or AMFI/SEBI guidelines etc. on a scale of 1 to 3, 1 being the lowest and 3 being the highest.

6. What are broad contents of the Due Diligence Checklist?

The broad areas covered under the Due Diligence Checklist include the following:

1. Information about the Distributor
2. Mutual Fund Business Activities
3. Operations & Customer Service-related Processes
4. Compliance and Risk Management
5. Human Resources Management
6. Legal (including that of associates & subsidiaries)

7. Who should have NISM certificate & AMFI registration ?

As per SEBI MF Regulations, all employees of MFDs who are engaged in sales promotion and distribution of MF products (irrespective of whether the employee is temporary /on contract or permanent) are required to (i) obtain NISM certification and (ii) register with AMFI and obtain EUIN. Hence, the MFDs are expected to provide the figure in respect of employees engaged in MF sales promotion in the relevant section in the DDQ. The MFD may, optionally also mention the number of other employees holding valid EUIN in the DDQ.

8. Categorisation of Customer relationship and transactions

As per Clause 15.5.1.4 of the SEBI master Circular, Customer relationship and transactions shall be categorized as follows –

- (a) Advisory - where a distributor represents to offer advice while distributing the product, it will be subject to the principle of 'appropriateness' of products to that customer category. Appropriateness is defined as selling only that product categorization that is identified as best suited for investors within a defined upper ceiling of risk appetite. No exception shall be made.
- (b) Execution Only - in case of transactions that are not booked as 'advisory', it shall still require:
 - i. The distributor has information to believe that the transaction is not appropriate for the customer, a written communication be made to the investor regarding the unsuitability of the product. The communication shall have to be duly acknowledged and accepted by investor.
 - ii. A customer confirmation to the effect that the transaction is 'execution only notwithstanding the advice of inappropriateness from that distributor be obtained prior to the execution of the transaction.
 - iii. That on all such 'execution only' transactions, the customer is not required to pay the distributor anything other than the standard flat transaction charge.

There shall be no third categorization of customer relationship / transaction.

While selling Mutual Fund products of the distributors' group/ associates, the distributor shall make disclosure to the customer regarding the conflict of interest arising from the distributor selling of such products.

9. "Execution Only" & "Advisory" Relationship

- The "Execution only relationship" refers to only to such mutual fund distributors who provide online transaction platform services to their mutual fund clients whereby the client himself / herself decides the mutual fund scheme / chooses to do his/ her investments transactions without any involvement or incidental advise or recommendation from the concerned MFD.
- "Advisory relationship" in the context of a MFD refers to providing "incidental advice" w.r.t. mutual fund products and means providing basic advice pertaining to / limited to such schemes/ products being recommended by a mutual fund distributor to the clients/ prospective investors and recommending a curated list of mutual fund schemes to the client based on the distributor's assessment of the investor's risk profile and suitability of the product being recommended to aid the investor in making a choice.
- ***For avoidance of doubt, it is clarified that incidental advice does not include providing detailed financial planning and offering holistic investment advice. MFDs are not permitted to provide investment advice, unless they are registered with SEBI as RIAs.***

10. Distributor's Obligation under Execution Only Service

MFDs who provide Execution Only services are expected to maintain suitable record / email trail. The relevant extract of SEBI circular No. Cir/IMD/ DF/13/ 2011 dated August 22, 2011 is reproduced below –

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- ii) A customer confirmation to the effect that the transaction is 'execution only' notwithstanding the advice of in-appropriateness from that distributor be obtained prior to the execution of the transaction.

11. What does "Online" Service mean for DDQ purpose?

- 'Online Services' in the DDQ refers to MFD's own Online transaction platform.
- Transaction Platforms provided by BSE, NSE, MFU, CAMS, Kfintech etc. are market infrastructures (not MFD's own) etc. and not regarded as Online Service offered by the MFD.

12. Customer Risk Profiling and Assessment of Suitability

- In order to determine the suitability of the mutual fund schemes being recommended to the clients, MFDs are expected and obligated to do risk profiling of their clients, in order to make a reasonable assessment of the client's risk appetite, investment needs and objective.

13. Customers' Complaint Handling – MFD's Obligations

- All MFDs are expected to resolve the complaints of their customers and keep proper track, and assist the AMCs in resolving his customers' complaints, as a good practice.
- As per Clause 4(j) of Code of Conduct, MFDs shall endeavor to resolve investor grievances/ complaints arising out of marketing, sale and distribution activities and shall provide complete assistance to the AMCs for redressal of grievances/ complaints.
- It is not about whether it is compulsory for an MFD to maintain a register / record of the customers' complaints, but whether the MFD is diligent and methodical in this regard.
- If the MFD has not kept any record in this regard, the MFD may simply reply to the question accordingly/ suitably.
- It may be noted that electronic record with proper backup facility is acceptable in lieu of physical register.

14. What is Data Sharing Principles?

Please refer to AMFI circular no. 135/BP/ 99 /2021-22 dated 29-Mar-2022 on Data Sharing Principles available on AMFI Website at – <https://www.amfiindia.com/Themes/Theme1/downloads/circulars/AMFIBestPracticesGuidelinesCircularNo.99dt.29-Mar-22.pdf>

15. Client related obligations of MFD under Clause 4(k) of Code of Conduct for MFDs

- MFDs shall use marketing material as is provided to them by the AMCs and shall not design their own marketing materials in respect of any scheme or display the name, logo, mark of any AMC / MF including in their websites/apps without the prior written approval of the AMC.
- MFD needs to take prior approval of the AMC for displaying / circulating any write ups/articles/performance comparison reports / customised performance comparison reports involving / mentioning the scheme name.

