Mutual Funds - Recent Regulatory Trends and Experiences

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The Indian mutual funds (MF) industry has seen frenzied activity in the last few quarters. While assets under management (AUM) have been at a record high (and still climbing, despite Brexit!), several foreign fund houses have thrown in the towel and withdrawn from the retail funds management space in India. High cost structures, funds distribution challenges, too many players (43 on last count) with top 3 managing over 60% of total assets under management (AUM), regulatory issues (curbs on fees/ loads, new scheme launch delays), etc. are the oft-quoted reasons for such exits.

On the back of this, the Securities and Exchange Board of India (SEBI), the Indian mutual funds industry regulator, has been proactive with introducing regulatory changes, investor protection measures (especially in the context of recent MF portfolio liquidity risks), exploring ways to broad-base the retail funds market and widen the pools of capital available to mutual fund asset managers (AMCs).

This article examines some of the current and possible MF industry trends, key recent regulatory developments/ changes coming out of the SEBI fold and their implications for market participants.

Evolving Distribution Avenues and Sources of Capital – Shifting Sands:

MF distribution through electronic platforms

SEBI's recent proposal to permit fund houses to offer MF schemes on e-commerce platforms (being examined by the Nandan Nilekani Panel) is a welcome step towards digitalizing MF distribution and channelizing household savings into mutual funds, which empirically have been funneled into fixed income and hard assets (real estate, gold, etc). It remains to be seen how challenges around know your customer (KYC) norms, distribution incentives, expense ratios and adequate protection against mis-selling are addressed by SEBI before 'online plans' are rolled out in addition, and as an alternative, to direct and regular plans.

A spanner in the works could be the regulatory prohibition on using credit cards (i.e. borrowing) for making equity investments. The utility of online plans in deepening MF investor base and ensuring ease of MF investments would, to an extent, depend on whether users on Indian e-commerce websites can invest in MFs with the same ease with which they can buy electronics, apparel or furniture, i.e. through plastic money. Current regulations do not permit the use of credit cards for purchase of mutual funds.

For similar reasons, the permissibility of using e-wallets (which are gaining in popularity) to make MF investments may also be debatable. Limitations around permissible debits/ credits under RBI's pre-paid payment instruments (PPI) guidelines may further impact the use of stored value cards for promoting MF investing culture.

Distribution challenges

Despite recent regulatory strides in widening the distribution reach of MF asset managers, caps on upfront distributor commissions are often cited by the industry as a road block to increasing MF sales. Whilst curbing MF mis-selling continues to be the regulator's priority (and rightly so), the 2015 'best practice guidelines' issued by the Association of Mutual Funds of India (AMFI), relating to distribution cost-commission pay-out (capping upfront commission to 1%, limiting total distributor commission and expenses to distributable expense ratio of the scheme, etc). The recent Sumit Bose Committee Report (constituted by the Ministry of Finance to recommend measures for curbing mis-selling and rationalising distribution incentives in financial products) has also recommended wholesale abolition of upfront distributor commissions (and extra commission for B-15 centres) and is currently in SEBI's domain for consideration.

This, coupled with SEBI's abolition of MF entry-load (which, incidentally, is not uncommon in the western world – US/ European jurisdictions recognize entry-load up to 5% as necessary for business viability), will further impose distribution challenges for the private non-bank and foreign asset managers who have historically struggled with MF distribution (despite scheme performance) and high cost structures.

A recent step by the RBI towards widening MF distribution channels available to fund houses has been allowing NBFCs to now distribute MF schemes without taking RBI approval, if on a non-risk sharing basis. Given there are over 12,000 NBFCs in the country, this relaxation will incentivize NBFCs (especially non-deposit taking) to add MFs to their bouquet of financial products offering without going to the regulator.

Management of retirement / pension funds

SEBI's proposal to introduce MF-linked retirement/ pension plans, similar to insurance-oriented retirement benefit plans under Section 80CCD, Income Tax Act (also recommended by the Sumit Bose Committee) is a welcome step and addresses a long-standing demand by the MF industry. This is likely to significantly broad-base the pools of capital available to MF asset managers and acknowledges MF industry's argument that regulatory distinction between asset managers based solely on "end-use" (i.e. short v. long term investment goals) deprives the investor of more options in picking its asset management service providers – i.e. if MF fund managers perform better, then why be limited to pension/ retirement fund managers.

Though to ensure a level playing field for MF asset managers, the argument in favour of all long-term MF products getting the same tax treatment as life insurance, provident and pension fund products deserves to be explored. In this behalf, granting the 'EEE' (exempt-exempt-exempt) tax benefit to MF-linked retirement plans, i.e. being out of tax net throughout the investment's life cycle – investment, earning and maturity/ withdrawal – similar to Public Provident Funds (PPFs), will go a long way in promoting MFs as a long-term asset class among retail investors.

Recent Regulatory Developments – Challenges & Way Forward:

Executive compensation

An evolving area of concern for fund houses for attracting and retaining talent, both at the management level and in the dealing room, has been SEBI's proposal to impose limits on senior executive pay in MF AMCs. While the intent cannot be disputed, i.e. to lower fund management costs (which have a pass through implication for unitholders), the MF industry has the following arguments against adopting such an approach:

- Total expense ratio (TER) chargeable to any MF scheme is already regulated (and capped, pro rata to scheme AUM). In addition, AMCs are also subject to senior management remuneration limits imposed under the Companies Act, 2013.
- Globally, a disclosure based approach is followed by regulators in relation to MF executive remuneration, e.g., the US Securities Exchange Commission (SEC) and UK Financial Conduct Authority (FCA) require MFs to only disclose compensation details online (with industry self-regulation), with a provision for non-binding shareholder vote ('say-on-pay' vote).

SEBI regulation of debt exposure and redemptions

In 2016, SEBI introduced several changes concerning debt exposure by mutual funds aimed at mitigating portfolio liquidity risks. In its board meeting on January 11, 2016, SEBI lowered the single issuer investment limit for debt instruments from 15% to 10% of scheme NAV, extendable to 12% (against the erstwhile 20%) with trustee and AMC board approval.

Thereafter, through its circular on May 31, 2016, SEBI issued guidelines for imposing restrictions on redemptions from MF schemes (popularly known as 'gating'), which was hitherto loosely regulated. Per the SEBI circular, redemption restrictions can be imposed only when there are circumstances leading to a 'systemic crisis' or event which 'severely constricts market liquidity' or the 'efficient functioning of markets', such as:

- *Liquidity issues:* When market at large becomes illiquid affecting almost all securities rather than any issuer specific security (i.e. scheme portfolio liquidity risks arising out of investment decisions cannot result in gating redemptions). Redemption restrictions cannot be imposed merely to manage scheme liquidity.
- *Market failures, exchange closures:* If security markets are affected due to unexpected events (related to emergencies – political, economic, military or monetary) impacting the overall functioning of exchanges or regular course of transactions.
- *Operational issues:* When exceptional circumstances arise out of force majeure (i.e. act of god), unpredictable operational problems and technical issues (e.g. blackouts), occurring despite third party diligence and disaster recovery procedures/ systems.

Any redemption restriction cannot be imposed for more than 10 working days in any 90-day period (similar to SEC's MF gating norms), and only with prior trustee and AMC board approval. Further, SEBI and unitholders are to be immediately informed. A carve out has been provided in favour of redemption requests below Rs. 2 lakh (*de minimis* threshold), i.e. no restriction on redemption requests received from 'retail' investors.

While any regulatory clarity is helpful for market participants, the new SEBI norms leave a scope for wide interpretation. A parallel to SEBI's 'gating' norms can be found in the changes introduced by SEC in the aftermath of the 2008 financial crisis, which resulted in US based mutual funds facing heavy redemptions requests and portfolio liquidity challenges. Based on the SEC experience (which seems to have influenced SEBI's 'gating' circular) and with a view to strike a balance between investor interest and the overall health and operational interests of the mutual fund, the following suggestions may be considered:

- Framing norms for valuation of illiquid debt investments held by MF schemes, especially in case of rating suspension.
- Imposition of a 'redemption fee' on investors to mitigate knee-jerk redemptions (linked to market events) creating portfolio imbalance, which affects the remaining investors.
- Linking redemption gating norms to the mutual fund's overall portfolio liquidity, i.e. its liquid assets as against total assets (on daily/ weekly basis).
- Providing discretion to the AMC and trustee to impose redemption limits even for issuer specific reasons, if in the larger interest of the unitholders.
- Deepening secondary market for troubled debt paper (especially unlisted) – e.g., 'scavenger' funds are globally a popular avenue for offloading defaulted bonds. RBI permitting foreign portfolio investors (FPIs) to acquire non-convertible debentures/ bonds under default was a step forward in this direction, as is RBI's recent draft proposal to expand the FPI investment basket by permitting them to buy unlisted debt.