# Making mutual funds accountable, SEBI style - The Morning Context

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After years of trying to make mutual fund house executives accountable for the performance of their funds, the Securities and Exchange Board of India finally bit the bullet last week by putting out a circular, which despite being muddled, set the cat among the pigeons.

The 28 April circular from SEBI states, among other things, that 20% of the salaries of key mutual fund house executives should be invested in units of the schemes over which they have oversight or are managed by them.

As with almost any reform, the industry is unhappy. But if they're looking for someone to blame, it should be Franklin Templeton India. Clearly the measure is a fallout of the crisis triggered by the asset management company shutting down its suite of six debt mutual fund schemes in April last year, effectively dragging the entire industry into SEBI's crosshairs. We have tracked the sordid saga in a series of stories on how key officials put their own interest ahead of investors when the schemes were shuttered and how the fund managers doled out preferential treatment to some corporates, to the detriment of investors.

Santosh Kamath, chief investment officer for fixed income at Franklin Templeton India, who drew a salary of Rs 12 crore last fiscal year, was barely invested in the company's six debt mutual funds.

"SEBI's thought process is had he been invested in these funds, perhaps his investment decisions would have been more prudent," says a person with direct knowledge of the matter, asking not to be named.

The circular itself isn't perfect. It suffers from poor drafting and may also run into implementation issues. But there is no mistaking its intent. There is also no glossing over the regulator's resolve. So much so that SEBI, normally big on stakeholder consultations to the point that it often goes overboard, seems to have held the bare minimum of discussions, leaving the Rs 31.6 lakh crore mutual fund industry shocked by the suddenness of the reform.

"The issue of ensuring skin in the game was discussed with the Mutual Fund Advisory Committee but the entire nitty-gritty and mechanics of how this will be implemented was not discussed," says the person cited above.

The industry, led by the Association of Mutual Funds in India, is now in a huddle and has held at least three rounds of meetings in the last week to figure a way out. They are in a fix on how to address the issue without antagonizing the regulator or jeopardizing their employees' interests.

As for SEBI, it appears it may not be as amenable to lobbying as before, when it could be made to tweak or water down circulars in the face of intense stakeholder pressure.

"The intention here is to kickstart a conversation from the clear intent that SEBI wants mutual fund officials to be aligned with unitholders' interests. Any attempts in the past at stakeholder consultation were generally stonewalled by the industry. The implementation issues and concerns on the circular can always be addressed," says a regulatory official, requesting anonymity.

In fact, in what is a fairly unusual move for SEBI, it is ready with an explanation to each of the circular's provisions that have created a furore. It clearly doesn't want a repeat of the Franklin Templeton episode where an ambitious and reckless fund manager puts thousands of crores of investors' money at risk.

Also, in the recent past, especially on the debt side, fund managers have been taking risks—investing in lower rated bonds offering substantially higher returns. Ironically, while these funds were sold as highreturn products, the fund managers themselves were seldom investors in them. They were clearly not taking risks with their own money while exposing investors to the possibility of loss of capital.

Before we get into why SEBI is more sure-footed this time around, let's take a look at the contentious circular.

## Skin in the game

SEBI's circular states that 20% of a key employee's compensation at an asset management company should be invested in mutual fund schemes managed by it. This investment would be locked in for three years. If at a later stage the employee is found to be in violation of the SEBI-prescribed mutual fund code of conduct, the entire amount would be clawed back to the schemes in question. That is, the employee would not be entitled to this money and it would go back to the schemes for the benefit of investors. SEBI's definition of key employees, though, is extremely broad.

This circular thus is an attempt to pave the way for levying monetary damages on key officials of the mutual fund industry if found guilty of lapses. In the process, it also ensures that mutual fund house officials are exposed to risks similar to those being imposed on investors.

However, this intent is lost somewhat in the muddled wording of the circular, specifically its broad applicability to both senior and junior staff of an AMC and the requirement that they invest in all of the schemes of their fund house.

“Whenever we go out to sell our funds to corporates, institutions, domestic or foreign, the first thing we are asked is, how much is our senior employees’ and fund managers’ investment in the schemes managed by us,” said the sales head of a large fund house, asking not to be named.

His statement is a reflection of what is construed as a bare minimum requirement to convince potential investors to put money in a fund. It speaks to fund managers’ and chief executives’ faith in their funds and investment strategy. This holds true across the globe and India is no exception.

But how many actually invest in their funds?

In a majority of cases, the bulk of investments by senior management and fund managers is with their own fund house. For instance, Radhika Gupta, CEO, Edelweiss Mutual Fund, has 70% of her investments in schemes managed by Edelweiss. A similar story plays out with the chief executives and fund managers of top fund houses like SBI Mutual Fund, HDFC Mutual Fund, ICICI Mutual Fund and Kotak Mutual Fund.

“It’s not as though SEBI had to direct mutual fund executives to show confidence in their funds and align their interest with unitholders. Majority of us were already doing so,” says the chief executive of a large fund house, declining to be named.

“Skin in the game is great if done with one’s own free will. It shows that people are confident and convinced with what they are doing. I am against this forcing people to do things. It dilutes the whole skin in the game concept,” adds Neil Parag Parikh, chairman and chief executive of PPFAS Mutual Fund.

The question then is, do all mutual fund managers follow the same principle? Claims aside, scheme information documents show that while most mutual fund officials are invested in their own funds, the investment is by no means uniform. In the higher risk funds requiring active fund management, the investment is minuscule or next to zero. We looked at the top five fund houses and the investment by fund managers and key managerial personnel in two fund categories—credit risk funds and flexi cap funds.

# Risk averse

Fund managers and key managerial personnel have little stake in high-risk funds.

## SBI Mutual Fund

**AUM:** Rs 5.04 lakh crore

| Category of fund | Investment by fund managers | Investment by KMP |
| --- | --- | --- |
| Credit Risk Fund | Lokesh Mallya and Mansi Sajeja - Nil | Nil |
| Flexi Cap Fund | Anup Upadhyay - Rs 1 lakh | Rs 1.5 crore |

## HDFC Mutual Fund

**AUM:** Rs 4.07 lakh crore

| Category of fund | Investment by fund managers | Investment by KMP |
| --- | --- | --- |
| Credit Risk Fund | Shobhit Mehrotra - Nil | Rs 22.47 crore |
| Flexi Cap Fund | Prashant Jain - Rs 3.94 lakh | Rs 47 crore |

## ICICI Pru MF

**AUM:** Rs 4.06 lakh crore

| Category of fund | Investment by fund managers | Investment by KMP |
| --- | --- | --- |
| Credit Risk Fund | Manish Banthia and Akhil Kakkar - Rs 2.43 lakh | Rs 5.39 crore |

| | | |
|---|---|---|
| Focused fund (flexi cap) | Mittul Kalawadia and Prakash Goel - Rs 2 lakh | Rs 11 lakh |

**Aditya Birla Sunlife Mutual Fund**

**AUM:** Rs 2.66 lakh crore

| Category of fund | Investment by fund managers | Investment by KMP |
|---|---|---|
| Credit Risk Fund | Maneesh Dangi and Sunaina Da Cunha - Rs 6.4 crore | Rs 21 lakh |
| Flexi Cap Fund | Anil Shah - Nil | Rs 6 lakh |

**Kotak Mahindra Mutual Fund**

**AUM:** Rs 2.30 lakh crore

| Category of fund | Investment by fund managers | Investment by KMP |
|---|---|---|
| Credit Risk Fund | Deepak Agarwal - Nil | Nil |
| Flexi Cap Fund | Harsha Upadhyaya - Nil | Rs 19.6 crore |

KMP: Key managerial personnel

**Source: Scheme information documents of individual funds as of 31 March 2020**

Credit risk funds, which focus on investing in below super rated bonds and saw the highest outflows in the last one year, attracted little by way of investments from fund managers and key managerial personnel. A similar story plays out in flexi cap funds, which invest in companies of different sizes, depending on where they expect maximum gains. To be sure, these officials could be invested in other funds of their fund house based on their own risk profile.

Some fund managers even raised apprehensions that the SEBI diktat is akin to making fund house employees permanent insiders.

“A fund manager withdraws some funds and the market falls after a few days. Imagine the accusations that will fly; why did he not tell everybody to withdraw?” asks Shankar Sharma, co-founder of investment advisory firm First Global on his twitter handle.

## The key employee conundrum

The other thing that has left the mutual fund industry perplexed is the circular’s wide definition of “key” employees. A key employee is not a concept that has been defined under SEBI norms or the Companies Act, 2013. What the act does is define key managerial personnel as someone who is in charge of managing the operations of a company. Key managerial personnel, under the act, include chief executive officer, managing director, chief financial officer, manager, company secretary and whole-time director.

However, SEBI in its circular last week, goes much further and comes up with an extremely broad definition of key employees. It includes:

1. Chief executive officer, chief investment officer, chief risk officer, chief information security officer,chief operation officer, fund manager(s), compliance officer, sales head
2. Investor relation officer(s), heads of other departments, dealer(s) of the AMC
3. Direct reportees to the CEO (excluding personal assistant/secretary)
4. Fund management team and research team
5. Other employees as identified and included by AMCs and trustees

SEBI thus covers employees who are not directly included in any fund management and strategy decision. As bizarre as this may sound, going by this definition, 20% of the human resource head or information technology head's salary will also have to be invested in units of their fund house.

The skin in the game theory just doesn't work in their case, given that the chief executive officer or a fund manager of a mutual fund are paid a whole lot more, with their packages being among the highest in the industry. A quick look at the disclosures for fiscal year 2019-20 helps drive this point home. Milind Barve, former CEO of HDFC Mutual Fund, earned Rs 7.43 crore; Nilesh Shah, chief executive officer of Kotak MF, had a pay package of Rs 7.32 crore; and ICICI Prudential MF paid Rs 6.98 crore to its managing director Nimesh Shah.

"This circular applies to not just senior employees but junior research staff, dealers, and support function heads. These people don't earn the kind of money CEOs and CIOs do. It is forcing them to lock 20% of their income for three years. It mandates how much one saves. For a guy earning Rs 15-20 lakh, imagine how difficult it is to put away Rs 3-4 lakh. We are constraining employee cash flows," said Radhika Gupta of Edelweiss in a tweet on 28 April.

The measure may also impair the cash flow of an AMC. If, for instance, the AMC were to hike salaries of junior employees by 20% to account for their compulsory 20% contribution to its schemes, it could jeopardize the fund house's cost structure. Disclosures by fund houses suggest that on average the year-on-year hikes for employees has been about 5-10%. So if an AMC were to shield the take-home pay of junior staff, then its expenses on account of salaries could increase significantly.

## The regulator's take

As it turns out, SEBI has an explanation for this broad definition of key employees.

"Sure the IT head may not have any say in fund management decisions, but such heads are part of key committees. So, if their own money is at stake, they may raise their voice in the committee meetings rather than being a mute spectator. While deciding on the 20% threshold we had considered individuals who are earning more than Rs 50 lakh. Taking the bonuses, ESOPs into consideration, it roughly translates to about 12% of gross," says the regulatory official quoted earlier.

"As far as dealers and research analysts are concerned, they are the first ones to get price-sensitive information and it is more likely that front running, manipulation can happen at that level. It is difficult to levy monetary penalties in such cases. This circular brings them in the ambit of the clawback provision," he added.

How will the employees' contribution be invested across schemes?

The SEBI circular says it has to be across all schemes managed or overseen by the official concerned. So a CEO overseeing 40-odd schemes will need to invest in all the schemes (barring exchange-traded funds, index funds and overnight funds). And if a fund house has more debt funds vis-a-vis equity funds, then an employee's asset allocation will be on similar lines, even if his own risk profile calls for higher equity allocation. This completely messes up an individual's asset allocation.

SEBI has, to some extent, addressed the issue of diversification for fund managers.

In case of fund managers managing only a single scheme, or a single category of schemes, 50% of the compulsory deduction will be invested in the units of the scheme/category managed by the fund manager and the remaining can be in units of those schemes whose risk value is equivalent to or higher than the scheme managed by the fund manager, said SEBI by way of explanation.

Even this, in a way, throws the fund manager's personal risk management for a toss as the diversification of his investment is limited to a similar or higher risk category.

## Fears of an exodus

Personally, we select jobs if our interests align with those of the company and the attractiveness of the salary on offer. SEBI's diktat is akin to telling the management of a company what and how much to pay employees.

This forced salary restructuring could still work for key managerial personnel and promoters but should it be applied to dealers and research analysts? Typically, dealers and analysts are not locked into the fund management industry. The fear is that it could trigger an exodus of talent from AMCs to competing industries such as banking, insurance, portfolio management and hedge funds.

There are also unforeseen tax implications on employees, The Economic Times reported on 4 May.

"This SEBI circular has the potential to open a pandora's box. It is a case of micromanagement and over-regulation which is likely to hurt a lot of personnel of AMCs given that the scope of key employees is very wide under SEBI Mutual Fund Regulations. In pandemic times, it is likely to cause more pain. This also starts a new era of SEBI prescribing employment conditions for government as well as private mutual funds," says Sumit Agrawal, founder, Regstreet Law Advisors and a former SEBI officer.

The worried mutual fund industry is considering two principal options—sending a comprehensive submission to SEBI highlighting their concerns or getting some employees to file writ petitions in courts.

“Nothing has been finalized yet. But a discussion with the regulator seems a better approach,” says a member of the Association of Mutual Funds of India, asking not to be named.

## Will SEBI buckle?

Many in the industry are betting that SEBI’s latest circular will go down the same road of muddled circulars that have had to be tweaked and clarified later. In a short span of nine months, this could very well be the third circular targeting the mutual fund industry that has required modifications and clarifications.

In September last year, SEBI had directed multi-cap funds, the portfolios of which are dominated by large cap stocks, to keep at least 25% of their assets each in large-, mid- and small-cap stocks by 31 January 2021. This led to concerns that a strict reassignment of assets could trigger massive inflows into mid- and small-cap stocks. This forced the regulator to issue a fresh directive outlining options.

On 10 March, SEBI issued a circular to cap a mutual fund’s exposure to the extremely risky additional tier-1 bonds at 10%, and value them with a 100-year horizon. After the industry’s lobbying efforts, SEBI tweaked the circular to increase the valuation of AT1 bonds in a phased manner, starting with a 10-year tenure.

As someone who has been tracking SEBI very closely for years, this writer can attest to the fact that this is straight out of the regulator’s playbook. Come out with overarching norms for difficult areas, cause a furore in the market and ultimately consider feedback (read: negotiate) for final reform.

The real intent is hidden in the so-called clawback provision.

Mutual fund units allotted to the key employees shall be subject to clawback in the event of any violation of the code of conduct, fraud or gross negligence as determined by SEBI. Upon clawback, the units shall be redeemed and the amount shall be credited to the mutual fund scheme.

From SEBI circular dated 28 April•

While there is no denying that the measure is game-changing, it is undone in no small measure by poor drafting. Plugging loopholes is important but that cannot happen if the new rules come across as rushed and not well thought out. Then the so-called reform actually chips away at the regulatory authority and makes it look weak.

The circular itself is the product of the regulatory mindset in India. Whenever things go wrong in an industry, everyone faces the brunt of tough regulatory action, even if they are not in the wrong. The other aspect to this is that actual perpetrators of the crime enjoy years of freedom before enforcement action actually catches up with them.

So, there are two things that SEBI should do. The first order of business should be to pass the final orders in the Franklin Templeton India case. Second, tweak the latest circular to ensure its efficient and fair execution.

Jayshree is a journalist with nearly a decade of experience across Mint, Business Standard and Bloomberg TV India. The bulk of her career has been devoted to tracking the capital markets regulator, exchanges, regulatory policies, financial scams and corporate governance issues. One of her biggest breaking stories was her incisive coverage of the colocation scam which put the lapses at NSE in the public domain. Her understanding, her knowledge and access to key market players makes her an important storyteller of the most relevant issues plaguing Indian businesses.