

Security Cover For Investment By Mutual Funds In Debt Instruments: A Need For Clarity In The Regulatory Regime

Sumit Agrawal : 8-10 minutes : 17/06/2021

The Securities and Exchange Board of India (SEBI) has introduced a slew of norms in the past two years in order to regulate investment by mutual funds in debt instruments.¹ One such measure concerns the security cover in the form of equity shares for debt instruments prescribed by SEBI Circular dated 1 October 2019 ("**Security Cover Circular**").² While this Circular has been in place for more than a year, the scope and extent of its application remains unclear. In this article, we discuss the implications of this Circular and argue that while it goes a long way towards protection of unitholders of these mutual funds, it fails to exhaustively deal with the myriad issues which mutual funds face when dealing with debt instruments.

The requirement of security cover for debt instruments

The Security Cover Circular prescribes various norms for investment by mutual funds in debt and money market instruments. One of the rules stipulates that "[i]nvestment in debt instruments, having credit enhancements backed by equity shares directly or indirectly, shall have a minimum cover of 4 times considering the market value of such shares". In other words, mutual funds investing in debt instruments where the security for the debt is provided in the form of equity shares would have to ensure that the quantum of security cover in the form of equity shares provided for the debt instrument by the issuer is 4 times that of the total debt being subscribed by the mutual fund. The Circular also requires mutual funds to "initiate necessary steps to ensure protection of the interest of the investors" in the event that the value of equity shares falls below the mandated limit of 4 times the debt instrument. To illustrate, if the value of debt being subscribed by a mutual fund is INR 100, the minimum value of equity shares being furnished as security for the debt must be INR 400, and in the event that the value of the shares falls below INR 400, the mutual fund is required to take necessary steps to protect the interest of the investors.

The aforesaid prescription was presumably introduced in the aftermath of a drastic fall in the price of shares of the Essel group in early 2019 which had been provided as security for debt instruments issued by the Essel group and subscribed by mutual funds. The mutual funds in that case, instead of enforcing the security, reportedly granted an extension to the Essel group to repay the debt.

Aspects relating to the minimum security cover not dealt with in the Circular

While the Security Cover Circular now makes it mandatory for mutual funds to have security cover of 4 times the value of the debt where the security is provided in the form of equity shares, it does not deal with a situation where the security for a debt instrument is provided in multiple forms. It also does not specify the manner of calculation of value of equity shares, and whether there are any exceptions to the requirement of minimum security cover. Indeed, it is not uncommon that apart from being secured by way of equity shares, the debt is secured by way of immovable property, and movable property other than equity shares. In a situation where the debt being subscribed to is, say, worth INR 100, and the value of the other security is equal to or more than INR 100, would the security cover for equity shares still be required to be INR 400? In another scenario where the value of the other security is INR 70, should the value of equity shares given as security be INR 120 (i.e. 4 times the deficit between the debt and the value of the other security) or INR 400 (i.e. 4 times the value of total debt)?

The requirement of the security cover being 4 times the debt has been imposed to account for extreme volatility in the price of equity shares which are pledged as security for debt instruments, and it is assumed that such large security cover would protect the interest of investors even if the price of equity shares takes a nosedive. In this background, applying the principle of purposive construction,³ this requirement of 4 times the value of the debt, prescribed in the Security Cover Circular, must be construed to be applicable only in those instances where the *only* form of security for the debt (or a part of the debt) is in the form of equity shares. In cases where the debt is secured through other forms of security and the value of such security is equivalent to the quantum of debt, additional security in the form of equity shares need not be 4 times the value of the debt. In such cases, the value of equity shares can be any amount that the issuer and the mutual fund mutually agree upon, since it is being provided as additional security for the debt.

Applying this principle to the second scenario discussed above, i.e. where a part of the debt amounting to INR 70 out of the total debt amount of INR 100, is secured through other means and the remaining debt amounting to INR 30 is secured through equity shares, the value of equity shares provided as security must be INR 120, i.e. 4 times the amount of debt which is secured only through equity shares.

Obligations of Mutual Funds in the event of fall in security cover

As to the consequential steps to be taken in the event of the security cover falling below the prescribed limit of 4 times the amount of debt, the Circular leaves it to the discretion of mutual funds, with the overarching principle that the action must protect the interests of investors. This may include steps such as requiring the issuer to furnish additional security in order to make up for the deficit caused by the fall, or even to liquidate the equity shares and realize the monies due from the issuer.

Would it, however, justify the mutual fund entering into a standstill agreement and granting an extension of time to the issuer for the repayment of debt? The language of the Circular does not prohibit this measure so long as the mutual fund can establish that the extension was in the interests of the investors. It is also well-settled that courts do not ordinarily interfere with a decision taken on a business consideration in good faith.⁴ Nonetheless, SEBI's stance⁵ suggests that such agreements are impermissible. The dichotomy between the phraseology of the Circular and SEBI's publicly adopted position leaves much to be desired, as there can be serious repercussions on mutual funds for violations of the Circular. Any lapse on the part of mutual funds to comply with the Circular can lead to action against them by SEBI under Regulation 68 and/or Regulation 75 of the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996.

Conclusion

SEBI's mandate of the security cover in the form of equity shares being 4 times the value of the debt is a welcome step, but it requires more clarity on the prevailing regulatory regime when the security for debt instruments includes items other than equity shares. It has also left mutual funds guessing about the scope of measures they are entitled/obligated to take when the security cover falls below the prescribed limit of 4 times the amount of debt. While it may be possible to deduce the norms that would govern such scenarios, it is in the interests of all stakeholders that SEBI steps in and clarifies the position on these recurring issues faced by mutual funds.

Footnotes

1. See, for example, SEBI Circular No. SEBI/HO/IMD/DF4/CIR/P/2021/032 dated 10 March 2021 *limiting the investment in debt instruments with special features*.
2. Circular No. SEBI/HO/IMD/DF2/CIR/P/2019/104 on 'Review of investment norms for mutual funds for investment in Debt and Money Market Instruments'.
3. See *Swedish Match AB v. SEBI*, (2004) 11 SCC 641.
4. *Sangramsinh P. Gaekwad v. Shantadevi P. Gaekwad*, (2005) 11 SCC 314 (para 204).
5. See the statement made by SEBI chief Mr. Ajay Tyagi at FICCI's 16th Annual Capital Market Conference – CAPAM 2019 in September 2019, available at (https://www.business-standard.com/article/markets/mutual-fund-borrower-standstill-pacts-not-recognised-sebi-s-ajay-tyagi-119092601624_1.html).

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

POPULAR ARTICLES ON: Finance and Banking from India