Worldwide: An Analysis Of SEBI's Policy For Mutual Fund Key Employees – Skin In The Game Or Regulatory Overreach?

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The Securities and Exchange Board of India ("**SEBI**") on April 28, 2021 introduced a new circular pertaining to the remuneration of key employees of Mutual Fund houses. The national media is using the phrase 'Skin in the game' to colloquially describe SEBI's recent circular[1] that has made it mandatory for mutual fund houses to pay 20% of the compensation (net of taxes and statutory contributions like Pension Funds and National Pension Scheme) of their key employees in the form of units of schemes in which they have a role or oversee.

Such key employees include the CXOs including CEOs, CIOs, CROs along with the Compliance Officer, fund managers, sales head and department heads among others. SEBI has also mandated that such unit-based compensation will be locked-in for a minimum period of three years or the tenure of the schemes, whichever is lower. While barring redemptions during the lock-in period, SEBI has allowed fund houses to lend against such units *'in exigencies such as medical emergencies or on humanitarian grounds, as per the policy laid down by the AMC'* – something akin to buyback.

The Rationale

It seems that SEBI was concerned with the high remuneration of fund managers especially when the schemes of fund houses were not performing well. There were also some regulatory concerns that emerged during inspections and forensic audits of certain fund houses. It was found that few key employees were putting their own interest over the interest of unitholders, thereby failing in their fiduciary responsibilities. Hence, SEBI thought of linking incentives of key employees of the AMCs to the performance of the schemes which they oversee.

Surprisingly, however, this new policy has come without any discussion paper or public comments thereby leaving the market guessing at its rationale. Issued under a legal provision that empowers SEBI 'to remove any difficulties in the application or interpretation' of Mutual Fund Regulations[2], this circular has the potential of opening a Pandora's Box. The circular will come into effect from July 1, 2021.

Pandora's Box

While the industry and the national media is rife with questions – and theories as well - there could be a few potential issues with this new policy.

Firstly, the wide definition of key employees (covering even the non-senior employees) and the basis for introducing the threshold of 20% compensation and three-years' lock-in without taking into consideration risk-suitability of employees. Secondly, SEBI has extended its jurisdiction into employment and service conditions for personnel of public and private mutual funds. Finally, the unintended encouragement to fraudulent and unfair trade practices by building an inherent conflict of interest situation.

The “minimum” 20% compensation in unit-form could make it challenging for mutual fund houses to retain or attract talent. More importantly, the circular directly contradicts the various judgements of constitutional courts that have held salary to be a right to property and no person shall be deprived of their property unless by the authority of law.[3] Courts have also held that employment conditions cannot be changed to the detriment of employees during employment, based on the whims and fancies of any entity, as it is a facet of human right, as well as right to life and right to carry on profession.

During this ongoing pandemic of COVID-19, a previous notification by the Ministry of Home Affairs and the Ministry of Labour and Employment noted that employers of public and private establishments shall make the payment of wages of their employees on date without any deduction[4] and any reduction in wages during the pandemic would be detrimental to the employee.[5] The SEBI Circular is likely to have detrimental effect on the morale of Mutual Fund personnel in these Covid times.

Global Practices

Interestingly, such policies do not seem to exist in any country globally. Especially in the manner SEBI has sought to achieve. SEBI's circular is clothed in mandatory requirement. Indian courts in many matters have read down a mandatory provision of law as directory and vice-a-versa.

In brief, while the US SEC and ESMA nudges the industry to have policies on fund manager's remuneration it does not make it a mandatory requirement of law. New Zealand and China follow a disclosure practice but does not link remuneration and performance.

United States of America

A study[6] done in the US in 2019 by the National Bureau of Economic Research found that fund managers became less aggressive when they had their own personal commitments in the fund. The study, however, also argued that while it resulted in better returns, there was lower participation by outside investors. This study analysed the performance and investor characteristics of 720 hedge funds registered with the Securities and Exchange Commission (“**SEC**”).

Incidentally, SEC has encouraged performance-linked incentives in its speeches[7] though it has never made it mandatory for any category of fund managers, the way SEBI has done.

On the contrary, a detailed reading of some of the enforcement orders[8] of the SEC would show that the so-called ‘skin in the game' approach actually puts the interests of the investors and the fund managers in direct conflict. It further encourages fund managers to violate their fiduciary responsibilities by deliberately distorting the disclosures to avoid disclosing under-performance among other things, including tweaking expenses and related party disclosures.

European Union

Although European Securities and Markets Authority (“**ESMA**”) has multiple directives and regulations with regard to Undertakings for Collective Investment in Transferable Securities (“**UCITS**”) (akin to Mutual Funds in India) and Alternative Investment Funds (“**AIF**”) which deal with their remuneration policies. For instance the Capital Requirements Directive which set out requirements in relation to the remuneration policies of banks and financial institutions. They state that employees whose activity has a material impact on the institution and where the remuneration policy is performance based (variable income which is in addition to a fixed income) shall have at least 50% of their variable income consist of shares or share linked instruments of the institution.[9]

Further the Alternative Investment Fund Managers Directive ("**AIFMD**") in relation to the remuneration policies of AIFs[10], firstly defines the 'Identified Staff' to which the policies would apply to include '*senior management, risk takers…and employees whose professional activities would have a material impact on the risk profile of the AIF*'. Additionally the guidelines distinguish remuneration between fixed and variable and note that fixed remuneration '*should be sufficiently high*' since the variable remuneration can go down to zero in case of negative performance. The AIFMD also recommend that at least 50% of the variable remuneration of the identified staff should consist of 'units or shares of the AIF'.

In the context of AIFMD, a KPMG report[11] (sanctioned by the European Commission) which surveyed 478 entities including AIFs, Investors, regulatory bodies, asset managers etc in 15 European Union member states concluded that 62% (excluding those who had no opinion) of those surveyed expressed concern regarding the remuneration policies, agreeing that a strict implementation of the remuneration requirements led to a competitive disadvantage for EU firms. However the report also concluded that even though there was an increase in the fixed remuneration and a decrease in the variable remuneration there was no evidence to indicate that the remuneration rules have led to a reduction in excessive risk taking by key personnel.

Finally, the Markets in Financial Instruments Directive ("**MIFID**") guidelines on remuneration[12] which is applicable to '*credit institutions…UCITS management companies and external AIF Managers (AIFMs) when they are providing the investment services of individual portfolio management*' including persons who have a material impact on services provided and '*whose remuneration may create inappropriate incentives to act against the best interests of their clients'.* Further the guidelines state that a higher variable (performance based) remuneration can put the relevant persons focus on short term gains rather than the clients best interests.

New Zealand – Disclosure Practices

The Financial Markets Authority which is the capital markets regulator for New Zealand has under the Financial Markets Conduct Regulations, 2014[13] ("**FMC Regulations**") specified the kinds of disclosures a fund manager must make in the funds Product Disclosure Statement and in the ongoing quarterly fund update in respect of their fees. The Regulations state that a fund must disclose the fund managers basic fee (which is a subset of the fund's total management and administration charges) which is payable by investors in respect of the management services provided for the fund. Further the fund must also disclose any performance-based fees which are charged by the manager based on the performance of the fund including the performance based fee charged from a related underlying fund.

China – Disclosure Practices

The Asset Management Association of China ("**AMAC**") with regard to annual information disclosure by Private Investment Funds asked private funds to disclose 'regular management fees and performance-based compensation obtained by the fund managers, including basis for provision, way of provision and payment mode.'

Aligning the Interest or Building Conflict of Interest?

SEBI wants to align the interest of key employees of AMCs with the unitholders of MF schemes. It is based on the assumption that key employees would share the risk and reward with the unitholders and hence be more cautious. It is akin to thinking that a chauffeur will not be reckless and put passengers' lives on the line because he shares the same risk. This is theoretical.

SEBI's recently introduced Code of Conduct for Fund Managers and Dealers mandate them to act fairly, professionally, independently and at arm's length basis.[14] The recent circular conflicts with this Code as well. SEBI's latest diktat has made the medicine causing the pain. Doctors, lawyers and other professionals are required by law to act on the best-effort basis. By law, they are required to not have their 'skin in the game' or 'personally engage' to avoid conflict of interest.

The latest move has made many wonder if such a policy would be extended to fund managers of AIFs or Portfolio Managers (having a sponsor lock-in similar to a MF) or the key employees of Merchant Bankers (who are not underwriters) that sell public issues. One could argue that the 'skin in the game' logic could lead to better IPOs in the market!

Also, in-built in this policy is an incorrect signal – for the investors - that the fund manager or the fund house has invested its own money and so the fund will operate better. It is not necessary that the correlation between ownership and risk reduction would apply in a situation where professional judgement is required.

SEBI has not made available any empirical study, which leads to the belief that perhaps such a study is yet to be conducted.

The Way Ahead

SEBI has been bringing new policies for regulating the Mutual Fund industry on a regular basis. Whether it was about the colour codes of schemes, the risk-o-meter[15] or even introducing Code of Conduct for Fund Managers and Dealers, SEBI has been quite active in this segment. However, the frequency of new circulars, clarifications and amendments to SEBI Regulations would show that the industry has always been struggling with compliance of these sweeping strokes of law that change the way the business has to be done. While it is likely that SEBI may review this circular based on industry feedback, maybe it is time, Government of India – and its regulatory arm, SEBI in particular – could mull over some long-term vision or strategy in terms of regulating the MF industry. It would undoubtedly be better than the current approach of plugging one hole at a time that emerges after every episode that questions the role of the fund manager or the fund house.

Government of India recently notified new SEBI Annual Report Rules[16] directing SEBI to provide progress or impact assessment of the new regulations/rules introduced in the previous year. It will be interesting to see if this circular would be explained therein - technically it is neither regulations nor rules.

Legally, the Mutual Fund industry has the option to request SEBI to reconsider the circular or challenge it in the High Courts. It could even request the Ministry of Finance to intervene, but it is an open secret that a regulated entity is always weighing the cost of a miffed regulator against the cost of compliance!

Respectfully, 'skin in the game' should not mean that a capital market regulator decides the manner in which key employees of fund houses should get their compensation. A better approach could be setting deterrents in the form of exemplary punishments to thick skinned fund houses and their key officials but sadly, the statistics are abysmal.

Footnotes

1 SEBI Circular No. SEBI/HO/IMD/IMD-I/DOF5/P/CIR/2021/553 dated 28.04.2021 titled 'Alignment of interest of Key Employees of Asset Management Companies with the Unitholders of the Mutual Fund Schemes'

2 Regulation 77, SEBI (Mutual Fund) Regulations, 1996

3 Article 300A of the Constitution of India

4 Ministry of Home Affairs Notification No. 40-3/2020-DM-I(A) dated 29.03.2020

5 Ministry of Labour and Employment Notification dated 20.03.2020

6 NBER Working Paper "Skin or Skim? Inside Investment and Hedge Fund Performance" dated July 2019

7 SEC speech on "Incentivizing good compliance" by Lori A. Richards dated 30.08.2008

8 For instance, SEC Administrative Proceeding No. 33-8913 "SEC Charges Banc of America Investment Services with Failing to Disclose It Favored Affiliated Mutual Funds" dated 01.05.2008

9 ESMA Capital Requirements Directive Article 94 (l) titled 'variable elements of remuneration'

10 ESMA Guidelines on sound remuneration policies under the AIFMD No. ESMA/2013/232 dated 03.07.2013

11 KPMG Report dated 10.12.2018 titled 'Report on the operation of the AIFMD'

12 ESMA Guideline No. ESMA/2013/606 dated 01.10.2013 titled 'Remuneration policies and practices (MIFID)'

13 Financial Markets Conduct Regulation, 2014

14 SEBI (Mutual Fund) (Second Amendment) Regulations, 2020

15 SEBI Circular No. SEBI/HO/IMD/DF3/CIR/P/2020/197 dated 05.10.2020 titled 'Product Labeling in Mutual Fund Schemes Risk-o-meter'

16 See Gazette of India, SEBI (Annual Report) Rules, 2021 dated 12.03.2021