

Regulatory Hotline

May 20, 2020

ARE MUTUAL FUNDS TOO BIG TO FAIL – NOT REALLY!

INTRODUCTION

Amidst the global liquidity crunch, mutual funds market could also not stay immune against the COVID-19 pandemic. What was once considered to be the safest form of investment, despite turbulent market conditions, no longer appears to be the same after the recent announcement by Franklin Templeton Mutual Fund (“**Franklin Templeton**”) to wind up six of its yield-oriented schemes.¹

As per the notice released by Franklin Templeton on its website², “the primary reason which forced the decision to wind up these six schemes was the severe market dislocation caused by the COVID-19 pandemic and related lockdown which led to severe market illiquidity particularly for papers rated below AAA, combined with heightened redemptions during this period”.

In the aftermath of the above announcement, the next obvious question on the minds of every investor is likely to be – who’s next. However, the Association of Mutual Funds in India (“**AMFI**”) has reassured the investors by issuing a press release³ in this regard, stating that yield / income oriented debt schemes of most mutual funds have superior credit quality as confirmed by ratings of independent credit rating agencies and they continue to remain fairly liquid even in these challenging times.

Further, a set of liquidity measures announced by the Reserve Bank of India, which among others, required the funds to be availed by the banks under Targeted Long Term Operations (TLTRO) to be invested in grade bonds, commercial paper, and non-convertible debentures of NBFCs (with at least 50 percent of the total amount availed going to small and mid-sized NBFCs and MFIs), is also going to help alleviate the liquidity burden on the debt schemes of mutual funds.

WHAT WENT WRONG WITH FRANKLIN TEMPLETON?

According to the FAQs on Winding up of 6 Yield-Oriented Fixed Income Schemes released by Franklin Templeton⁴ (“**FAQs**”), these schemes followed the investment strategy of investing in credits across the rating spectrum including active investments in below AAA rated securities and so far (i.e. pre-COVID-19 pandemic) such a strategy was able to deliver meaningful outcome for the investors. However, the current market dislocation caused due to COVID-19 and resultant lock down, disproportionately impacted the securities rated below AAA in the form of mark to market losses and rising illiquidity due to lower trading volumes.

Further, a steep rise in the redemption requests from the investors caused mainly due to increased volatility in the capital market, made things even more difficult for Franklin Templeton to handle. Therefore, after assessing the viability of other possible options such as borrowing, suspending redemptions, elongate redemption payment and distressed sale, Franklin Templeton resorted to the ultimate option of winding up the schemes in order to preserve value for unitholders and to enable an orderly and equitable exit for investors in these unprecedented circumstances. Accordingly, a public notice was issued in this regard on April 23, 2020.

CAUSES OF LIQUIDITY CRUNCH

On a quick analysis of the performance graph of these six schemes, it can be noted that throughout its lifetime, they have constantly performed better than their benchmark(s) index. However, it was only around mid-February, 2020 onwards, that the performance of these schemes started declining due to increased redemption requests amidst the volatile market conditions caused by the COVID-19 pandemic.

In this regard, while it is apparent that the decline in the performance of the schemes have been triggered due to market dislocation caused by COVID-19 pandemic, however a few news articles on this subject seems to suggest that one of other factors that may have added pressure to debt schemes was the action taken by Securities and Exchange Board of India (“**SEBI**”) last year to tighten the norms for investment in unlisted debt by mutual funds.

On September 23, 2019, SEBI amended the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 (“**Mutual Fund Regulations**”), to insert Para 1A in the Seventh Schedule to the Mutual Fund Regulations, that restricted a scheme of a mutual fund from investing in unlisted debt instruments with an exception to invest in non-convertible debentures (“**NCDs**”) upto 10% of the debt portfolio of the scheme, subject to conditions prescribed by SEBI.

Further, a circular issued by SEBI on October 1, 2019 (“**SEBI Circular**”) in this regard stated, that the investment in unlisted NCDs not exceeding 10% of the debt portfolio of the scheme is allowed only when such unlisted NCDs have a simple structure (i.e. with fixed and uniform coupon, fixed maturity period, without any options, fully paid up upfront, without any credit enhancements or structured obligations) and are rated and secured with coupon payment frequency on monthly basis.

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In relation to the above, it is important to note that the circular not only grandfathered the existing investments in unlisted debt instruments (as on the date of the circular) till maturity of such instruments, so as to not disrupt the market, but it also allowed the schemes to align their investments in a phased manner i.e. investments in unlisted debt to be brought down to 15% by March 31, 2020 and to 10% by June 30, 2020. This time period was recently extended by SEBI to September 30, 2020 and December 31, 2020 respectively.

Upon surfacing of such news articles, both SEBI and Franklin Templeton through their respective press releases dated May 7, 2020 and May 8, 2020, issued necessary clarifications dismissing the idea of SEBI norms for investment in unlisted debt by mutual funds being the reason for on-going liquidity crunch or consequent pressure on debt schemes of a mutual fund. However, it cannot be overlooked that such norms would make the securities held by Franklin Templeton illiquid, as far as other mutual funds are concerned and hence limit their exit options from these positions. Therefore, the regulators should also factor in such hardships while issuing restrictive conditions.

WINDING UP OF MUTUAL FUND SCHEME

Winding up is the process of closing a scheme of a mutual fund after repaying the amount due to its unit holders upon liquidating all the assets of the scheme under management. As per Regulation 39(2) of the Mutual Fund Regulations, a scheme of a mutual fund may be wound up under following conditions:

- on the happening of any event which, in the opinion of the trustees, requires the scheme to be wound up; or
- if 75% of the unit holders of a scheme pass a resolution that the scheme be wound up; or
- if the Securities and Exchange Board of India ("**SEBI**") so directs in the interest of the unitholders.

Once it is decided to wind up a scheme of a mutual fund in light of any of the conditions mentioned above, the winding up process then start with the trustee(s) notifying SEBI and issuing a public notice⁵ disclosing the circumstances leading to the winding up of the concerned scheme. Immediately after publication of the public notice, the mutual fund shall (a) cease to carry on any business activities in respect of the scheme; (b) cease to create or cancel units in the scheme; and (c) cease to issue or redeem units in the scheme.

As a next step, the trustee(s) would be required to call a meeting of the unit holders to pass a resolution by simple majority (of present and voting) for authorizing the trustee(s) or any other person to take all necessary steps for winding up of the scheme, including liquidating the assets in the best interest of the unit holders of that scheme. The proceeds of sale realized upon liquidation of assets, after clearing all dues and expenses, are then to be paid to the unit holders in proportion to their respective interest in the assets of the scheme as on the date when the decision for winding up was taken.

Lastly, the trustee(s) is required to provide a report on the winding up to SEBI and the unit holders containing particulars such as circumstances leading to the winding up, the steps taken for disposal of assets of the fund before winding up, expenses of the fund for winding up, net assets available for distribution to the unit holders and a certificate from the auditors of the fund.

Further, it is important to note that unlike voluntary winding up of companies, there is no prescribed timeline under the Mutual Funds Regulations within which the process of winding up of a scheme of a mutual fund must be completed. Therefore, depending upon the liquidation strategy and market conditions, the process may even stretch till maturity of last security in the portfolio of the scheme being wound up.

INVESTOR GRIEVANCE REDRESS MECHANISM

In case the investors in a scheme of a mutual fund are not satisfied with justifications being provided by the asset management company with respect to winding up of the scheme, they have an option to seek redressal on their grievances as per the SEBI prescribed framework.

SEBI vide its Circular No. SEBI/HO/OIAE/IGRD/CIR/P/2018/58 dated March 26, 2018 ("**SCORES Circular**") had prescribed the new policy measures for investor grievance redress mechanism. According to the SCORES Circular, any investor who has a grievance against a listed company or a SEBI registered intermediary (including mutual funds) can first approach the concerned listed company or the SEBI registered intermediary with all requisite details to redress the complaint. However, if the listed company or SEBI registered intermediary fails to redress the complaint to the investor's satisfaction, the investor may then file a complaint in on the SEBI Complaints Redress System ("**SCORES**") platform.

SCORES is a web based centralized system to capture investor complaints against listed companies and SEBI registered intermediaries and is available 24x7. It was introduced on June 8, 2011 and has been facilitating redressal of investor grievances in a speedy manner.

As per the SCORES Circular, there are some complaints that are currently not allowed to be dealt through SCORES, which among others, include complaints against a sick company or a company where a moratorium order is passed in winding up / insolvency proceedings or suspended companies, companies under liquidation / BIFR / etc. In light of the aforesaid, a question that arises is whether the decision of the mutual fund to wind up its scheme may fall under the exceptions set out above and hence investor grievance cannot be registered through SCORES platform in this regard.

Based on strict interpretation of the provisions of SCORES Circular, the above said exemptions are specifically with respect to companies that are undergoing winding up / insolvency / liquidation to ensure that individual creditors are prevented from unilaterally initiating enforcement action against company, which could defeat the purpose of restructuring / liquidation. Hence, the same cannot be interpreted to be applicable *mutatis mutandis* on the schemes of a mutual fund, which in a manner of speaking is just one segregated account of entire asset under management by the mutual fund.

OTHER INVESTOR PROTECTION MEASURES

Franklin Templeton's tragedy is going to be other mutual fund's treasure, who may be experiencing similar spike in redemption requests. The learnings from this case should provoke other asset management companies and mutual funds to revisit their investment strategies and stress testing policies and make it more robust to deal with any illiquidity and/or redemption challenges that may arise due COVID-19 pandemic going forward.

This tragedy has also caught the attention of the regulator (i.e. SEBI). Accordingly, to curb the movements in the

mutual funds market, SEBI decided to extend the reduced cut-off timing for both subscription and redemption in mutual fund schemes till further notice. Earlier, the revised timings were effective from April 7 to April 30, 2020.

Further, SEBI also advised Franklin Templeton through its press release dated May 7, 2020, that they should focus on returning the money to its investors, in the schemes being wound up, as soon as possible. In the same press release SEBI also commented on the liquidity risks inflicted by mutual funds upon themselves by choosing to have high concentrations of high risk, unlisted, opaque, bespoke, structured debt securities with low credit ratings and how they have not rebalanced their portfolios even after several months since the SEBI Circular restricting investment by scheme of a mutual fund in unlisted debt instruments, with an exception to invest in non-convertible debentures (having simple structures) upto 10% of the debt portfolio of the scheme, was issued on October 1, 2019.

CONCLUSION

Economies around the world have been hit due to COVID-19 pandemic and its effect is going to last for several months even after the pandemic is over. Therefore, in the hindsight of Franklin Templeton experience, asset management companies should revisit their investment strategies and stress testing policies to ensure that it is equipped to meet with any future contingencies that may arise due to illiquidity in the market and/or increased redemption pressures. At the same time, the financial regulators should also ensure that their policy announcements are done in consultation with the industry as a whole, keeping in mind the importance of certainty in business operations and importance of investor confidence.

Further, the investors should also not lose confidence in the mutual fund market simply because one asset management company could not keep up with the redemption pressure. They should continue to focus on their investment goals and to the extent possible avoid any premature mass redemptions.

– Sanjana Rao, Prashant Prakhar & Pratibha Jain

You can direct your queries or comments to the authors

1 <https://www.franklintempletonindia.com/downloadsServlet/pdf/notice-of-winding-up-specific-schemes-k8lf815l>

2 <https://www.franklintempletonindia.com/downloadsServlet/pdf/notice-for-clarification-on-the-remarks-made-by-ms-jenny-johnson-president-and-ceo-franklin-templeton-k9fmjiqn>

3 <https://www.amfiindia.com/Themes/Theme1/downloads/AMFIApril242020PressRelease.pdf>

4 <https://www.franklintempletonindia.com/downloadsServlet/pdf/faqs-on-winding-up-of-6-yield-oriented-fixed-income-schemes-k9fminww>

5 In two daily newspapers having circulation all over India, a vernacular newspaper circulating at the place where the mutual fund is formed.

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