Investment Funds: Monthly Digest

October 30, 2019

PROPOSALS FOR NEW PORTFOLIO MANAGERS REGULATIONS: ENHANCED REQUIREMENTS AND DISCLOSURES (AUGUST-SEPTEMBER 2019 EDITION, PART II)

- A working group constituted by the Indian securities regulator (SEBI) submitted recommendations along with draft regulations to revise the portfolio manager regime.
- The recommendations touch upon several key aspects such as capital adequacy, charging of performance fee, charging of exit load by distributors and staffing.
- While the recommendations derive from a noble intention of professionalizing the portfolio management regime, SEBI should also account for practical considerations in determining which recommendations are adopted and how they are implemented.

INTRODUCTION

Under Indian securities laws, a 'portfolio manager' is defined to mean any person, who pursuant to a contract/arrangement with its client, advises or undertakes on behalf its client the management or administration of a portfolio of securities or goods or funds of its client, as the case may be[1]. Portfolio management services ("**PMS**") can either be discretionary or non-discretionary[2]. The Securities and Exchange Board of India ("**SEBI**") regulates portfolio managers under the SEBI (Portfolio Managers) Regulations, 1993 ("**Regulations**").

Since 2012, the PMS industry has grown nearly five folds in terms of total assets under management and has nearly doubled in terms of the clients[3]. Given the increase in the size of the PMS industry and a need for comprehensive review, SEBI constituted a working group consisting of industry experts ("**Working Group**") to carry out a review of the PMS regime. The Working Group submitted its report ("**Report**") on July 11, 2019, consisting of recommendations as well as a draft of a revised set of regulations to replace the Regulations ("**Draft Regulations**").

In this edition of the digest, we will discuss and analyse the key recommendations made by the Working Group and implications for portfolio managers and PMS clients ("**PMS Investors**").

KEY RECOMMENDATIONS AND ANALYSIS

I. Increase in (a) capital adequacy requirement of portfolio managers; and (b) minimum investment amount for a PMS Investor.

The Regulations prescribe for a portfolio manager to have a minimum capitalisation INR 20 million (approx. USD 280,000). However, the Working Group has recommended that, in view of the rising inflation levels, compliance costs and to deter non-serious players, the minimum capitalisation required to be registered as a portfolio manager should be increased to INR 50 million (approx. USD 700,000). A grace period of 12 months is proposed to be provided to existing registered portfolio managers to increase their net-worth.

Additionally, the Working Group has recommended that the minimum investment amount to avail PMS services should be increased from INR 2.5 million (approx. USD 35,000) currently to INR 5 million (approx. USD 70,000). However, for an existing PMS Investor, the revised minimum investment criteria should be applicable to any incremental investment by such existing PMS Investor. The background for this proposal appears to be the increased risk and complicated nature of PMS products compared to traditional retail products like mutual funds.

Analysis

The increase in minimum capitalisation requirement for portfolio managers is likely to adversely affect prospective and current portfolio managers. As a comparison, the net worth requirement for investment advisors seeking to be registered with SEBI is INR 2.5 million (approx. USD 35,000) whereas minimum commitment requirements from sponsors of alternative investment funds is INR 50 million (approx. USD 70,000). The Working Group's minimum capitalisation recommendation oddly moves portfolio managers away from professional service providers (like investment advisors), with which portfolio managers are arguably more naturally related, and closer to fund sponsors (like investors with skin-in-the-game). Therefore, this proposal may also deter serious players who fulfil other criteria but do not have the resources for the proposed capitalisation.

Similarly, the increase in minimum investment amount by a PMS Investor may also adversely affect the industry by leading to a decreased investor base for portfolio managers.

Taken together, the minimum capitalisation requirements for both portfolio managers and investors can affect portfolio managers adversely by increasing locked-in capital simultaneously with reducing the market size.

II. Increase in transparency by standardization of performance reporting and approach disclosure

The Working Group observed ambiguities and differences in performance reporting patterns used by different

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portfolio managers. Under the existing regime, a portfolio manager has a continuous performance reporting obligation both to its clients (semi-annual) and SEBI (monthly). While there exists a standard for performance reporting to SEBI, the Working Group observes that the same is differently interpreted by different portfolio managers. Further, there exists no standard for performance reporting to PMS Investors.

In view of the above, the Working Group has recommended that performance will be calculated using time-weighted rate of return to bring uniformity. Additionally, the Report provides for a revised template for reporting to SEBI and further introduces a template for reporting to the PMS Investors (on a quarterly basis). Further, to bring about standardisation of reporting and disclosure documents, the Working Group has recommended for the nomenclature “Investment Approach” to be used by portfolio managers in reporting, disclosures and marketing material to specify focus (such as those relating to time horizon, market cap etc.).

Analysis

While suggesting the aforesaid measures for standardisation, SEBI has also observed that the bespoke nature of contracts and relationship should be preserved. If followed in spirit, the recommendation should help to improve the accountability of portfolio managers, and is, to such extent, positive.

III. Framework for Fees and Expenses

There are several recommendations made by the Working Group in respect of the fees and expenses that a portfolio manager may charge. Certain key recommendations are discussed below

(i) Performance fee to be charged “without catch up”.

The Working Group observes that performance fees are usually charged by portfolio managers upon exceeding a hurdle rate, determined as per the agreement between the portfolio manager and the PMS Investor. Catch up generally refers to the amount that the portfolio manager may charge to make good the share of performance fee which the investment manager would have been entitled to had there been no hurdle rate. The Working Group has recommended that performance fee should be charged on a without catch-up basis i.e. only on the amount above the hurdle rate.

Analysis

This recommendation may affect the freedom of contract of portfolio managers and their clients. The minimum investment amount for becoming a PMS Investor should be seen as lending a level of sophistication which should be permissive of a bargain between the portfolio managers and PMS Investors. It would be preferable to allow parties to determine commercial terms such as hurdle rate, performance fee and catch-up. If the recommendation is adopted, the portfolio managers may be constrained to resort to other means of safeguarding their interests – for example, they may reduce the hurdle rates, or may start charging higher performance fee. Such changes may not always be in the interest of the PMS Investors.

(ii) Cap on Operating Expenses

The Working Group has recommended that the operating expenses of the portfolio manager, excluding brokerage should be subject to an upper limit of 50 bps. Further, it has also been recommended in the report that of the operating expenses, custody charges should not exceed 10 bps, audit fees/notary charges/ franking/ miscellaneous expenses should not exceed 25 bps.

Analysis

The recommendation is yet another example where the Working Group has recommended to bring yet another commercial element of the PMS relationship under regulatory control. As discussed above, the minimum investment amount by the PMS Investor should be seen as lending a level of sophistication which should be permissive of a bargain between the portfolio managers and PMS Investors and henceforth such terms should be left for the parties to decide, keeping into account the specific needs of PMS Investors. Different requirements of clients may require the incurring of expenses which may be above average – for example, the clients may insist on a particular standard of reporting of financial statements, which could lead to an escalation of even standard operating expenses. Therefore, it should be left to the parties to decide what expenses may be charged as operating expenses by portfolio managers.

(iii) Exit Load

The Working Group recognized that the portfolio managers are charging an early exit fee (“**Exit Load**”) which ranges from 1% to 8% and in some cases the portfolio managers are charging Exit Load even when the PMS Investor is exiting in the 5th year after investment[4]. The Working Group has noted that exorbitant exit loads are not in the interest of investors and that there is a need to standardise exit load structures. Therefore, in the Report, the Working Group has recommended that the Exit Load be capped as follows:

Year of Exit (period reckoned from the date of inflow / top up)	Maximum Exit Load
1st year of investment	3%
2nd year of investment	2%
3rd year of investment	1%
4th year and later from the date of investment	Nil

Analysis

The motivation behind the recommendation to standardise exit load structures i.e. investor protection is commendable. Having said that, exit loads may be required to factor in certain costs to which a particular PMS arrangement may be subject. Considering the commercial nature of the negotiation and the presence of sophisticated counterparties, a stricter disclosure regime for exit loads which are higher than market standards or certain thresholds (such as the Working Group has sought to set out) may have been more welcome.

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(iv) Distributor commission to be charged from management and on trail basis

The extant regulatory framework does not prescribe any mechanism for distributors to charge distribution commission from the client and its payment to the distributor of the investment product by the portfolio manager or the client, as the case may be. The Working Group has recommended that the distributor commission (i) be payable from the portfolio manager's fee; and (ii) be chargeable on a trail basis. To clarify, a trail basis fee charging mechanism is the one where the distributor is paid a recurring fee until the investment is withdrawn.

Analysis

The recommendation that the distributors fee may only be charged on a trail basis may be construed as an attempt to align the interests of the distributors and portfolio managers. The distributor will be incentivized for the investment period of the client rather than only subscription, which is both in the interests of the portfolio manager and the PMS Investor as it will lead to the reduction of the PMS Investor's initial cost of subscription for the services of a portfolio manager.

However, it needs to be noted that SEBI had, for mutual funds, abolished such entry loads in 2009. Some analysts noted that PMS services took off after entry loads in mutual funds were abolished by SEBI in 2009 and institutions sought to activate local PMS structures to garner higher commissions upfront[5]. Therefore, there may be a nexus between the abolition of entry loads under the mutual fund regime and the simultaneous increase in the PMS structures. Hence, if the recommendations of the Working Group, regarding charging of commission on a trail basis, are adopted, it may have adverse effect on income earned by the PMS manager or their affiliates in the form of upfront commission. From the regulators' perspective it may be a step to end the regulatory arbitrage between mutual funds and PMS products.

This recommendation by the Working Group, if adopted, may have an effect of formalising the role of distributors in the PMS context. Further recommendation in relation to regulation of PMS distributors have been discussed in the below section.

IV. Regulation of PMS distributors

Current regulatory framework of PMS did not list out any qualification re distributors of portfolio management schemes("**Distributors**"). The Working Group in its report has made several recommendations with regards to Distributors, one of which was discussed in the previous section. Among others, the Working Group has recommended the introduction of a qualifying criteria for Distributors. However, as of now, the Working Group has recommended that either a Distributor have AMFI[6] registration number or that such Distributor must have cleared the NISM exam for certifying mutual fund distributors[7]. The Report also provides for a draft code of conduct for Distributors.

Analysis

Stipulation of the interim qualification criteria and the code of conduct is in the interest of the PMS Investors as well as the portfolio managers keeping in mind the increase in the size of the PMS Industry and the formal recognition of distributors as an intermediary in the PMS regulatory framework. The qualifying criteria should help ensure that investors are not misled by such distributors who lack knowledge about the securities market.

V. Eligibility criteria for employees of the portfolio manager

The Working Group has made several recommendations with respect to the personnel that may be appointed by the portfolio manager. The Working group has enhanced the eligibility criteria for the principal officer. The Report recommends that to be eligible to be appointed as the principal officer, such person should have an experience of at least 5 years in related activities in the securities market, a professional qualification and relevant NISM[8] certification. This may be contrasted with the current requirements of either a professional qualification or an experience at least 10 years in the securities market.

Further, the Working Group has also recommended that it should be mandatory to appoint a compliance officer in addition to the principal officer.

Also, the Working Group has recommended that, in addition to the principal officer and the compliance officer, a portfolio manager should have at least 2 'qualified employees' to be employed by the portfolio manager, with such employees having at least 2 years of experience in the securities market coupled with a professional qualification and relevant NISM certification.

Analysis

These recommendations of the Working Group may lead to increase in the compliance costs for the portfolio managers as the portfolio managers may have an added obligation of appointing a compliance officer. However, the Working Group's recommendation will hopefully ensure that there are sufficient number of experts under employment of the portfolio manager so as to provide improved quality of PMS services to the PMS Investors.

CONCLUSION

A common, admirable thread running through the salient recommendations is a recognition of the growth of the PMS industry, growth in its importance therefore and the need for increased transparency and professionalism therein. For example, the recommendations include increased ticket sizes, increased capitalisation, standardised disclosures, limits on fees, staffing criteria. While all of these may be desirable ends towards which the PMS Industry should seek to move, SEBI should also consider the recommendations from the points of view of practicality (especially if the intent is to broad base participation in such products) and of not impinging on the freedom of (sophisticated) parties to contract. For example, like in the case with distributor commissions and mutual funds, SEBI may analyse such parallels to assess the potential impact of implementation of a similar recommendation on the PMS industry. It is hoped that the draft regulations, submitted by the Working Group based on its recommendations, also undergo these tests before notification.

Apart from the changes discussed above, there are also other recommendations made by the Working Group including recommendations simplifying reporting by portfolio managers, doing away with archaic requirements such as handwritten acknowledgements to mention a few, which have not been discussed in the above analysis. For more information on the recommendations of the Working Group you can access the Report of the Working Group by **clicking here.**

– Shivam Ahuja & Srikanth Vasudevan
You can direct your queries or comments to the authors

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[1] Regulation 2 (cb) of the SEBI (Portfolio Managers) Regulations, 1993.

[2] Discretionary PMS: The portfolio manager independently manages the client's account in accordance with the needs of the client to the extent specified in the contract between the client and the portfolio manager;
Non-discretionary PMS: The portfolio manager manages the funds of its clients according to the specific directions of the client.

[3] Pg 1 of the report of the working group, available at https://www.sebi.gov.in/sebi_data/commondocs/aug-2019/Report%20of%20Working%20Group%20on%20PMS_p.pdf

[4] Pg 18 of the report of the working group, available at https://www.sebi.gov.in/sebi_data/commondocs/aug-2019/Report%20of%20Working%20Group%20on%20PMS_p.pdf

[5] https://www.livemint.com/money/personal-finance/sebi-s-proposals-on-pms-rules-don-t-go-far-enough-1565519597544.html

[6] AMFI: Association of Mutual Funds in India

[7] NISM (National Institute of Securities Market) mutual fund examination is an examination conducted by the NISM which seeks to create a common minimum knowledge benchmark for all persons involved in selling and distributing mutual funds including mutual fund distributors. Fore more details please refer to: http://www.nism.ac.in/certification/index.php/nism-certifications/mutual-fund/mutual-fund-distributors

[8] NISM: National Institute of Securities Market
