

FAR REACHING AMENDMENTS TO THE MUTUAL FUND REGULATIONS

Vide its Notification dated 30 August 2011, the Securities and Exchange Board of India has issued certain amendments to the Mutual Fund Regulations. These amendments primarily seek to curtail and regulate the business activities of asset management companies. Further, certain new provisions have been introduced to regulate infrastructure debt schemes.

Some of the key amendments and their implications are discussed below:

Regulation 24 (b) – Restrictions on business activities of the asset management company

Regulation 24 has been amended to exclude management and advisory services to venture capital funds, portfolio management services, financial consultancy and exchange of research on commercial basis from the business activities of the mutual fund. It is not clear whether this amendment will apply retrospectively.

This notification specifically empowers the AMC to engage in providing management and advisory services to pooled assets provided the same does not conflict with the activity of a mutual fund. It is pertinent that as per a recently issued discussion paper dated August 1, 2011, SEBI is proposing a consolidated regulation to govern "Alternative Investment Funds", which would govern the manner in which funds would be pooled provide. The eventual manner in which pooled assets would be regulated remains to be seen.

An exception has been created for the provision of portfolio management services under proviso 2 to Regulation 24 whereby an asset management company is permitted to undertake portfolio management services and advisory services for other than "broad based funds" till further directions are issued by SEBI. A "*broad based fund*" has been defined as a fund having at least 20 investors and in which no single investor accounts for more than 25% of the corpus of the fund.

This amendment has sounded a virtual death-knell for portfolio managers as it seeks to severely restrict the activities of portfolio managers. In accordance with the extant SEBI Portfolio Managers Regulations, the investment and management of the funds accepted by the portfolio manager is governed strictly by the agreement between the portfolio manager and the client provided that the agreement between the portfolio manager and the client contains certain details including type of instruments, proportion of exposure and attendant risks involved. Further, the regulations do not prohibit the pooling of funds. As a result, portfolio managers are now increasingly offering structured portfolio products which are in the nature of broad based funds investing in special purpose vehicles engaged in sectors such as real estate, infrastructure etc.

Again, it is unclear whether this Proviso 2 to Regulation 24(b) applies retrospectively. If it does, AMCs providing PMS services and offering portfolio products which fulfil the criteria of a "broad based fund" may have to wind up such schemes leaving a very large of number of investors at a loss, particularly where the investments have been made in sectors such as real estate, which have a long gestation period.

Further, some very onerous obligations have been imposed on the asset management companies under Regulation 24 (b) if it proposes to undertake activities such as management and advisory services provided to pooled assets including offshore funds, insurance funds, pension funds, provident funds. Some of these obligations are as follows:

- § the asset management company shall appoint a separate fund manager for each separate fund managed by it unless the investment objectives and asset allocation are the same and the portfolio is replicated across all funds managed by the fund manager – this would impose a huge administrative burden on the asset management company, not to mention the cost implications;
- § the asset management company must ensure that independence to key personnel handling the relevant conflict of interest is provided through removal of direct link between remuneration to relevant asset management company personnel and revenues generated by that activity;
- § the asset management company must ensure fair treatment of investors across different products including simultaneous buy and sell in the same equity security only through market mechanism and a written trade order management system – this provision is rather ambiguous and it is not clear what this entails on the part of the asset management company.

Regulation 25(18) – Operations outside the Indian territory

In accordance with the newly inserted regulation 25(18) AMCs shall not carry out its operations including trading desk, unit holder servicing and investment operations outside India and if it does have such operations, it is required to wind up the same within a period of 1 year from the date of the notification. It is also unclear whether the marketing of the mutual fund schemes overseas and overseas operations for the same would be included within the ambit of “unit holder servicing” or “investment operations”.

Regulation 49L – Infrastructure Debt Schemes

This notification heralds the introduction of Infrastructure Debt Fund Scheme (‘IDFS’). IDFS has been explained as a mutual fund that invests minimum 90% of scheme assets in debt securities or securitized debt instruments of infrastructure projects pr SPVs created for the purpose of facilitating or promoting investment in infrastructure and other permissible assets. IDFs are required to be in accordance with these newly issued regulations or bank loans in respect of completed and revenue generating projects of infrastructure companies or SPVs.

The regulations issued herein broadly lists out the eligibility criteria for launching a infrastructure debt fund scheme, the permissible investments and conditions for infrastructure debt schemes. Additionally, the duties of the asset management company and the disclosures in the offer document have also been dwelt upon.

Surprisingly, prior to issuing the amendments, SEBI did not issue a Consultative Paper inviting questions and comments from the industry. The amendments to Regulation 24 clearly have serious implications and may invite opposition and requests for clarification from the asset management companies. There is however a glimmer of hope in that SEBI has indicated that further directions shall be issued in respect of provision of portfolio management services to broad based funds. However, the issue of how the existing portfolio funds will be treated still remains to be addressed.