

## Why Sebi's 9/11 strike on mutual funds has misfired

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- The regulator's circular on multi-cap mutual funds hasn't been well thought out. It needs to be quickly withdrawn
- From Sebi's perspective, better disclosures and investor education are areas it should focus on, rather than take upon itself the matter of asset allocation of a multi-cap fund

**MUMBAI** : Regulation-by-circular' is one of the most dreaded weapons in the hands of regulators such as the Securities and Exchange Board of India (Sebi) and the Reserve Bank of India. In its worst form, circulars are issued without consultations with market participants, and often, as some researchers argue, without much thought.

On the 19th anniversary of 9/11, Sebi decided to strike India's mutual fund industry with one such unusual circular.

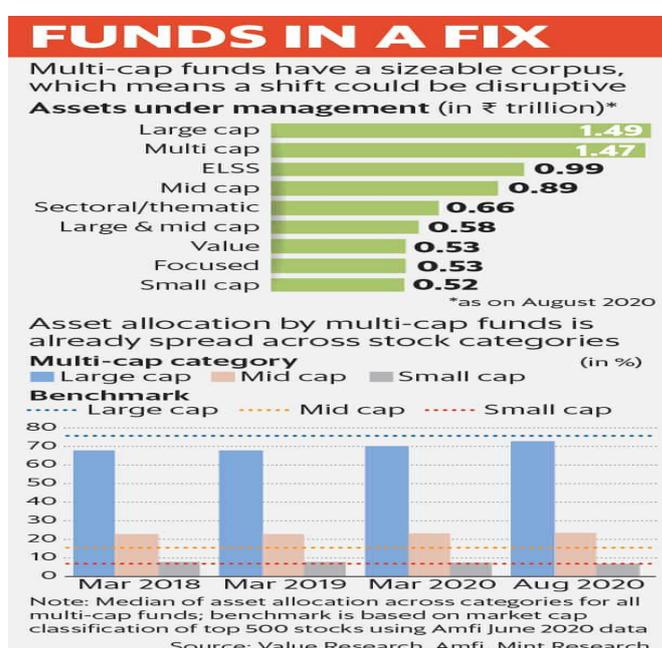
The circular addressed the market regulator's perceived problem of mis-labeling in certain mutual fund schemes. Sebi's concern was that many funds in the equity multi-cap category were essentially large-cap funds, and hence, not 'true to label'. Its solution was to enforce a minimum 50% holding in mid- and small-cap stocks for all multi-cap funds.

This led to a frenetic scramble, with both market participants and the regulator working long hours over the weekend. Mutual funds came up with reams of data to show why the proposal was ludicrous, and

that there was no way multi-cap funds with assets under management (AUM) of ₹1.5 trillion could be expected to park half of it in mid- and small-sized firms.

Traders tried to figure out the stocks fund managers were most likely to buy to meet the new norms. Sebi issued a 'clarification' on Sunday, stating that the funds had other options, such as converting their fund to a large-cap fund, and that they needn't necessarily have to buy small stocks.

But despite the additional solutions that were offered, the circular is still extremely disruptive, and many doubts and questions persist.



"Just like the safety net proposal for initial public offerings (IPOs), which was eventually shelved, the latest regulation for mutual funds comes across as impulsive and not well thought out. Sebi still has to go a long way in its rule-making process. For important decisions, consultations with market participants and experts are imperative," says Venkatesh Panchapagesan, associate professor of finance at IIM Bangalore.

Sebi has a mutual fund advisory committee (MFAC) made up of industry participants and experts. "The contents of the latest circular weren't discussed at MFAC. There may have been an apprehension

that the mutual fund industry representatives on the committee would have strongly resisted any such move," said a member of the committee requesting anonymity.

And as is wont with 'circulars-without-consultation', there are now frantic post-facto discussions between industry body, Association of Mutual funds of India (Amfi), and Sebi. Ajay Tyagi, chairman at Sebi said on Tuesday that the regulator is looking at Amfi's proposals on the multi-cap issue. It goes with saying that everyone involved would have been saved the trouble if such consultations had happened beforehand.

### **The genesis**

In late 2017, Sebi created a number of labels for mutual fund categories. Each fund house was allowed to have only one large-cap fund, one mid-cap fund and so on. Most of these categories had very clear specifications—a large-cap fund, for instance, had to invest a minimum of 80% of its assets under management in large-cap stocks. The aim was that fund houses don't randomly launch new funds with new names, while continuing with the same investment style of an existing fund. For investors, costs are lower with existing funds.

However, quite a few diversified equity funds didn't fit into the many labels that were on offer. The solution was to have a multi-cap category where fund managers could invest across large-, mid- and small-cap stocks.

There were no limits stated on how much needs to be in each category, which gave the impression that fund managers had the freedom to take their own call. If they saw value in large-caps in a particular season, they could have the majority of their portfolio in large stocks—or so they thought.

Sebi's latest stance suggests it had something else in mind when it created the multi-cap category. The circular suggests a definition

where funds need to have significant exposure to each category to qualify as a multi-cap fund.

"Multi-cap was generally understood as a category which gave fund managers the flexibility to take positions in any class of stocks, depending on where they saw value. Since there are many investors who want to delegate this decision to fund managers, it makes sense to have a category which has this flexibility. Since Sebi now clearly defines limits within all categories, what it effectively means is that every investor is expected to make the decision on market cap allocations among various equity categories," said Vishal Dhawan, founder, Plan Ahead Wealth Advisors.

Dhawan raises an important point. Sebi's intent to protect small investors has resulted in actions that are hurting them. After all, how many investors have the capacity to decide on what is an appropriate allocation to large-, mid- and small-cap stocks? Till now, all they had to do was buy a multi-cap fund. But Sebi's 9/11 circular takes this choice away.

"An important principle that needs to be considered is investor choice. A category that provides flexibility to the fund manager to move across large and small stocks is important from a choice perspective for investors who are seeking dynamic allocations," said J.R. Varma, professor of finance and accounting at Indian Institute of Management, Ahmedabad, and a former wholetime board member at Sebi.

And even if the mutual fund industry embraced a definition of multi-cap that was different from what the regulator intended, it's Sebi who is to blame for not making things clear all these years. To now force funds to either change their portfolios or categorisation is, to put it mildly, problematic.

## **The benchmark**

Apart from the concern on mis-labeling, Sebi has said that it's also trying to ensure funds are benchmarked appropriately. "It has recently been observed that some multi-cap schemes have skewed portfolios, with over 80% of investment in large-cap stocks, akin to large cap schemes, and some multi-cap schemes have near zero or insignificant asset allocation to small cap companies," Sebi said in the clarification it issued over the weekend. "Considering the above, in order to achieve the objectives of true-to-label and appropriate benchmark, a need was felt to review the scheme characteristics of multi-cap schemes," it added.

Its solution: allocate a minimum of 25% each to mid- and small-cap stocks. It's not clear how Sebi arrived at these numbers. "This reflects the arbitrariness involved in a non-consultative approach to decision-making," said Panchapagesan.

The industry's response is that there is no existing benchmark which has a 50% weight to mid- and small-cap stocks. "The profit of small-cap companies ranges between 7-11%, and 15-22% for mid-caps and the rest from large-caps. Our submission is that Sebi should definitely go for a minimum allocation to large- mid- and small-cap stocks, but it should be linked to the profit pool of the BSE or Nifty 500 companies," said the CEO of a large fund house.

Within the top 500 stocks, the proportion of large-, mid- and small-stocks is roughly 77%, 16% and 7% respectively. With a 50% weight in mid- and small-cap stocks, multi-cap funds will find it difficult to beat broad market indices such as the Nifty 500.

"How can you beat the benchmark if the allocation is altogether different from the benchmark," said Sunil Subramaniam, managing director, Sundaram Mutual Fund. Of course, there is nothing stopping the creation of a new benchmark. But the point really is that Sebi's definition of multi-cap is quite a departure from where the market is currently.

"If somebody allocates a minimum of 25% to small-cap stocks, that does not make it a multi-cap fund in its true sense. Also, the problem of liquidity in small stocks can't be ignored. 50-60% of these stocks are held by promoters, and free-float is low in absolute value terms. If large funds attempt buying or selling small caps in big quantities, it will have an unusual impact cost, which the fund's investors will have to bear. Keeping these in mind, the changes proposed for the multi-cap category rank very low on practicality," said Dhirendra Kumar, chief executive officer at Value Research.

### **The solution**

What about the argument that some funds are essentially large-cap funds masquerading as multi-cap funds? The worry is that fund houses do this to garner higher AUM by marketing two funds with similar characteristics, and also end up earning higher fees as a result. If the two schemes are merged, the fees would be lower, goes the argument. But this problem can be addressed in a different way.

"If any fund house is found flouting the norms prescribed by Sebi, the recourse for the regulator is to use its enforcement arm. Issuing a circular that paints everyone with the same brush is not the solution." said Panchapagesan.

To be sure, data from Value Research shows that three-fourths of the funds in the multi-cap category have a higher allocation to mid- and small-cap stocks than the 23% weight they have in the top 500 stocks in the market. Among the eight remaining funds, the data shows that only four funds have consistently had a weight of over 77% in large-cap stocks in the past three years.

As such, in a category with 35 funds, a circular is being issued to address a problem seen primarily in four funds, and to some degree in a few other funds. Enforcement would be a far better solution, provided wrongdoing is found. Of course, since Sebi hasn't so far

defined what multi-cap means, establishing wrongdoing would be a challenge in any case.

The best solution, most experts say, is to withdraw the muddled circular. Investor education and better communication to investors will go a long way in addressing any problems Sebi has detected.

"Informed investor choice requires improved communication. Currently, there is no way for investors to understand what goes behind their fund manager's investment philosophy. If a multi-cap fund manager is able to explain why a 90% weight to large-caps is necessary at a given point, investors are better positioned to take a call on whether they should stay with the fund or whether they will be better off with another fund," says Varma.

Moreover, investors taking the direct route now account for about a fifth of all AUM held by individuals. "Traditionally, mutual funds have communicated to their investors through intermediaries. Now, with many investors taking the direct route, it makes immense sense for fund managers to directly communicate with investors as well" said Dhawan.

From Sebi's perspective, better disclosures and investor education are areas to focus on, rather than taking upon itself the matter of asset allocation of a multi-cap fund. It is also an opportunity for Sebi to reconsider its rule-making process.