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SKIN IN THE GAME - ALIGNING INTERESTS OF KEY EMPLOYEES OF ASSET MANAGEMENT COMPANIES WITH INTERESTS OF UNITHOLDERS OF MUTUAL FUND SCHEMES

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Introduction

The Securities and Exchange Board of India (SEBI), on 6 October 2017 had introduced the circular on categorization and rationalization of mutual fund schemes in order to bring uniformity across mutual funds by standardizing scheme categories broadly into equity schemes, debt schemes, hybrid schemes, solution oriented schemes and other schemes. Further, on 5 October 2020 SEBI introduced the circular on Product Labelling in Mutual Fund Schemes - '*Risk-o-meter*' which imposed an obligation on mutual funds to assign a risk level to its schemes, based on the characteristics of the scheme, at the launch of the scheme or a new fund offer. The circular provided for classification of funds under six levels of risk under certain parameters, based on the nature of the instrument or security invested in by the scheme. The primary intent behind these circulars was to aid investors in making an informed decision, to improve transparency and uniformity, and to enable dynamic reporting of risk.

Keeping in line with the same intent, SEBI has, *vide* Circular (SEBI/HO/IMD/IMD-I/DOF5/P/CIR/2021/553) dated 28 April 2021 (Circular), notified a compensation mechanism for key employees of asset management companies (AMCs) having a role or oversight over mutual fund schemes managed by the AMC. Given that the management of the risk return profiles of the mutual fund schemes remain with the AMCs and the key employees of AMCs, the motivation behind the Circular is to align and reconcile the interests of the key employees of the AMCs with the interests of the unitholders of the mutual fund schemes. The Circular shall come into effect from 1 July 2021.

Classification of key employees

For the purpose of this Circular, key employees shall mean:

(i) chief executive officers, chief investment officers, chief risk officers, chief information security officers, chief operation officers, fund managers, compliance officers, sales heads, investment relation officers;

(ii) heads of any other departments and dealers of the AMC;

(iii) employees other than personal assistants or secretaries reporting directly to chief executive officers;

(iv) fund management teams and research teams; and

(v) any other employees so identified by the AMC or trustee.

However, the provisions of the Circular shall not be applicable to key employees exercising oversight or a role solely over exchange traded funds (ETFs), index funds, overnight funds, and other existing close ended schemes.

Modality of compensation as enumerated in the Circular

Key employees of the AMCs will be paid a minimum of 20% of the gross annual CTC (including perks, bonus, and any other non-cash compensation, net of income tax and any statutory contributions such as provident fund or pension) in the form of units of the schemes in which they have oversight, and such compensation shall be proportionate to the assets under management (AUM) of the said scheme.

In the case of fund managers managing a single scheme or a single category of schemes, 50% of the compensation shall be paid in the form of units of the scheme or category managed by them. At the discretion of the fund manager, compensation for the remaining 50% may be in the form of units of schemes whose risk value as per the risk-o-meter is equivalent to, or higher than the risk value of the scheme managed by the fund manager.

The units shall be paid proportionately over a period of 12 months from the date of payment of such salary, perks, bonus or non-cash compensation. In case of compensation paid in the form of employee stock options, the date of exercising such option shall be considered as the date of such payment. The units allotted to the key employees shall be subject to a lock-in period of a minimum of 3 years, or the tenure of the scheme, whichever is less. Further, no redemption of the units shall be allowed during the lock-in period, including in case of resignation or retirement before attaining age of superannuation. In case of retirement upon attaining age of superannuation, the allotted units shall be released from lock-in, except in cases of units in 'close ended schemes' which shall remain subject to lock-in until the tenure of the scheme has lapsed.

While redemptions of the allotted units shall not be allowed during the lock-in period, the AMC may, as per the policy laid down by it, allow for a provision of borrowing by key employees from the AMCs against the allotted units in case of medical exigencies or on other humanitarian grounds.

Clawback

The compensation paid to the key employees in the forms of units of the mutual fund schemes shall be subject to clawback in case of fraud, gross negligence, or violations of code of conduct by such key employees, as may be determined by SEBI. In case of such clawback, the amount shall be credited to the scheme by redeeming the units allotted to the key employees.

Responsibility and oversight

The responsibility to oversee compliance with the provisions of the Circular has been entrusted to the AMCs and such compliance shall be monitored by the trustees of the mutual fund. Any non-compliance with the provisions of the Circular will be required to be reported in the quarterly Compliance Test Report (CTR) by the AMCs as well as the half-yearly trustee report, by the trustee. Further, every scheme will also be required to disclose the aggregate compensation paid to key employees in the form of units of the said scheme on the website of the AMC.

Comments

It is observed that the standardisation of mutual fund schemes and enabling dynamic reporting of risk has led to the correction of irregularities, redressal of investor issues, and has improved investor confidence. Consistent with such efforts, the mechanism envisaged under the Circular is expected to further improve accountability and standardise the operation of AMCs and introduce some skin in the game.

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