Side Pocketing by Mutual Funds

1. Objective

1.1. This Board memorandum proposes to enable mutual funds to undertake side pocketing of debt and money market instruments in case of a credit event while ensuring fair treatment to all unit holders.

2. Background

2.1. During September-October of 2008, in the wake of global financial crisis, the money market in India had witnessed very tight liquidity conditions because of various reasons including advance tax outflows, suppliers' credit withdrawal partly due to the freezing of western credit markets, risk aversion in the market, etc. The tightness in liquidity led to the market for Certificates of Deposit (CDs) and Commercial Papers (CPs) drying up. Due to the liquidity crisis, mutual funds faced huge redemption pressure and there were few buyers for assets of even the highest credit quality. There was a shifting of investments from mutual funds to bank deposits, freezing up of the money markets and drying up of credit lines from banks to mutual funds, etc. During the said period, the valuation of debt and money market instruments with residual maturity of below 182 days was done on amortization basis, which was at variance with the fair value of these instruments in such volatile markets. The practice of amortization accentuated the liquidity crisis. To deal with this crisis, RBI, in consultation with SEBI provided a special repo arrangement of Rs. 20,000 crore to enable banks to meet the liquidity requirements of Mutual Funds. Towards this end, SEBI had also increased the mutual funds borrowing limit from 20% of net assets to 40% on a case-to-case basis.

2.2. In 2010, the valuation guidelines were modified by SEBI to ensure that all debt and money market securities were to be valued at the weighted average price at which they are traded on the particular valuation day. Securities with residual maturity of upto 91 days (reduced from 182 days) which were not traded on a particular valuation day, would have be valued on amortization basis and securities with

residual maturity of over 91 days which were not traded on a particular valuation day would have be valued at benchmark yield/ matrix of spread over risk -free benchmark yield obtained from agency(ies) entrusted with the said role by AMFI.

2.3. Subsequently, in 2012, the aforesaid valuation guidelines were further tightened and only securities with residual maturity of upto 60 days were permitted to be valued on amortization basis and principles of fair valuation of securities i.e. valuation to be reflective of the realizable value of the securities, were introduced.

2.4. In July 2013, the RBI raised short-term interest rates and reduced the liquidity adjustment facility (LAF) for each bank from 1% of its Net Demand and Time Liabilities (NDTL) to 0.5%. This led to an increase in yield of debt and money market instruments and resulted in increased redemption in debt oriented schemes more specifically in liquid schemes. As a contingency measure to address the liquidity requirements of mutual funds, RBI in consultation with SEBI provided a special re-finance window to commercial banks and similar to 2008, SEBI decided to increase funds borrowing limit, on a case-to-case basis from 20% of the net assets to 40% of net assets of mutual fund schemes. However, since the valuations were done based on the principles of fair valuation (i.e. based on realisable value), the incentive for investors to redeem first was relatively low and thus, mutual funds were less susceptible to redemption pressure. While no asset management company utilized the additional borrowing limit or RBI's special liquidity window to meet their liquidity requirements, the measures served to give confidence to the market and avoid a panic response to adverse market developments.

2.5. In May 2016, the guidelines on 'Restriction on Redemption in Mutual Funds (Redemption Gate) were issued to provide for restriction on redemptions in the event of significant redemption pressure due to an overall market crisis rather than entity specific situations.

2.6. The recent defaults on debt obligations by a few entities particularly in September, 2018 and subsequent volatility in the debt and money market instruments issued by NBFCs and HFCs had resulted in redemption pressures in debt mutual fund schemes, more specifically in liquid schemes. Further, during this period the net inflows to the industry were also reduced. Due to this, the most liquid assets in the portfolios were sold to meet the redemption requirements and remaining investors'

exposure to lesser liquid instruments increased. October saw a partial recovery in flows in response to the stabilization of the market. The details are given as under:

(in Rs. Cr.)

Open Ended Income / Debt Oriented Schemes	Funds mobilized	Repurchase/ Redemption	Net Inflow (+ve)/ Outflow (-ve)
August, 2018			
Liquid/ Money Market	1891069.67	1719962.43	171107.24
Gilt	148.56	432.00	-283.44
Other Debt Schemes	40402.03	41711.79	-1309.75
Total	**1931620.26**	**1762106.21**	**169514.04**
September, 2018			
Liquid/ Money Market	1627150.16	1838199.73	-211049.57
Gilt	115.14	1083.14	-968.00
Other Debt Schemes	23640.43	58052.88	-34412.45
Total	**1650905.73**	**1897335.75**	**-246430.03**
October, 2018			
Liquid/ Money Market	2271941.69	2216646.34	55295.35
Gilt	217.17	507.32	-290.15
Other Debt Schemes	21051.57	57226.64	-36175.07
Total	**2293210.43**	**2274380.30**	**18830.13**

From an analysis of Asset under Management (AUM) of all debt oriented schemes, it is observed that the AUM declined from Rs.12,12,687.43 Cr. as on 31st August, 2018 to Rs.9,92,980.45 Cr. as on 31st October, 2018 i.e. a decline of around 18% over a period of 2 months. In case of liquid and money market schemes the AUM had declined by around 25% during the same period. This was despite the fact that the total exposure of mutual fund schemes to the IL&FS group was only approx. Rs.3,500 Cr. as on 31st August 2018 i.e. around 0.24% of the debt AUM of the mutual fund industry.

During that period, many mutual funds needed to keep an extremely tight watch on the liquidity scenarios in their various debt oriented schemes. There was also a request from a mutual fund for enhancement of the borrowing limits from 20% to 30% of the net assets of the scheme for a period of 7 days in order to meet the redemption requirements.

Thus, it was observed that a credit event in even one issuer/group could lead to significant liquidity risk in the entire industry which in turn can lead to further volatility in the market. Accordingly, a need is felt to put in place a mechanism to deal with a situation that arises in a Mutual Fund scheme due to a credit event on a debt security in its portfolio.

2.7. In this backdrop, and in order to have an understanding on the prevailing liquidity scenario and the risk management mechanisms being used to deal with the emanating liquidity risk for mutual funds, SEBI had a meeting with various mutual funds and Association of Mutual Funds in India (AMFI) on September 28, 2018. One of the suggestions that emerged from the discussion was to permit 'Side Pocketing' for mutual fund schemes. Subsequent to the said meeting, AMFI vide letter dated October 05, 2018 submitted a proposal on side pocketing.

2.8. "Side Pocketeting" is a mechanism to separate distressed, illiquid and hard-to-value assets from other more liquid assets in a portfolio. This prevents the distressed assets from damaging the returns generated by more liquid, better-performing assets. The side pocket is generally formed by creation of a separate portfolio of distressed, illiquid and hard-to-value assets. Each investor is allocated his / her pro-rata interest in the side pocketed portfolio. When a recovery is made in the side pocketed portfolio, the same is distributed amongst those investors on a pro-rata basis.

2.9. Currently, in the absence of side pocketing, in case of credit events, the existing investors potentially lose all value. Any future recovery accrues to the investors in the scheme at the time of recovery. With side pockets the investors who take the hit when the credit event happens get the full upside of future recovery.

3. Global Practices

3.1. As per IOSCO reports on 'Open-Ended Fund Liquidity and Risk Management -Good Practices and Issues for Consideration' (February, 2018) and on 'Liquidity Management Tools in Collective Investment Schemes (CIS): Results from an IOSCO Committee 5 (C5) Survey to Members' (December, 2015), based on the responses of 26 jurisdictions to C5 Survey on liquidity management tools, it was observed that in

11 jurisdictions (including India), there are no provisions relating to side pocketing. Out of the remaining 15 jurisdictions where side pockets are permitted, in 7 jurisdictions, there are no restrictions on type of schemes for applicability of side pocketing and in the remaining 8 jurisdictions, side pocketing is considered only for non-retail portfolios i.e. for hedge funds and/ or alternate investment funds, etc.

3.2. One view that emerged upon discussion with the industry was that developed markets permit side pockets for non-retail funds because retail funds predominantly invest in assets in which markets are very wide and deep. In such jurisdictions even the junk bond market is active and exit is available at a price. Thus, the need for a side pocket in retail funds is not high. The Indian bond market on the other hand, has relatively less depth and width and particularly in case of credit events, trading in those securities freezes, as has been seen recently. Thus, Indian mutual funds which invest in debt and money market instruments face liquidity constraints that is very different from major developed markets.

4. Consultative Process and Recommendations

The issue of side-pocketing was taken up for deliberation in the Mutual Fund Advisory Committee (MFAC) meetings held on November 12, 2018 and November 20, 2018. The recommendations of MFAC are detailed below:

4.1. Side pocketing of debt and money market instruments may be permitted in all mutual fund schemes.

4.2. Side pocketing may be permitted on the day of 'downgrade' of a debt instrument to 'below investment grade' or on the day of each subsequent downgrade from 'below investment grade'. In case of difference in rating by multiple agencies, the conservative assessment may be considered.

4.3. Side pocketing may not be mandatory and shall be at the discretion of fund house.

4.4. Side Pocketing shall be based on issuer level credit events. However, the side pocketing shall be implemented at the ISIN level.

4.5. In order to ensure fair treatment of all investors and prevent misuse of side pocketing the following needs to be adhered to:

4.5.1. The mutual fund has to decide whether to side pocket or not on the day of the credit downgrade.

4.5.2. If a mutual fund decides to side pocket a security, approval of trustees shall be mandatory (For this purpose, trustees' approval would mean that at least a majority of the trustees agree to the proposal of creating side-pocket).

4.5.3. Till the time the decision of trustees is received, subscription and redemption in the scheme shall be suspended.

4.6. No TER can be charged on the side pocketed portfolio during the currency of the side pocket. However, TER can be charged upon recovery of the dues on a pro-rata basis i.e. only on amount recovered out of the total dues.

4.7. The following shall be adhered to subsequent to the creation of side pocket:

4.7.1. An e-mail and SMS should be sent to all unit holders of the concerned scheme on the day of creation of side pocket.

4.7.2. A revised statement of holding indicating the units held by the unitholder in the side pocket along with the applicable NAV of the main portfolio must be communicated to the unitholders within 5 working days of creation of the side pocket.

4.7.3. Adequate disclosure of the side-pocket should appear in all the scheme documents and the monthly portfolio disclosure.

4.7.4. The name of the scheme as appearing at all places shall include the information of number of side-pockets that have been created in the scheme.

4.7.5. Mutual funds shall make best possible efforts to recover the maximum amount in as little time as possible.

4.7.6. In every meeting of trustees, an ATR shall be placed to update on the efforts made to recover the dues. The trustees shall ensure that mutual funds make rigorous attempts to recover the dues and report the same in the half-yearly trustee report to SEBI.

MFAC further recommended that SEBI may finalise the operational modalities relating to side pocketing.

4.8. Further, during the deliberations, it was felt that the Net Asset Values (NAVs) of mutual fund schemes should move closer to their realizable market value, so as to reduce the incentive of large investors to take the first mover advantage by redeeming during tight liquidity situations. Accordingly, MFAC has inter-alia recommended modification in the valuation guidelines for debt and money market instruments: uniform valuation of securities below investment grade, reduction in residual maturity of securities from the present 60 days to 30 days for which amortization may be permitted and reduction in the spread over the reference / market price, from the existing ±0.10%.

5. Proposal

5.1. Taking into account the recommendations of MFAC, it is proposed to permit side-pocketing by mutual funds with the following broad principles:

5.1.1. Side pocketing may be permitted for debt instruments in mutual fund schemes based on credit events at issuer level.

5.1.2. It may be optional for mutual funds to exercise side pocketing.

5.1.3. Activation of side pocketing to be subject to trustee approval.

5.1.4. Monitoring by trustees to ensure timely recovery of side pocketed assets.

5.1.5. Adequate Disclosure to existing and prospective investors to enable informed decision.

5.1.6. Adequate safeguards to ensure protection of interest of investors.

5.2. Taking into account the recommendations of MFAC, it is proposed that SEBI may review the valuation guidelines for investment in debt and money market instruments.

5.3. The Board may consider and approve the proposals at paragraphs 5.1 and 5.2 above and may authorize the Chairman to take steps to implement the proposal by issuance of circular, with consequential and appropriate changes, as may be required in this regard.

Supplementary Board Memorandum on Side Pocketing by Mutual Funds

1. Background

1.1. A broad framework on side pocketing of debt and money market instruments by mutual funds was proposed under paragraph 5.1 of Board Memorandum on Side Pocketing by Mutual Funds for protecting the interest of the investors.

2. Implementation of Side Pocketing

2.1. Side pocket being a new concept, based on learnings, certain modifications may have to be carried out from time to time, which may require changes in the circular(s).

2.2. Thus, paragraph 5.3 of the on Side Pocketing by Mutual Funds shall now read as submitted for information. Necessary circular(s) on side pocketing shall be issued with approval of the Chairman.

2.3. The provisions for side pocketing shall be implemented prospectively from the date of issuance of the circular.

3. Illustrative List of Safeguards

3.1. It is proposed to have certain safeguards in place for side pocketing, in order to minimize potential mis-use of this mechanism. An illustrative list of safeguards of side pocketing is given below.

3.1.1. Side pocketing of debt and money market instruments may be permitted in mutual fund schemes with effect from the day of happening of the following credit events at issuer level:

3.1.1.1. Downgrade of a debt or money market instrument to 'below investment grade' by a Credit Rating Agency (CRA), or

3.1.1.2. Subsequent downgrades from 'below investment grade' by a CRA, or

3.1.1.3. Similar downgrade of loan rating by a CRA.

In case of difference in rating by multiple CRAs, the most conservative assessment may be considered. Side Pocketing shall be based on issuer level credit events and shall be implemented at the ISIN level.

3.1.2. It may be optional for mutual funds to exercise side pocketing.

3.1.3. Activation of side pocketing shall be subject to prior approval of the trustees of the mutual fund.

3.1.4. Monitoring by trustees to ensure timely recovery of side pocketed assets:

3.1.4.1. The Asset Management Company (AMC) shall make best possible efforts to recover the dues from the side pocketed portfolio.

3.1.4.2. The AMC shall place an updated Action Taken Report (ATR) on the efforts made to recover the dues from the side pocketed portfolio in every trustee meeting till the dues are fully recovered/ written-off. The trustees shall ensure that the AMC puts in sincere efforts to recover the dues and report the same in the half-yearly trustee report to SEBI.

3.1.4.3. In order to avoid mis-use of side pocketing, trustees shall ensure to have a mechanism in place to negatively impact the performance incentives of Fund Managers, Chief Investment Officers (CIOs), etc. involved in the investment process, mirroring the existing mechanism for performance incentives of the AMC, including claw back to the side pocketed portfolio of the scheme and to ensure monitoring and reporting of the same in the half-yearly trustee reports to SEBI in respect of every side pocket created.

3.1.5. Disclosure to existing and prospective investors enabling them to take informed decision:

3.1.5.1. In case of existing schemes, the enabling provisions for creation of side pockets shall be included in the Scheme Information Document (SID) subject to appropriate disclosure and compliance with Regulation 18(15A) of SEBI (Mutual Funds) Regulations, 1996, as this will lead to change in fundamental attributes of the scheme and all unit holders shall be given a time-period of at least 30 days to exercise the option to exit at prevailing NAV without charging of exit load.

3.1.5.2. A press release should be issued by the concerned mutual fund on the day of creation of side-pocket and also provide the information regarding the same to SEBI.

3.1.5.3. An e-mail or SMS should be sent to all unit holders of the concerned scheme on the day of creation of side pocket.

3.1.5.4. Adequate disclosure of the side-pocket shall appear in all scheme related documents, in monthly and half-yearly portfolio disclosures and in the annual report of the mutual fund and the scheme.

3.1.5.5. The name of the scheme as appearing at all places such as SID, advertisement, AMC and AMFI websites, etc. shall include the information of side-pockets created in the scheme.

3.1.5.6. The scheme performance as disclosed at various places shall include the impact of side pocketing.

3.1.5.7. A statement of holding indicating the units held by the investors in the side pocketed portfolio along with the revised NAV of both side pocketed and non side pocketed portfolio to be communicated to the investors within 5 working days of creation of the side pocket.

3.1.5.8. The disclosures regarding side pocketing shall be carried out for at least a period of 3 years or till such time the dues are finally recovered/ written-off, whichever is later.

3.1.6. Additional safeguards to ensure protection of interest of investors:

3.1.6.1. No investment and advisory fees can be charged by the AMC on the side pocketed portfolio. However, TER (excluding the investment and advisory fees) can be charged on the side pocketed portfolio but only upon recovery, on a pro-rata basis i.e. on the recovered amount. The TER (excluding the investment and advisory fees) charged shall not exceed the simple average of such expenses charged on daily basis on the non-side pocketed portfolio (in % terms) during the period for which side-pocket was created. The costs related to recovery of the assets side pocketed may be charged to the side pocketed portfolio upon recovery, within the maximum TER limit. The recovery cost in excess of the TER limit shall be borne by the AMC.

3.1.6.2. The existence of the provisions for side pocketing should not encourage the AMCs to take undue credit risk in the scheme portfolio.

3.1.6.3. Mis-use of the provisions of side pocketing, would be considered serious and stringent action may be taken against the concerned AMC.

4. The proposals made at paragraphs 2 and 3 above are for information to the Board. Necessary circular(s) on side pocketing shall be issued with the approval of the Chairman.