FRANKLIN TEMPLETON- A CASE IN POINT

The case of Franklin Templeton provides a perfect example of what may go wrong with your investments in a worst possible scenario. There may be several questions lying in the minds of the unitholders *viz.* Considering that the schemes were constituted as "moderately" risky, how could such a drastic action of winding-up be taken by the asset management company? Did the trustees fail to protect investment interest and breached their fiduciary duty by not informing the investors of "sustained" fall and instead opted to wind-up the schemes thereby stalling any redemption activity from the investors? Did the fund managers falsely represent to the investors that it possessed skill and experience to protect investor's investment?

Priyanka Devgan (Counsel) and Anuj Sharma (Associate) of Verus answer some of the most relevant questions surrounding Franklin Templeton's decision to wind up 6 debt schemes.

We would be happy to receive any feedback or comments you may have on this update. You can reach out to Priyanka at priyanka.devgan@verus.net.in and Anuj Sharma at anuj.sharma@verus.net.in.

FRANKLIN TEMPLETON- A CASE IN POINT

1. *What are the schemes that Franklin Templeton ("FT") has decided to wind-up?*

FT Trustee Services Pvt. Ltd. has, pursuant to Regulation 39(3)(b) of the SEBI (Mutual Funds) Regulations, 1996 ("**Mutual Fund Regulations**") given a notice to wind up 6 of the following open ended debt schemes:

1. Franklin India Low Duration Fund;
2. Franklin India Dynamic Accrual Fund;
3. Franklin India Credit Risk Fund;
4. Franklin India Short Term Income Plan;
5. Franklin India Ultra Short Bond Fund; and
6. Franklin India Income Opportunities Fund.

2. *What are the circumstances under which an open ended scheme can be wound up under the Mutual Fund Regulations?*

As per Regulation 39 of the Mutual Fund Regulations, open-ended schemes may be wound up, after repayment of the amount due to the unitholders in any of the following circumstances: (a) on the happening of any event which, in the opinion of the trustees, requires the scheme to be wound up; or (b) if seventy-five per cent of the unitholders of a scheme pass a resolution that the scheme be wound up; or (c) if Securities and Exchange Board of India ("**SEBI**") so directs in the interest of the unitholders.

When a decision to wind-up the schemes is taken, the trustees are required to give notice disclosing the circumstances of such winding-up to the SEBI and also issue a public notice in 2 daily newspapers.

3. *Could you explain the reasoning provided by FT for winding up of schemes and its meaning?*

The FT schemes which are subject to winding up are all debt fund schemes. Usually, debt funds invest in fixed-interest generating securities such as corporate bonds, government securities, commercial papers and other money market instruments. Debt funds invest in securities based on their credit ratings. Credit ratings are assigned taking into account the repayment capability of the issuer of a debt instrument. A higher credit rating means the entity is more likely to pay interest on debt security regularly and also return the principal amount. The credit rating also determines the risk in the investment. The credit risk is highest in funds which buy low-rated corporate bonds and lowest in funds that buy government securities. As a return for taking such risk, companies usually offer higher coupon rates i.e. the debt funds get bonds with high yields by investing in low rated debt instruments. The returns also rise if these holdings get an upgrade in rating by credit rating agencies or their credit profile improves causing a rise in their market prices. However, if issuer of debt instruments defaults on repayment then such default results into downgrading of the debt instruments, resulting in such investments carrying higher risk.

FT had reported that the schemes that are subject to winding up witnessed higher redemption requests by unitholders in recent times which had, in turn, resulted in FT selling liquid and higher-rated bonds leaving the unitholders with riskier debt. Therefore, in this scenario, FT had decided to wind-up the schemes.

---

4. *What is the effect of winding up of a scheme and its effects?*

As per Regulation 40 of the Mutual Fund Regulations, from the date of publication of the winding up notice, the trustee or the asset management company: (a) cease to carry on any business activities in respect of the relevant scheme for which notice has been given; (b) cease to create or cancel units in such scheme; and (c) cease to issue or redeem units in the scheme.

As a result of the above, the unitholders of the scheme cannot invest, exit, or receive dividends from the schemes.

---

5. *Who will be responsible to dispose of the assets of the scheme and how will the unitholders be paid upon winding up?*

As per Regulation 41(1) of the Mutual Fund Regulations and the FT's Statement of Additional Information ("**SAI**"), the next steps would involve holding the meeting of the unitholders of each of the schemes where necessary resolution by simple majority is required to be passed to authorise the trustee or any other person to take steps for winding up of the scheme. The person authorised will then be responsible to dispose of the assets of the concerned scheme in the best interest of the unitholders of that scheme.

As per Regulation 41(3) of the Mutual Fund Regulations and FT's SAI , the proceeds of sale realized from the disposal of the scheme's assets will be utilized/distributed in the following order: (a) first, to discharge the borrowings and liabilities as are due and payable under the scheme *(Mutual funds can borrow upto a fixed percentage of their AUM)*; (b) to make appropriate provision for meeting the expenses connected with such winding up *(e.g.: lawyers and accountant fees)*, and (c) to pay the unitholders in proportion to their respective interest in the assets of the scheme as on the date when the decision for winding up was taken.

No time limit has been prescribed within which the assets will have to be disposed and redemption is to be made to the unitholders. While absence of an outer timeline, on one hand, lends to uncertainty of the time within which the unitholders will receive their redemption amounts but, on the other hand, provides leeway / flexibility to the trustees in managing the sale of assets such that the returns for the unitholders are maximised.

Naturally, the winding up process goes on for a while. The scheme which has been wound up shall cease to exist only when SEBI has received a report from the trustee, containing particulars of circumstances leading to the winding up, the steps taken for disposal of assets of the fund before winding up, expenses of the fund for winding up, net assets available for distribution to the unitholders and a certificate from the auditors of the fund, and is satisfied that all measures for winding up the scheme have been completed. Only after SEBI is satisfied that all measures for winding up of the schemes have been complied with, will the SEBI order the closure of the scheme.

---

6. *Will the unitholders receive information of their schemes during the winding up process?*

Yes. The unitholders will get information about their schemes by half-yearly and annual reports as submitted by the FT's trustee under the Mutual Fund Regulations. Such information will continue to be available until winding up is completed or the scheme ceases to exist.

7. Generally, what are the responsibilities on the trustees and the asset management company to the unitholders as prescribed under the Mutual Fund Regulations?

Under the Mutual Fund Regulations, the trustees are responsible for general superintendence and direction to the asset management company and are responsible to make disclosures to the unitholders as are essential to keep them informed about any information which may have an adverse bearing on their investments. While the trustees are accountable for and custodian of the funds and property of the respective schemes and are required to hold the same in trust for the benefit of the unitholders, it is the asset management company that actually manages all the funds of the unitholders by making investments in securities.

Regulation 25(1) and (2) of the Mutual Funds Regulations, read with the Code of Conduct framed under the Mutual Fund Regulations require that an asset management company takes all reasonable steps and exercises due diligence and proper care in all its investment decisions based on its independent professional judgment as would be exercised by other persons engaged in the same business. Regulation 25(6A) of the Mutual Fund Regulations mandates that the Chief Executive Officer of the asset management company ensures that the investments made by the fund managers are in the interest of the unitholders and also is responsible for the overall risk management function of the mutual fund. Under Regulation 25(6B) the fund managers are responsible to ensure that the funds of the schemes are invested to achieve the objectives of the scheme and in the interest of the unitholders. Regulation 29 read with the Code of Conduct under the Mutual Fund Regulations mandates that the offer document contain all adequate disclosures that would enable investors to make informed investment decisions and ensure dissemination of adequate, accurate, explicit and timely information fairly presented in simple language about the investment policies, investment objectives, financial position and general affairs of the scheme.

In effect it is the asset management company that is principally responsible for handling the investment of the unitholders. Therefore, in a situation where a decision to wind up the mutual fund is taken by the trustees it is largely due to the asset management company's management of the funds of the unitholders and its ability to manage the risk on investments made in the mutual funds.

8. What were the disclosures made by FT in its SID with respect to the risks involved in the investments?

The FT's Scheme Information Document ("**SID**") provided certain ***risks involved in investing in their funds*** such as liquidity or marketability risks, extreme volatility, interest rate risk and credit or default risk etc.

Further, the SID also provided certain ***risk mitigation measures*** which required the fund managers to:

- ***Minimise credit-default risk*** by primarily investing in medium-high investment grade fixed income securities (rated BBB and above).
- Follow an ***active investment strategy*** within the broad framework of asset allocation pattern stated in the SID. The asset allocation pattern may be altered from time to time on a short-term basis keeping in view market conditions, market opportunities, applicable regulations and political and economic factors (i.e. for reasons other than downgrade in rating), and in such cases, would be rebalanced within 30 days from date of deviation.

- Adhere to the ***investment restrictions*** specified in SID and by SEBI from time to time.
- ***Transfer investments*** from one mutual fund to another provided the transfers are in conformity to investment objectives of the scheme.
- ***Suspend sale of units*** in periods of extreme volatility which in the opinion of the fund manager is prejudicial to the interest of the unitholders.
- Fund managers can also alternatively ***suspend redemption of units*** when there are extreme volatility and liquidity issues in the market, for a maximum period of 10 working days in a 90 days period.

Just by reading those texts, it is difficult for an ordinary unitholder to understand how likely the risks are and how different they could be in different scenarios across various schemes. The unitholder is expected to simply rely on the professional judgment of the fund managers to determine whether a situation has arisen when the sale/redemption of units could be suspended or a winding-up action of the scheme all-together, should be undertaken.

9. Is FT legally correct in its decision to wind up?

It is a nuanced question and the answer lies only after a long road of careful legal analysis.

If the action of FT is reviewed by a court or SEBI, then the FT's trustee and the asset management company will be required to show that their decision to winding up has not come about on account of any failure on their part to comply with the Mutual Fund Regulations, the SAI and the risk mitigation measures set out in the SID. The court or the regulator will also analyse whether the fund managers rendered complete duty of care in performing their duties under the Mutual Fund Regulations and whether the steps taken by them were such that the interest of the unitholders is safeguarded.

Coming specifically to the decision of winding up, Regulation 39 of the Mutual Fund Regulations provides wide power to the trustees of a mutual fund to decide the nature of the event where a scheme requires to be wound up. There is no express guidance or criteria which must be met by the trustees while making this judgement. However, there is a general obligation on the trustees to always act in the interest of the unitholders. Naturally, the analysis as to the accuracy of the decision will need to take into account substantial factual details considered by FT at the time of making the decision.

FT in its notice in the newspapers had stated that the winding-up was due to "*dramatic*" and "*sustained*" fall in liquidity in certain segments of the corporate bond markets on account of COVID-19 crisis and the resultant lock-down of the Indian economy. FT's notice further stated that the trustee after "*careful*" analysis and review of the recommendations of the asset management company and in close consultation with the investment team, were of the opinion that an "*event*" had occurred which required that the schemes be wound up and that was the only "*viable option*" to "*preserve value*" for unitholders and to enable "*orderly*" and "*equitable*" exit for all unitholders in these "*unprecedent times*". The statement by FT is an attempt to show that the trustees fulfilled the first criteria for winding-up the schemes.

If trustees are called upon to show that that there was no option other than winding-up, the trustees will need to demonstrate how the usual measures taken by similar mutual funds where it faces higher redemption requests like taking credit lines from banks to meet redemptions, having stiff exit loads and capping the investment per investor, did not work in the scenario of FT. It should also be kept in mind that FT had a right to declare suspension upto 10 business days on redemption of its units and also suspend trading of units. Clearly the fund managers did not opt to go through such temporary suspension route. This could also be due to the reason that there is no regulatory prescription permitting such suspension. Indeed the courts tend to injunct attempts to suspend redemption en-masse as evidenced by Delhi High Court's recent order in Indiabulls Housing Finance Ltd. case. It will also be likely, in such hypothetical situation that each step taken by the trustees, asset management company and its officers till the time of winding-up will be carefully scrutinised to check whether the decision to wind up was in the interest of the unitholders or was it a decision taken to avoid responsibility.

10. Have there been any instances of winding up of mutual fund schemes in the past, court ordered or suo moto?

Yes, there have been multiple cases where mutual funds have wound-up their schemes or transferred their schemes to other funds *suo moto* due to varied reasons like accumulated losses or to focus on core business areas. Some examples of such mutual funds are Dundee Mutual Fund, Sriram Mutual Fund, Pioneer ITI Mutual Fund, First India Mutual Fund etc.

However, very few cases of such winding-up have been pursuant to a SEBI order. One example of SEBI's action has been with respect to Sahara mutual fund where in 2015, SEBI cancelled Sahara mutual fund's registration stating that it was no longer "fit and proper" to carry on the business and ordered transfer of its operation to another sponsor. Thereafter, Sahara appealed against the said order before SAT and the Supreme Court which rejected the appeals. SEBI then issued a letter to Sahara to comply with the said order. Subsequently, Sahara wrote to SEBI seeking time such that the schemes could be transferred to a new sponsor and justified such a request on the ground that one of its schemes was a tax saver scheme with a stipulation for lock-in of 3 years and immediate implementation of the SEBI order could lead to denial of benefits to the investors of the said tax saver scheme. Considering the aforesaid, the SEBI directed Sahara mutual fund to wind-up its schemes, except the tax saver scheme which was granted time of 3 years to completely wind-up its scheme.

11. What are the types of allegations against mutual funds that have generally been adjudicated upon by SEBI?

There have been several cases where orders have been passed by SEBI for violations of the Mutual Fund Regulations against the trustees, asset management companies and its directors. The allegations range from non-disclosure of key information in the offer document, procedural lapses, failure in submission of reports, breach of fiduciary duties, professional misconduct etc. SEBI while evaluating whether an action of the asset management company, trustee and its officers has caused violation of the Mutual Fund Regulations and the Code of Conduct prescribed thereunder, looks at whether such decision has caused such mutual fund intermediaries to gain unlawfully and due to which losses have been suffered by the unitholders.

<u>ICICI MF- NCDs Issued by Jindal Steel & Power</u>

A pertinent example to illustrate on this matter would be SEBI's recent order dated 23 December, 2019 where SEBI had to *inter alia* determine whether the decision of ICICI trustee and ICICI asset management company to not rebalance the portfolio, despite downgrading of the non-convertible debentures ("**NCDs**") issued by Jindal Steel and Power Limited ("**JGLS**") by credit rating agencies, had led to the violation of the Mutual Fund Regulations. The SEBI considered various factual details of the actions taken by the fund managers while determining their bonafides and made the following observations:

- ***Decision taken based on prior experience and expertise*:** On downgrading of the credit rating of JSPL's NCDs, the fund managers had tried selling the NCDs, however, they were not able to find a buyer at the terms favourable to the schemes and in turn, to the investors. As fiduciaries to the unitholders and based on their prior experience and expertise, the fund managers took the view that such distress sale of the NCDs would cause huge losses to the unitholders.

- ***Satisfaction of the best-efforts requirement and risk-reward analysis*:** The fund managers took the call based on their understanding that as there was lack of depth in the corporate debt market, if buyers were found for such debt instruments whose credit ratings have been downgraded, the purchase price quoted would be at a very steep discount to the nominal value. Thus, the efforts made by fund managers were in accordance with the "*best efforts*" requirement, as provided in the SID of close ended schemes of ICICI mutual fund. The fund managers had also in line with the SID undertaken a risk *(factors leading to the downgrade of credit rating)*-reward *(probability of repayment)* analysis.

- ***Implications of the investment decisions***: Despite downgrade, JSPL had paid its debts on the respective due dates with respect to the NCDs and therefore, the fund managers were of the view that the interest of the unitholders would be duly protected and the losses that might have occurred to the unitholders on account of panic selling at a huge discount, would be prevented. The SEBI noted that *"not only was the abstention of divestment decisions of the fund manager right in foresight, but was also right in hind-sight and thus, protected investors."*

HDFC MF and Debt Instruments issued by Essel

Another pertinent example is SEBI's handling of a settlement application filed by HDFC trustee, HDFC asset management company and its officers towards settlement of their non-compliances of Mutual Fund Regulations in various mutual fund schemes in the debt instruments of Essel group of companies. The SEBI *vide* order dated 16 April, 2020 accepted settlement of an amount of Rs. 4.20 crores on the assurance that the said liability would not be passed to the unitholders but would be paid out of the funds of the asset management company. The HDFC fund managers had also submitted that there were no subsisting complaints from the unitholders and that they had already compensated the unitholders by an amount of Rs.4.46 crores.

12. Could the unitholders file a civil suit or a class action suit for compensation against the asset manager and the trustees of the wound up schemes?

Assuming that the unitholders could factually fasten liability of losses arising from unexpected winding up, a further question will be could the unitholders get together and file a combined action.

In this regard, the unitholders could explore filing a "representative suit" under the Civil Procedure Code, 1908 or filing a class action under the Companies Act, 2013. Section 245 of the Companies Act, 2013 permits filing of class action suit by atleast 100 depositors before the National Company Law Tribunal *inter alia* for restraining a company from acting on a resolution or to claim damages or compensation or demand any other suitable action from or against the company, its directors for any fraudulent, wrongful act or omission or any incorrect or misleading statement or other similar remedies. However, considering that as FT is regulated by SEBI and Section 20A of the SEBI Act, 1992 bars a civil court from having jurisdiction on any matter that is under the regulatory purview of SEBI, it is possible that FT could take a defence that such a class action suit may not lie.

On the other hand, it can be argued that payment of compensation to the unitholders for negligence of FT is not a matter expressly covered by the SEBI Mutual Fund Regulations and to that extent a plea of mass compensation/damages before an appropriate civil court or a class action suit may still lie. Of course, that by itself would not be sufficient to claim compensation; but unitholders will have to show that they have suffered losses as a result of this unexpected winding up. Indeed, there has been at least a precedent, where a unitholder has filed suit for negligence against the asset management company, the trustees and their officers on their failure to render duty of care by not taking sufficient steps to prevent an event from happening and due to which losses and damages were suffered by the unitholders.

The remedy of class action is widely used in the USA by unitholders of mutual fund schemes. In the USA, such class action law suits have been filed against mutual funds market-timing and late trading arrangements, mutual fund fee practices including revenue sharing and directed brokerage, sales practices with respect to different share classes, failure to adhere to fund’s stated investment objective, omission of relevant risks and inaccurate valuation of the fund’s assets. However, there have been no cases of such class action in India.

---

13. What are the recent steps taken by SEBI and RBI to ease the pressure on debt funds?

On 27 April, 2020, the RBI announced Rs. 50,000 crores special liquidity fund for mutual funds in order to ease the stress being faced by high-risk debt mutual funds. The scheme is available till 11 May, 2020 or upto the utilisation of the allocated amount, whichever is earlier. The funds shall be utilised by banks exclusively for meeting liquidity requirements of mutual funds by (i) extending loans; and (ii) undertaking outright purchase of and/or repos against the collateral of investment grade corporate bonds, commercial papers, debentures and certificates of deposit held by mutual funds.

On 23 April, 2020, the SEBI has directed that valuation agencies should consider differential treatment of default on a case to case basis, as to whether the default has occurred solely due to lockdown or loan moratorium. It has directed the valuation agencies to not consider the temporary operational challenges in servicing debt in light of COVID-19 and the moratorium granted by the Reserve Bank of India on repayment, as a default.

Further, to provide liquidity in the market for unlisted debt instruments, SEBI has, also extended timelines under its previously issued circulars:

(i) SEBI *vide* circular dated 28 April, 2020, clarified its circular dated 1 October, 2019, which directed Mutual Funds to not invest in unlisted debt instruments except as provided therein and such that existing investments of mutual fund schemes in unlisted debt instruments (as on 1 October, 2019) (“**Identified NCDs**”) may be grandfathered till maturity date of such instruments. Now, it is clarified that: (a) the mutual funds can continue to transact in such Identified NCDs and the direction to not make fresh investments in unlisted debt instruments will not be applicable with respect to such Identified NCDs, and (b) the timeline for compliance with the maximum limits for investment in unlisted non-convertible debentures (as issued vide SEBI Circulars dated 01 October, 2019 and 23 March, 2020) as 15% and 10% of the debt portfolio of the scheme is extended to September 30, 2020 and December 31, 2020 respectively.

(ii) By circular dated 30 April, 2020, SEBI has also extended implementation of following policy initiatives:

Circular Name	Directions	Extended Date
Risk management framework for liquid and overnight funds and norms governing investment in short term deposits dated 20 September, 2019	Liquid funds shall hold at least 20% of its net assets in liquid assets.	30 June, 2020
Review of investment norms for mutual funds for investment in Debt and Money Market Instruments dated 1 October, 2019	Existing open ended mutual fund schemes shall comply with the revised limits for sector exposure.	30 June, 2020
Valuation of money market and debt securities dated 24 September, 2019	Amortization based valuation shall be dispensed with and irrespective of residual maturity, all money market and debt securities shall be valued in terms of paragraph 1.1.2.2 of the circular	30 June, 2020

14. Road Ahead for FT and Unitholders?

In this investigation, the role of trustees will be carefully examined to see whether they exercised their judgement adequately in supervising the actions of the asset manager from time to time.

For the investor it could be a long road before they are able to get their monies back. They key question is whether they would accept the outcome as *fait accompli* or dig deeper into the issues for securing a just and fair outcome for themselves.