Mutual Funds: SEBI's Skin-in-the-game rule

What is the issue?

- A glance at the returns from mutual fund (MF) equity schemes over the years suggest a grand underperformance.
- In this backdrop, the markets regulator, Securities and Exchange Board of India (SEBI), recently came out with a circular which is being termed as 'skin in the game'.

What does this mean?

- The phrase 'Skin in the game' refers to owning the risk by being involved in achieving a particular goal.
- Best known as 'Hammurabi's code', it is named after King Hammurabi (Mesopotamia, 1972-1750 BC), who laid out this set of laws to manage risk.
- Three concepts associated with this code are reciprocity, accountability, and incentives.

Why now?

- New SEBI rule comes in the wake of the recent debacle of Franklin Templeton Mutual Fund debt schemes.
- The Franklin Templeton (FT) episode showed exactly how carefully fund managers are making investments and how closely they scrutinise the companies they buy into.
- Allegedly, some employees of FT encashed their personal holdings in six of the schemes just before they were shut down.
- Conflicts of interest in mutual funds between managers, fund sponsors, and unit holders have recently gained attention across the globe.
- The low returns in equity funds would have made sense for investors to simply park their money in index funds or, in some cases, even a bank account.
- Barely a handful of fund managers have beaten the indices, with the majority turning out returns that are sub-standard.
- It is obvious that the MF industry needs some cleaning up.

- Fund managers, as also other key executives of AMCs, should have been made accountable long ago.

What is SEBI's recent decision?

- Now, SEBI rightly believes that a fund manager's compensation should be in some way linked to the performance of the scheme he or she is managing.
- A part of the compensation of key employees of asset management companies (AMC) must be paid in the form of units of the schemes under their purview or managed directly by them.
    - These include board directors, fund managers, etc.
- At least 20% of their compensation—excluding tax and mandatory PF contributions—should be earned in the form of units managed by them.
- These units would be locked in for three years.
- Of the 20%, fund managers can invest up to 50% in their own schemes and the rest in a scheme with a similar or higher risk profile.
- For members of the senior management—CEO or CIO—the investment needs to be made across schemes managed by the AMC.
- And this should be in proportion to the assets under management.

What are the challenges?

- To be sure, this will neither be easy to implement nor monitor.
- Even random checks based on self-declarations by the fund managers could be difficult.
- There are hundreds of schemes—even within a fund house, the number is not small.
- Perhaps the fund manager should buy units of just one or two schemes—that s/he manages—else, it could get unnecessarily complicated.
- Though the rules appear apt from the investors' perspective, it may bring in certain peculiarities in its application within the AMCs.

- For instance, if this rule applies to all top-level executives, then it appears a bit harsh.
- Some of these top executives (like heads of IT, HR, sales) may not have played any significant role in the investment decision and performance of the said fund.
- Further, for other members of the fund houses, the 20% figure might be burdensome.
- They would be forced to invest in a particular form and a stringent fixed

amount.
- It might be burdensome, especially because it comes in with a lock-in period of three years.

What is the way forward?

- To conclude, ‘skin in the game’ rule is a necessary step keeping in mind the larger investing ecosystem.
- It will bring in increased ownership and discipline among fund managers as fines or monetary penalties should not replace personal accountability.
- But there should be a better way to name and shame fund managers who do not perform but take home hefty pay packages.
- Every newsletter or factsheet that a fund house puts out should detail the performances of its managers.
- The data should be presented in a transparent manner.
- AMFI (Association of Mutual Funds in India) should take the lead in highlighting poor performances.
- It could, from time to time, put out reports on the worst-performing schemes.

Source: Financial Express

