

Franklin Templeton's lapses in 6 credit risk schemes, and Sebi's action

GEORGE MATHEW &
SANDEEP SINGH

MUMBAI, NEW DELHI, JUNE 14

MORE THAN a year after Franklin Templeton Asset Management Company abruptly shut down six credit risk schemes involving Rs 26,000 crore, the Securities and Exchange Board of India (Sebi) has found major lapses and a breach of the regulator's mutual fund guidelines, and come down heavily on the fund house.

Sebi order against FT

Sebi barred FT AMC from launching any new debt scheme for two years, and asked it to refund Rs 512.5 crore, the investment management and advisory fees collected from June 4, 2018 to April 23, 2020 with respect to the six debt schemes, along with simple interest at the rate of 12% per annum. It also imposed a penalty of Rs 5 crore.

Sebi said it had found several irregularities in the running of the schemes, which impacted the interests of unitholders, and that FT

MF had violated provisions of Mutual Funds Regulations and certain Sebi circulars.

It noted serious violations with regard to scheme categorisation (replicating high-risk strategy across several schemes); pushing long-term papers into short-term duration; non-exercise of exit options in the face of emerging liquidity crisis; and securities valuation, risk management, and due diligence.

Showcause notice

Following the forensic audit report, which included responses of the AMC/trustees, Sebi issued a showcause notice to FT AMC on November 24 last year.

It said FT had invested in illiquid securities without proper due diligence, and had made investments that were akin to giving loans to issuers. The notice alleged FT was running the inspected debt schemes like credit risk fund schemes, and had not disclosed to investors its strategy of investing in high-yield securities with low credit rating of AA and A. It also accused FT of giving incorrect maturity dates; the securities were thus valued incorrectly. It alleged FT had not disclosed the

change in terms of investment immediately to valuation agencies and credit rating agencies, and had made incorrect disclosures of the monthly portfolio of securities.

Investment irregularities

Sebi said the inspected debt schemes had exposure to illiquid securities in the range of 73-85% for May 2019, and 85-94% for January 2020, long before the Covid-19 pandemic hit the financial markets. It is not clear why the fund house did not exercise the exit option in the face of increasing liquidity stress.

Between October 2019 and March 2020, there were eight instances of put options in the ultra short bond scheme that AMC had not exercised; the market value of the securities on the date of put option was around Rs 900 crore. Also, there were 15 instances of interest rate reset (excluding the call and put options) wherein the scheme had not exited even though the security had become illiquid; the amount involved was Rs 4,708 crore.

In the low-duration scheme, during October 2019 to March 2020, there were four instances of put option that were not exer-

cised; the amount involved was Rs 315 crore.

The regulator said the decision to remain invested in such illiquid securities was a strong pointer to the (commercial) arrangement of lending money to the issuer for the pre-decided time, or until the issuer repaid.

Role of Kudvas

Vivek Kudva, Director of Franklin Templeton AMC, his wife Roopa Kudva, and mother Vasanthi Kudva sold units worth Rs 30.70 crore just before FT shut down the schemes on April 23, 2020. Vivek Kudva had been privy to information such as concerns of redemption, concentration and liquidity risk pertaining to the stress in the impugned debt schemes, most of which was not in public domain, Sebi said.

Sebi fined Vivek Rs 4 crore, Roopa Rs 3 crore, and banned them from the markets for one year. "It was alleged that the act of redemption of units by the Kudvas... amounted to an unfair trade practice in securities market and a fraud on the other unsuspecting unit holders of said debt schemes who were not privy to such confidential information and

therefore, could not redeem their investments," Sebi said.

FT's explanation

Franklin Templeton AMC said the six schemes have followed a consistent strategy of investing in credits across the rating spectrum and have delivered meaningful outcomes to investors over long periods of time. It said it places "great emphasis on compliance" and believes that it has always acted in the best interest of unitholders and in accordance with regulations.

"These schemes provided an important source of funding to growing companies in India that to date have proven to be sound investments. Many of these holdings are now being liquidated by the schemes at fair value under normal market conditions," it said.

It said the six schemes under winding-up have distributed Rs 14,572 crore to unitholders as of April 30, 2021, and Rs 3,205 crore is available for distribution as of June 4, 2021. After this, the total amount disbursed will range between 40% and 92% of AUM as of April 23, 2020 across the six schemes.

Vivek Kudva said: "My personal transactions in the two schemes (under winding-up) have been conducted in good faith and with no intent to gain unfair benefit. As stated in the Sebi order, I had already placed myself in a similar position as investors in April 2020 and the proceeds of the redemptions were voluntarily set aside such that I and my family will ultimately receive no more than the investors remaining in the schemes."

Impact on MF industry

When FT shut down six schemes in April 2020, there was panic among debt scheme investors across fund houses, and huge redemptions in credit risk schemes of other mutual funds. Assets under credit risk funds plummeted by Rs 36,000 crore to Rs 25,656 crore from February 2020 to May 2021.

"Some fund houses were using the same modus operandi that FT used in the six closed schemes. They have invested in illiquid instruments of unknown companies. We don't know the fate of such investments. The Sebi move will clean up the system," an investment advisor said.