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SEBI releases consultation paper on introduction of new asset class/product category

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Summary

On 16 July 2024, SEBI[1] issued a Consultation Paper inviting public comments on the proposed introduction of a new asset class/product category under mutual funds structure, with the aim to provide investors with a regulated investment product featuring higher risk-taking capabilities, higher ticket size of INR 10 lakhs and increased regulatory flexibility. This is likely to curb the proliferation of unregistered and unauthorised investment products/schemes. The proposed new asset class/product category expects to bridge the gap between mutual funds and PMS[2].

Background

- Currently, the range of regulated investment products with varying risk-reward profiles for investors includes:
  - Mutual fund schemes[3]: Typically, retail oriented with a low ticket size (INR 100)
  - PMS[4]: Typically for HNIs[5] with a minimum ticket size of INR 50 lakhs
  - AIFs[6]: Typically for HNIs and institutional investors with minimum ticket size of INR 1 crore
- The flexibility in terms of regulatory framework for the above products is inversely related to the ticket size (i.e. higher the ticket size, more the flexibility).
- Over the years, a notable opportunity for a new asset class / product has emerged between mutual funds and PMS in terms of flexibility in portfolio construction. In absence of such an investment product, investors of this segment resort to unregistered and unauthorised investment schemes / entities that promise unrealistically high returns, leading to potential financial risks.
- Accordingly, a new investment product could provide a regulated and structured investment suitable to investors in this segment.
- The new asset class is intended to have a risk-return profile between mutual funds and PMS, that shall enable higher risk-taking than mutual funds with adequate safeguards / risk mitigation measures.
- SEBI has proposed to introduce the new asset class / product category under the mutual fund structure.

1 Securities Exchange Board of India (SEBI)
2 Portfolio Management Services (PMS)
3 Mutual Funds regulated by the SEBI under the SEBI (Mutual Fund) Regulations, 1996 (Mutual Fund Regulation)
4 PMS as regulated by the SEBI under the SEBI (Portfolio Manager) Regulations, 2019
5 High Net-worth Individuals (HNIs)
6 Alternative Investment Funds (AIFs) as regulated by the SEBI under the SEBI (AIF) Regulations, 2012

Key features of the proposed new asset class / product category

Distinct nomenclature

- New asset class will have a distinct nomenclature to distinguish it from traditional mutual funds and other investment products already available in market such as PMS, AIF, REITs[7], InvITs[8] etc.

Eligibility criteria for AMCs[9]

- To facilitate new and existing AMCs to offer products under this new asset class, SEBI has proposed the below 2 routes:

  Route 1: Strong track record

  - All registered mutual funds will be eligible, provided they have been in operation for atleast 3 years and have a minimum average AUM[10] of INR 10,000 crore in immediately 3 proceeding years.

  Route 2: Alternate Route

  All newly registered and existing mutual funds not fulfilling the conditions of Route 1 above can also launch the new asset class, provided the following conditions are fulfilled:

  - AMC appoints a CIO[11] and an additional fund manager[12] for new asset class having requisite experience.

  Under both these routes, no regulatory action should have been initiated /taken by SEBI against sponsor/AMC in the last 3 years[13].

Registration and approval requirements

- The registration process for new asset class will be a two-stage process (i.e. in-principal and final approval), similar to the process currently followed for mutual funds.
- Sponsor may not be required to maintain segregate net-worth and infrastructure facilities for new asset class since, it would be treated as a new arm / service offered by mutual funds.
- Mutual Fund Regulations and circulars issued thereunder would continue to apply to new asset class, unless specified otherwise.

Branding of new asset class

- Since, products offered under the new asset class would be relatively riskier than traditional mutual fund schemes, it is essential to maintain distinction between the branding of products under the new asset class and those under the traditional mutual funds.
- For this purpose, distinction in the branding and advertisement of new asset class *vis-à-vis* traditional mutual funds needs to be ensured.
- This may be achieved through differential usage of brand / logo of sponsor/ AMC, use of specific nomenclature and disclaimers in advertisements of products under the new asset class.

7 Real estate investment trusts (REITs)
8 Infrastructure Investment Trusts (InvITs)
9 Asset Management Companies (AMCs) regulated by the SEBI under the SEBI (Mutual Fund) Regulations, 1996
10 Asset Under Management (AUM)
11 Chief Investment Officer (CIO) of the new asset class to have atleast 10 years of experience in managing funds having minimum AUM of INR 5,000 crore
12 Fund manager of the new asset class to have at least 7 years of experience in managing funds having minimum AUM of INR 3,000 crore
13 Under section 11, 11B, and/or Section 24 of the SEBI Act, 1992

Structure of new asset class

- It is proposed that the nomenclature for the new asset class launched by the mutual funds would be '***Investment strategies***'[14], to distinguish it from the traditional mutual fund schemes. Also, such investment strategy must be approved by the trustee.
- Redemption frequency of these investment strategies may vary (i.e. daily / weekly/ fortnightly / monthly/ quarterly/ annually/ fixed maturity) basis the nature of investments.
- Under the new asset class, mutual funds may launch Investment strategies specified by SEBI from time to time. Presently, SEBI has permitted long-short equity fund and inverse ETF/ Fund[15] Investment strategies.

Minimum investment threshold

- Investors may have an option of systematic plans such as SIP[16], SWP[17] and STP[18] for investment strategies under new asset class.
- Under the new asset class, minimum investment amount is proposed to be INR 10 lakhs per investor, across one or more investment strategies, to be maintained at all times (irrespective of the investor's action such as systematic transactions or withdrawals), except due to fall in the value of investments.

Permissible investments

- All investments permissible under the Mutual Fund Regulations shall be available for new asset class, as well.
- Further, subject to fulfilment of relevant provisions, new asset class may take exposure in derivates for purposes other than hedging and rebalancing, to potentially generate higher returns. Borrowing may not be permitted for making investments, except for temporary liquidity needs, as provided in Mutual Fund Regulations.
- In order to relax the restrictions imposed under the Mutual Fund Regulations and Circulars issued thereunder, SEBI has proposed revised investment limits for new asset class, which are as under:
  - Cumulative gross exposure through all investable instruments (including derivatives) not to exceed 100% of the net assets of the investment strategy.
  - **Single issuer limit for debt securities:** 20% of NAV[19] (plus 5% with approval of trustees and AMC board)
  - **Credit risk based single issuer limit for debt securities:**
    - AAA – 20% of NAV
    - AA – 16% of NAV
    - A and below – 12% of NAV

    Plus 5% with approval of trustees and AMC Board
  - **Sector limits for debt securities:** 25%
  - **Ownership of paid-up capital carrying voting rights:** 15%
  - **Percentage of NAV in equity & equity related instruments:** 15%
  - **Investment in REITs and InvITs:**
    - Single issuer limit at new asset class level across all investment strategies: 20%
    - No scheme to invest more than 20% of NAV in units of REITs and INVITs, with not more than 10% of its NAV in units of REIT and INVIT issued by single issuer

[14] Products launched by traditional Mutual Funds are called 'Schemes', whereas products offered under PMS are termed as 'Investment Approaches'
[15] Inverse Exchange Traded Fund (ETF)/ Fund seeks to generate returns that are negatively correlated to returns of underlying index
[16] Systematic Investment Plan
[17] Systematic Withdrawal Plan
[18] Systematic Transfer Plan
[19] Net Asset Value (NAV)

– **Derivatives:** 50% of the net assets (Total exposure[20] through derivatives of a single stock not to exceed 10% of the net assets).

Disclosure requirements

- Disclosure requirements as applicable to traditional mutual funds will apply to new asset class, that may include categorisation of investment strategies under Risk-o-meter which must have a different depiction and nomenclature than traditional mutual fund schemes, portfolio disclosure of all its investment strategies on monthly basis on its website, constitutional documents (i.e. SID/ SAI/ KIM[21]) to be publicly available.

Our comments

The proposed introduction of new asset class between mutual funds and PMS seeks to incentivise investors with investment corpus in the range of INR 10 lakhs to INR 50 lakhs towards such regulated high risk / sophisticated products managed by professional fund manager instead of being propelled towards unregistered and unregulated investment schemes / entities.

In addition to existing mutual fund AMCs, global investment managers and investment managers of large Category III AIFs, who otherwise have an experience and expertise in presently managing complex derivatives strategies for HNIs and institutional investors, may consider registering with SEBI under the Mutual Fund Regulations to launch investment strategies under the new asset class, possibly in a much tax efficient manner compared to Category III AIFs, albeit with a higher capital requirement by the sponsor of the mutual fund.

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[20] total exposure at any point of time shall be the sum of exposure through instruments in both cash market and derivatives market.
[21] Scheme Information Document (SID) / Statement of Additional Information (SAI) / Key Information Memorandum (KIM)