WTM/GM/IMD/ 08 /2021–22

SECURITIES AND EXCHANGE BOARD OF INDIA

ORDER

UNDER SECTIONS 11(1), 11(4), 11(4A) and 11B OF THE SECURITIES AND EXCHANGE BOARD OF INDIA ACT, 1992.

IN THE MATTER OF INSPECTION OF SIX DEBT SCHEMES OF FRANKLIN TEMPLETON MUTUAL FUND.

NOTICEE	PAN
FRANKLIN TEMPLETON ASSET MANAGEMENT (INDIA) PVT. LIMITED	AAACT1609B

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*THE PRESENT MATTER EXAMINES THE COMPLIANCE OF AN ASSET MANAGEMENT COMPANY ("**AMC**") OF A MUTUAL FUND WITH THE PROVISIONS OF THE SEBI (MUTUAL FUNDS) REGULATIONS, 1996, THE CIRCULARS ISSUED THEREUNDER AND OTHER PROVISIONS OF THE SECURITIES LAWS, DURING THE PERIOD LEADING UP TO THE WINDING UP OF THE SIX SCHEMES MANAGED BY THE AMC, IN APRIL 2020. THE CASE SPECIFICALLY EVALUATES THE ROBUSTNESS OR OTHERWISE OF THE INTERNAL SYSTEMS, COMPLIANCE, RISK MANAGEMENT PRACTICES, DUE DILIGENCE PROCESSES AND THE METHOD OF CATEGORIZATION OF SCHEMES, FOLLOWED BY THE AMC.*

	SYNOPSIS OF THE ORDER	PAGE NOS.
A.	**BACKGROUND.**	1 – 2
B.	**SHOW CAUSE NOTICE DATED NOVEMBER 24, 2020.**	3 – 10
C.	**PERSONAL HEARING.**	10
D.	**PRELIMINARY OBJECTIONS RAISED BY THE NOTICEE.**	11
E.	**FINDINGS ON MERITS:**	
	5.1 MULTIPLE SCHEMES RUN IN A SIMILAR MANNER.	12 – 30
	5.2 PRACTICES RELATED TO INTEREST RATE RESET PAPERS AND CALCULATION OF *MACAULAY DURATION*.	30 – 45
	5.3 VALUATION PRACTICES.	45 – 53
	5.4 PORTFOLIO RISK MANAGEMENT.	54 – 73
	5.5 INVESTMENT RELATED DUE DILIGENCE.	73 – 89
	5.6 PROCESSING OF REDEMPTION OF AN ENTITY DEBARRED BY SEBI – FAILURE TO IMPLEMENT SEBI DIRECTIONS VIDE ORDER NO. WTM/GM/CFD/35/2019–20 DATED SEPTEMBER 17, 2019.	90 – 91
	5.7 CONCLUSION.	91
F.	6.1 **DIRECTIONS PROPOSED TO BE ISSUED UNDER SECTIONS 11(1), 11(4), 11B(1) AND SECTIONS 11(4A) AND 11B(2) OF THE SEBI ACT.**	92 – 98
G.	**ORDER**	98 – 100

BACKGROUND:

1.1 Franklin Templeton Mutual Fund ("**FT–MF**") is a mutual fund having a Certificate of Registration granted by SEBI [Regn. No. – MF/026/96/8]. Franklin Templeton Asset Management (India) Pvt.

Limited ("**FT–AMC**"/"**Noticee**") is the Asset Management Company of FT–MF. Vide a Notice dated April 23, 2020, Franklin Templeton Trustee Services Pvt. Ltd. ("**Trustees**") had *inter alia* informed the concerned unitholder(s) that it had decided to wind up the following schemes of FT–MF pursuant to the provisions of Regulation 39(2)(a) of the SEBI (Mutual Funds) Regulations, 1996 ("**Mutual Funds Regulations**"), viz.:

i. Franklin India Ultra Short Fund/Ultra Short Bond Fund;
ii. Franklin India Low Duration Fund;
iii. Franklin India Short Term Income Fund/Plan;
iv. Franklin India Income Opportunities Fund;
v. Franklin India Dynamic Accrual Fund and
vi. Franklin India Credit Risk Fund.

1.2 Based on certain media articles/complaints received by the Securities and Exchange Board of India ("**SEBI**"), a Forensic Audit/Inspection ("**Forensic Audit**") was initiated with regard to FT–MF in terms of Regulation 66 of the Mutual Funds Regulations, to verify compliance with the provisions of securities laws including the SEBI Act, 1992 ("**SEBI Act**"), Mutual Funds Regulations, etc. Accordingly, SEBI appointed M/s. Chokshi and Chokshi LLP, Chartered Accountants ("**Auditor**") to conduct the Inspection of FT–MF, including of its in house RTA activities, its Asset Management Company and Board of Trustees/Trustee Company *inter alia* with respect to the above mentioned six debt schemes ("***debt schemes inspected***") amongst other schemes. The Auditor's appointment was communicated to the Trustees vide SEBI letter dated May 27, 2020. Thereafter, the findings of the Forensic Audit/Inspection Report were communicated to FT–MF vide SEBI letter dated August 5, 2020, wherein FT–AMC and its Trustees were advised to provide comments/explanations along with relevant supporting documents/records, if any, on the observations contained therein. Supplementary observations to the Forensic Audit/Inspection Report, as received by SEBI from the Auditor, were also forwarded to FT–MF vide SEBI's e–mail dated August 24, 2020. FT–AMC and Trustees submitted their response to the above mentioned SEBI letter vide a common reply dated September 3, 2020, which was then forwarded by SEBI to the Auditor for its comments. The Auditor submitted its supplementary comments to the Forensic Audit/Inspection Report, to SEBI, vide a letter dated October 9, 2020.

<u>SHOW CAUSE NOTICE DATED NOVEMBER 24, 2020</u>:

2.1 Upon a consideration of the Forensic Audit/Inspection Report, FT–AMC/Trustees' response to the said Report and the Auditor's letter dated October 9, 2020, SEBI issued a Show Cause Notice dated November 24, 2020 ("**SCN**") to FT–AMC/the Noticee, under the provisions of Sections 11(1), 11(4), 11(4A) and 11B of the SEBI Act, containing the following allegations:

A. The Noticee was running *debt schemes inspected* akin to Credit Risk Fund scheme and in a similar manner (in terms of investment strategy, credit rating, *Macaulay duration*, portfolio and Fund Manager) despite the investment objectives of these schemes being different. The *debt schemes inspected* were projected as duration–based schemes instead of Credit Risk Fund schemes.

B. The Noticee had not disclosed its strategy of investing in high yield securities with credit rating of AA and A to investors of the respective *debt schemes inspected*.

C. The Noticee incorrectly calculated *Macaulay duration*, taking interest rate reset dates as deemed maturity date even though there was no explicit exit to both the parties i.e. Issuer and Investor, on the interest rate reset date. As incorrect date was taken as deemed maturity date, the securities were valued incorrectly. Further, the *Macaulay duration* disclosed to investors was also incorrect. By way of taking interest rate reset date as deemed maturity date, the Noticee had accommodated many long duration securities in shorter duration portfolios and had managed to run multiple schemes with a similar strategy.

D. The Noticee had entered into terms of investment which were ambiguous and without equal rights to both the Issuer and Investor.

E. The Noticee did not value the securities as per the *Principles of Fair Valuations*, thereby not reflecting the true realisable value of the underlying securities.

F. The Noticee had not disclosed change in terms of investment immediately to valuation agencies and credit rating agencies.

G. The Noticee had made incorrect disclosures of the monthly portfolio of securities.

H. The Noticee invested in illiquid securities without proper due diligence.

I. The Noticee had made investments which were akin to giving loan to Issuers.

J. The Noticee had not ensured independence of risk management function and also reduced the role of Business Risk Management Committee, without approval from its Board.

K. The Noticee's Board had not provided guidance or suggested any concrete steps to manage various risks (concentration, downgrades, early warning signal and liquidity issues) of the securities in the portfolio even though it was repeatedly reported to its Board.

L. The Noticee did not have any policy on detail objective criteria to be recorded in the Investment Process Note ("**IPN**"). Adequate documentations for investment decisions, were also not maintained.

M. The Noticee did not exercise due diligence to ensure that investment parameters were analysed for individual Issuers (and not only at Group level), adequate documentations were maintained/obtained, terms of investments (covenant) were enforced, all material information about terms of investments (which had a bearing on the investments) were timely disseminated to unit holders.

N. The Noticee had failed to ensure appropriate policy to have pro–rata allotment of partial buy–back to all the schemes and had managed liquidity across schemes by allocating partial buyback on non–pro–rata basis in the instances of partial buy back of securities, which benefited investors of one scheme over others.

O. The Noticee had allowed a SEBI debarred entity to redeem units of mutual fund.

P. The Noticee had failed to maintain high standards of integrity, exercise due diligence, ensure proper care and exercise independent professional judgement as per the Code of Conduct specified in the Fifth Schedule to the Mutual Funds Regulations.

2.2 Several documents including the following were also annexed to the SCN to substantiate the allegations made therein, against the Noticee.

LIST OF ANNEXURES	
ANNEXURE	**DETAILS**
A.	Extract of Auditor's letter dated October 9, 2020.
B.	Revised term sheet with ISIN–INE081T08090.
C.	Re–calculated *Macaulay duration* of FI–UBF and FI–LDF.
D.	Details of FT–AMC's investment in securities issued by Companies forming part of Future Group.
E.	Details of FT–AMC's exposure in Unlisted/Illiquid debt securities.
F.	Presentation made by FT–AMC's Head–Risk Management.
G.	Chronology of events in reference to the presentation made by FT–AMC's Head–Risk Management.
H.	End Use Certificate.
I.	Internal exchange between fund managers of FT–AMC in respect of e–mail dated February 6, 2019.
J.	ADA Group's e–mail dated February 8, 2019.
K.	Essel Group's disclosure on BSE.
L.	SEBI's letter no. SEBI/HO/IMD/DOF4/OW/P/2018/19378/1 dated July 9, 2018 to AMFI and related correspondence.

2.3 Accordingly, the Noticee was alleged to have violated the following provisions of the Mutual Funds Regulations and certain SEBI Circulars:

REGULATIONS/ CIRCULARS	REGULATION, ETC.	DETAILS
MUTUAL FUNDS REGULATIONS	Regulation 25 (1), (2), (3), (16) and (19)	***Asset management company and its obligations*** *(1) The asset management company shall take all reasonable steps and exercise due diligence to ensure that the investment of funds pertaining to any scheme is not contrary to the provisions of these Regulations and the Trust Deed.* *(2) The asset management company shall exercise due diligence and care in all its investment decisions as would be exercised by other persons engaged in the same business.* *(3) The asset management company shall be responsible for the acts of commission or omission by its employees or the persons whose services have been procured by the asset management company.* *(16) The asset management company shall abide by the Code of Conduct as specified in the Fifth Schedule.* *(19) The asset management company shall compute and carry out valuation of investments made by its scheme(s) in accordance with the investment valuation norms specified in Eighth Schedule, and shall publish the same.*
	Regulation 44(3)	***Investment, borrowing, restriction, etc.*** *(3) Save as otherwise expressly provided under these regulations, the mutual fund shall not advance any loans for any purpose.*
	Regulation 47	***Valuation of investments*** *Every mutual fund shall ensure that the asset management company computes and carries out valuation of investments made by its scheme(s) in accordance with the investment valuation norms specified in Eighth Schedule, and publishes the same.*
	Clauses (2), (6), (8) and (9) of the Code of Conduct as specified in the Fifth Schedule	***Code of Conduct*** *(2) Trustees and asset management companies must ensure the dissemination to all unitholders of adequate, accurate, explicit and timely information fairly presented in a simple language about the investment*

		policies, investment objectives, financial position and general affairs of the scheme. *(6) Trustees and asset management companies shall carry out the business and invest in accordance with the investment objectives stated in the offer documents and take investment decision solely in the interest of unitholders.* *(8) Trustees and the asset management company shall maintain high standards of integrity and fairness in all their dealings and in the conduct of their business.* *(9) Trustees and the asset management company shall render at all times high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgment.*
	Clauses (a), (c), (g), (h) and (i) of the Code of Conduct as specified in the Eight Schedule	***Investment Valuation Norms*** ***Principles of Fair Valuation*** *Mutual fund shall value its investments in accordance with the following overarching principles so as to ensure fair treatment to all investors including existing investors as well as investors seeking to purchase or redeem units of mutual funds in all schemes at all points of time:* *(a) The valuation of investments shall be based on the principles of fair valuation i.e. valuation shall be reflective of the realizable value of the securities/assets. The valuation shall be done in good faith and in true and fair manner through appropriate valuation policies and procedures.* *(c) The assets held by the mutual funds shall be consistently valued according to the policies and procedures. The policies and procedures shall describe the process to deal with exceptional events where market quotations are no longer reliable for a particular security.* *(g) The responsibility of true and fairness of valuation and correct NAV shall be of the asset management company, irrespective of disclosure of the approved valuation policies and procedures i.e. if the established policies and procedures of valuation do not result in fair/ appropriate valuation, the asset management company shall deviate from the established policies and procedures in order to value the assets/ securities at fair value:* *Provided that any deviation from the disclosed valuation policy and procedures may be allowed with appropriate reporting to Board of Trustees and the Board of the asset management company and appropriate disclosures to investors.*

	(h) The asset management company shall have policies and procedures to detect and prevent incorrect valuation. *(i) Documentation of rationale for valuation including inter scheme transfers shall be maintained and preserved by the asset management company as per Regulation 50 of these regulations to enable audit trail.*
SEBI CIRCULAR NO. MFD/CIR/6/73/2000 DATED JULY 27, 2000	*Sub-regulation (2) of Regulation 25 of Mutual Funds Regulations stipulates that the asset management company (AMC) shall exercise due diligence and care in all its investment decisions as would be exercised by other persons engaged in the same business. With a purpose to implement the regulation in an effective manner and to bring about transparency in investment decisions, the AMCs are hereby advised to maintain records in support of each investment decision which will indicate the data, facts and opinion leading to that decision. While the AMC boards can prescribe broad parameters for investments, it is important that the basis for taking individual scrip-wise investment decision in equity and debt securities should be recorded. While there should be a detailed research report analysing various factors for each investment decision taken for the first time, the reasons for subsequent purchase and sales in the same scrip should be recorded. The contents of the research reports may be decided by the asset management companies and the trustees.* *AMC boards may develop a mechanism to verify that due diligence is being exercised while making investment decisions. They may pay specific attention in case of investment in unlisted and privately placed securities, unrated debt securities, NPAs, transactions where associates are involved and the instances where there is poor performance of the schemes.*
SEBI CIRCULAR NO. MFD/CIR/8/92/2000 DATED SEPTEMBER 18, 2000	***Valuation of securities with Put/Call Options*** *The option embedded securities would be valued as follows:* *Securities with call option:* *The securities with call option shall be valued at the lower of the value as obtained by valuing the security to final maturity and valuing the security to call option.* *In case there are multiple call options, the lowest value obtained by valuing to the various call dates and valuing to the maturity date is to be taken as the value of the instrument.* *Securities with Put option:*

	The securities with put option shall be valued at the higher of the value as obtained by valuing the security to final maturity and valuing the security to put option. *In case there are multiple put options, the highest value obtained by valuing to the various put dates and valuing to the maturity date is to be taken as the value of the instruments.* *<u>Securities with both Put and Call option on the same day</u>:* *The securities with both Put and Call option on the same day would be deemed to mature on the Put/Call day and would be valued accordingly.*
SEBI CIRCULAR NO. MFD/CIR/15/19133/2002 DATED SEPTEMBER 30, 2002	***Risk Management Function*** *The Mutual Fund should have an independent risk management function consisting of one or more risk managers. …* *The function should be separate from fund management and should report to the Chief Executive Officer of the AMC. …*
SEBI CIRCULAR NO. SEBI/HO/IMD/DF3/CIR/P/2017/114 DATED OCTOBER 6, 2017	*It is desirable that different schemes launched by a Mutual Fund are clearly distinct in terms of asset allocation, investment strategy etc. Further, there is a need to bring in uniformity in the characteristics of similar type of schemes launched by different Mutual Funds. This would ensure that an investor of Mutual Funds is able to evaluate the different options available, before taking an informed decision to invest in a scheme. …* *Process to be followed for categorization and rationalization of schemes:* *a. Only one scheme per category would be permitted, except:* *i. Index Funds/ ETFs replicating/ tracking different indices;* *ii. Fund of Funds having different underlying schemes; and* *iii. Sectoral/ thematic funds investing in different sectors/ themes* *b. Mutual Funds would be required to analyze each of their existing schemes in light of the list of categories stated herein and submit their proposals to SEBI after obtaining due approvals from their Trustees as early as possible but not later than 2 months from the date of this circular.* *c. The aforesaid proposals of the Mutual Funds would also include the proposed course of action (viz., winding up, merger, fundamental attribute change etc.) in respect of the existing similar schemes as well as those that are not in alignment to the categories stated herein.* *d. Subsequent to the observations issued by SEBI on the proposals, Mutual Funds would have to carry out the necessary changes in all respects within a maximum period of 3 months from the date of such observation.*

	e. Where there is a merger of schemes/change of fundamental attribute(s) of a scheme (as laid down under SEBI Circular No. IIMARP/MF/CIR/01/294/98 dated February 4, 1998), the AMCs would be required to comply with Regulation 18 (15A) of SEBI (Mutual Funds Regulation, 1996). *f. Mutual Funds are advised to strictly adhere to the scheme characteristics stated herein as well as to the spirit of this circular. Mutual Funds must ensure that the schemes so devised should not result in duplication/minor modifications of other schemes offered by them. The decision of SEBI in this regard shall be binding on all the mutual funds.*
SEBI CIRCULAR NO. SEBI/HO/IMD/DF3/CIR/P/2017/126 DATED DECEMBER 4, 2017	*SEBI, vide Circular no. SEBI/HO/IMD/DF3/CIR/P/2017/114 dated October 6, 2017, has issued guidelines regarding categorization and rationalization of Mutual Fund Schemes. …* *In respect of sr. nos. 3, 4, 6, 7, 8 and 9 of Section B of Annexure to the aforesaid circular, it is clarified that Macaulay duration shall be at portfolio level and accordingly, the column 'Type of Scheme (Uniform description of scheme)' of the respective scheme of the aforesaid sr. nos. is modified and shall be read as given below:* *'An open ended XYZ scheme investing in instruments such that the Macaulay duration of the portfolio is between A to B years (please refer to page no.__)#.'* *#Please refer to the page number of the Offer Document on which the concept of Macaulay Duration has been explained.*
CLAUSE 9.1.1 OF SEBI CIRCULAR NO. SEBI/HO/IMD/DF4/CIR/P/2019/102 DATED SEPTEMBER 24, 2019	*Any changes to the terms of investment, which may have an impact on valuation, shall be reported to the valuation agencies immediately.*
CLAUSE 1 OF SEBI CIRCULAR NO. SEBI/HO/IMD/DF4/CIR/P/2019/126 DATED NOVEMBER 6, 2019	*Para 9 of SEBI Circular No. SEBI/HO/IMD/DF4/CIR/P/2019/102 dated September 24, 2019 on conditions to be adhered to by Mutual Funds, while making any change to terms of an investment. In partial modification to the above circular, Para 9.1.1. shall read as follows:* *Any changes to the terms of investment, including extension in the maturity of a money market or debt security, shall be reported to valuation agencies and SEBI registered Credit Rating Agencies (CRAs) immediately, along-with reasons for such changes.*
SEBI CIRCULAR NO. CIR/IMD/DF/21/2012 DATED SEPTEMBER 13, 2012	*Mutual funds/AMCs shall disclose portfolio (along with ISIN) as on the last day of the month for all their schemes on their respective website on or before the tenth day of the succeeding month in a user-friendly and downloadable format.*

2.4 In view of the above, the Noticee was called upon to show cause as to why appropriate directions under Sections 11(1), 11(4) and 11B of the SEBI Act should not be issued against it for the alleged violation of the above mentioned provisions of law including:

A. Directions for –

i. Suspension of launching of any scheme(s) for a specified period;

ii. Refund of the investment management and advisory fees to the *debt schemes inspected* from the effective date of the SEBI Categorization Circulars in respect of the said schemes.

B. Monetary penalty, in exercise of SEBI's powers under Sections 11(4A) and 11B(2) of the SEBI Act read with Sections 15A(b), 15D(b), 15D(f), 15E and 15HB of the aforesaid Act.

2.5 The Noticee replied to the SCN vide a letter dated January 22, 2021.

PERSONAL HEARING:

3.1 Thereafter, an opportunity of personal hearing was granted to the Noticee on March 17, 18 and 19, 2021, through video conferencing on the WebEx App. The Noticee was represented by Shri Janak Dwarkadas, Senior Counsel, Shri Mustafa Doctor, Senior Counsel, along with Shri Saurabh Gangrade, Chief Compliance Officer, FT–AMC. The Noticee reiterated the submissions contained in its reply dated January 22, 2021 and also made additional oral submissions. The Noticee was granted two weeks' time to file additional written submissions, which it did so vide a letter dated April 5, 2021.

3.2 The allegations in the SCN and the submissions/contentions raised by the Noticee in its reply/additional submissions are being considered at length *in seriatim* while examining each issue identified for the purpose of this Order. Before getting into the merits, I would like to deal with certain preliminary objections raised by the Noticee.

PRELIMINARY OBJECTIONS RAISED BY THE NOTICEE:

4.1 To begin with, the Noticees have raised certain preliminary objections to the instant proceedings, such as (a) lack of clarity in the charges contained in the SCN, (b) Circulars alleged to have been violated are '*Advisory'* in nature and (c) the procedure prescribed under the SEBI (Procedure for Holding Inquiry and Imposing Penalties) Rules, 1995 ("**SEBI Inquiry Rules**") has not been followed. I would like to deal with these objections at the outset.

4.2 The allegations enlisted under paragraph 2.1 hereinabove, clearly summarizes the violations levelled against the Noticee. Further, the SCN has brought out the analysis of facts and the circumstances that have led to such allegations. Thus, I do not find any lack of clarity, as alleged by the Noticee. The second objection raised is with regard to the binding nature of Circulars alleged to have been violated by the Noticee i.e. whether the Circulars are '*advisory'* or mandatory in nature. Primarily, the Circulars in question are all prescriptive in nature and are issued with the purpose of implementing the Mutual Funds Regulations and towards enhancing the efficacy and transparency in the activities of the asset management company with respect to its functions. Given that these Circulars have been issued in furtherance of the Mutual Funds Regulations, they are undoubtedly binding in nature and hence, I do not find any merit in this objection. The third objection pertains to non–adherence to the procedure laid down under the SEBI Inquiry Rules with regard to the issuance of two Notices (a preliminary one, limited to why an inquiry ought not to be conducted and a detailed one, for conducting the inquiry, upon satisfaction that it is required) to be issued at two stages for the purpose of adjudicating, before the imposition of any monetary penalty under the SEBI Act. I find the said objection to be unsustainable, in the facts and circumstances of the case. Moreover, in a given case of an adjudication proceeding under Sections 11(4A) and 11B(2) of the SEBI Act, which is combined with a proceeding under Section 11B(1) of the SEBI Act, there is a commonality of facts and allegations and in my view, no purpose will be served by separately following a different procedure for adjudging the penalty. It is trite law that procedure is only a handmaiden of justice and cannot be made a stumbling block to substantive justice. In any case, the Noticee has failed to show that any prejudice has been caused or that the principles of natural justice have been violated. I am thus, inclined to reject the objections raised and proceed to consider on merits.

Consideration on Merits:

5. I have considered the SCN, the Noticee's replies dated January 22, 2021 and April 5, 2021, the Forensic Audit Report along with all the material available on record. I shall now proceed to deal with the violations alleged in the SCN *in seriatim* by detailing the response of the Noticee to the SCN; the analysis of the Forensic Auditor on the issue and conclude the issue with my findings on the same.

5.1 Multiple Schemes Run In A Similar Manner:

5.1.1 The SCN has alleged that the *debt schemes inspected* were run in a similar manner on account of the following alleged similarities observed across the *Schemes*:

I. ***All debt schemes inspected had high exposure to securities with rating AA and below.***

a. Each of the *debt schemes inspected* had taken exposures of more than 65% of their net asset to securities rated AA and below, which is the exclusive scheme characteristic prescribed for a Credit Risk Fund such as FI–CRF, consistently for a long time.

b. The comparative analysis of FI–CRF vis–à–vis the other five *debt schemes inspected* with respect to holding in corporate bonds rated AA and below is as under:

Table I – % of Asset Under Management (AUM)					
Scheme	**31–Mar–19**	**29–Jun–19**	**30–Sep–19**	**31–Dec–19**	**31–Mar–20**
FI–CRF	82.90%	76.14%	75.96%	85.94%	97.99%
FI–DAF	81.30%	77.27%	75.31%	86.09%	88.60%
FI–IOF	73.34%	71.56%	78.67%	83.58%	96.82%
FI–LDF	71.42%	70.94%	73.40%	84.04%	105.51% #
FI–STIP	81.51%	74.72%	76.52%	79.84%	101.42% #
FI–UBF	76.06%	69.46%	69.91%	72.68%	93.49%
#Due to borrowings, % has exceeded 100%.					

II. ***Macaulay durations of three Schemes, viz. FI–STIP, FI–DAF and FI–CRF, were similar.***

a. The *Macaulay duration* of the *debt schemes inspected* for the period FY 2019–20, as provided by the Noticee, is given below:

TABLE II – MACAULAY DURATION (IN YEARS) FOR FY 2019–20						
MONTH | SCHEME ->	FI–UBF [3–6 MONTHS]	FI–LDF [6–12 MONTHS]	FI–STIP [1–3 YEARS]	FI–IOF [3–4 YEARS]	FI–DAF	FI–CRF
31.03.2020	0.54	1.20	2.15	3.22	1.91	2.22
28.02.2020	0.51	0.99	1.93	3.14	1.88	2.02
31.01.2020	0.52	0.99	1.93	2.95	1.93	2.03
31.12.2019	0.50	1.03	1.97	2.92	1.90	2.04
29.12.2019	0.54	1.05	2.01	3.05	1.99	2.16
31.10.2019	0.49	0.99	2.20	3.31	2.29	2.43
30.09.2019	0.49	1.03	2.31	3.33	2.27	2.61
30.08.2019	0.51	0.96	2.26	3.31	2.21	2.38
31.07.2019	0.55	0.95	2.28	3.33	2.19	2.40
28.06.2019	0.49	0.91	2.36	3.32	2.27	2.47
31.05.2019	0.50	0.95	2.37	3.51	2.28	2.50
30.04.2019	0.49	0.99	2.35	3.55	2.24	2.50

b. The *Macaulay duration* of the schemes viz. FI–STIP, FI–CRF, FI–DAF along with rating composition of the said schemes as mentioned in Tables I and II, are summarized below:

TABLE III – *MACAULAY DURATION* OF THE SCHEMES VIZ. FI–STIP, FI–CRF, FI–DAF ALONG WITH RATING COMPOSITION				
AS ON END OF MONTH	PARTICULAR	FI–CRF	FI–STIP	FI–DAF
JUN–19	AA AND BELOW RATED SECURITIES (% TO AUM)	76.14%	74.72%	77.27%
JUN–19	*MACAULAY DURATION*	2.47	2.36	2.27
SEP–19	AA AND BELOW RATED SECURITIES (% TO AUM)	75.96%	76.52%	75.31%
SEP–19	*MACAULAY DURATION*	2.61	2.31	2.27
DEC–19	AA AND BELOW RATED SECURITIES (% TO AUM)	85.94%	79.84%	86.09%
DEC–19	*MACAULAY DURATION*	2.04	1.97	1.90
MAR–20	AA AND BELOW RATED SECURITIES (% TO AUM)	97.99%	101.42%	88.60%
MAR–20	*MACAULAY DURATION*	2.22	2.15	1.91

c. As noted from Table III, the *Macaulay duration* of FI–STIP, FI–DAF and FI–CRF are similar and are also moving in the similar manner throughout the FY 2019–20. Further, FI–STIP, FI–DAF and FI–CRF had exposure to AA and below rated securities of more than 65% of the net assets. Accordingly, there was no distinction between any of the aforementioned schemes; rather, FI–STIP and FI–DAF are replication of FI–CRF.

III. ***Three of the Schemes (viz., FI–STIP, FI–IOF and FI–DAF) had a high percentage of common investments vis–à–vis FI–CRF.***

a. The percentage of common securities of FI–STIP, FI–DAF, FI–IOF respectively with the Credit Risk Fund (FI–CRF) is tabulated as below:

TABLE IV – COMMON SECURITIES AS PERCENTAGE TO AUM OF THE SCHEME				
AS ON MONTH END-> SCHEME	JUN–19	SEP–19	DEC–19	MAR–20
FI–CRF	**70.92%**	**74.41%**	**62.02%**	**66.10%**
FI–STIP	**65.94%**	**67.81%**	**63.75%**	**72.60%**

TABLE V – COMMON SECURITIES AS PERCENTAGE TO AUM OF THE SCHEME				
AS ON MONTH END	JUN–19	SEP–19	DEC–19	MAR–20
SCHEME	% OF COMMON SECURITY	% OF COMMON SECURITY	% OF COMMON SECURITY	% OF COMMON SECURITY
FI–CRF	**65.80%**	**65.53%**	**64.52%**	**69.05%**
FI–DAF	**65.86%**	**68.56%**	**68.91%**	**66.66%**

TABLE VI – COMMON SECURITIES AS PERCENTAGE TO AUM OF THE SCHEME				
AS ON MONTH END	JUN–19	SEP–19	DEC–19	MAR–20
SCHEME	% OF COMMON SECURITY	% OF COMMON SECURITY	% OF COMMON SECURITY	% OF COMMON SECURITY
FI–CRF	**48.01%**	**52.45%**	**44.81%**	**50.29%**
FI–IOF	**59.64%**	**63.96%**	**58.81%**	**67.46%**

b. As noted from Tables IV, V and VI, on an average 65% of the portfolio (AUM) of FI–STIP is matching with on an average 65% of the portfolio of FI–CRF. Similarly, in terms of AUM, on an average 65% of the portfolio of FI–DAF is matching with on an average 65% of the portfolio of FI–CRF. Further, in case of FI–IOF, on an average 60% portfolio of FI–IOF is matching with on an average 50% of the portfolio of FI–CRF in terms of AUM.

c. Further, value of common securities in FI–CRF and in the portfolio of at least three out of rest of the five debt schemes inspected as percentage of AUM of FI–DAF, FI–IOF and FI–STIP is tabulated below:

TABLE VII – VALUE OF COMMON SECURITIES				
SCHEME NAME/MONTH	**29–JUN–19**	**30–SEP–19**	**31–DEC–19**	**31–MAR–20**
FI–DAF	46.44%	47.55%	39.37%	38.30%
FI–IOF	43.82%	45.69%	38.46%	43.15%
FI–STIP	49.93%#	50.09%	46.71%	53.65%
INTERPRETATION OF ALL VALUES: # FOR INSTANCE, 49.93% OF AUM OF FI–STIP IS CONSTITUTED BY COMMON SECURITIES THAT ARE PRESENT IN FI–STIP, FI–CRF AND AT LEAST IN ANY 2 OF THE OTHER 4 DEBT SCHEMES INSPECTED.				

d. As noted from Table VII, on an average 40% of the portfolios (AUM) of each of the above mentioned three schemes viz. FI–DAF, FI–IOF and FI–STIP, are constituted by securities which are in the portfolio of FI–CRF and at least two out of four non–credit risk fund *debt schemes inspected* and the said pattern of investment had continued for a long period of time.

e. Further, during the period FY 2017–20, same securities worth of ₹34,264.07 Crore were subscribed to by at least four of the *debt schemes inspected* (FI–CRF is taken as the base).

f. Accordingly, non–credit risk schemes were taking similar risk as being taken by the Credit Risk Fund by investing in the same securities which were subscribed by the FI–CRF.

IV. ***The 'investment pattern' of the Schemes were similar in that the Schemes subscribed to more than 70% of a single debt issuance on multiple occasions.***

a. The concentration of securities where FT–AMC has subscribed more than 70% of the debt issuance through the *debt schemes inspected* and which are rated AA and below is given in the below table:

TABLE VIII – PERCENTAGE OF AUM OF THE SCHEME					
SCHEME	**31–MAR–19**	**29–JUN–19**	**30–SEP–19**	**31–DEC–19**	**31–MAR–20**
FI–CRF	35.81%	39.02%	45.08%	51.27%	63.41%
FI–LDF	37.31%	43.96%	51.28%	62.63%	85.69%
FI–STIP	37.16%	41.68%	47.22%	50.61%	68.62%
FI–UBF	29.49%	26.93%	31.20%	40.81%	55.47%
FI–IOF	34.01%	36.28%	43.95%	46.65%	53.96%
FI–DAF	42.59%	46.38%	48.38%	53.13%	58.37%

b. As noted from Table VIII, over a period of time, all the *debt schemes inspected* were having similarity in investment pattern by subscribing to ISINs (International Securities Identification Number) where FT–AMC has subscribed significant portion (more than 70%) of the issue and the securities were rated AA and below. Such investment pattern across all the *debt schemes inspected* indicated that the schemes were being run in a similar manner.

V. ***The Schemes were managed by common fund managers.***

a. In four of the debt schemes inspected, Santosh Kamath and Kunal Agrawal were common fund managers while in the remaining two of the six schemes, Santosh Kamath is one of the fund managers.

TABLE IX – COMMON FUND MANAGERS		
SCHEME	**FUND MANAGERS**	**TENURE OF THE FUND MANAGER**
FI–STIP	SANTOSH KAMATH & KUNAL AGARWAL	1.04.2017–23.04.2020
FI–LDF	SANTOSH KAMATH & KUNAL AGARWAL	1.04.2017–23.04.2020
FI–IOF	SANTOSH KAMATH & SUMIT GUPTA	1.04.2017–31.07.2018
	SANTOSH KAMATH	1.08.2018–24.10.2018
	SANTOSH KAMATH & KUNAL AGARWAL	25.10.2018– 23.04.2020
FI–CRF	SANTOSH KAMATH & SUMIT GUPTA	1.04.2017– 31.07.2018
	SANTOSH KAMATH	1.08.2018–24.10.2018
	SANTOSH KAMATH & KUNAL AGARWAL	25.10.2018– 23.04.2020
FI–USBF	PALLAB ROY & SACHIN PADWAL DESAI	1.04.2017- 30.09.2018
	PALLAB ROY	1.10.2018 – 24.10.2018
	PALLAB ROY & SANTOSH KAMATH	25.10.2018– 23.04.2020
FI–DAF	SANTOSH KAMATH, UMESH SHARMA & SACHIN PADWAL- DESAI	1.04.2017–23.04.2020

b. Having common fund managers for the *debt schemes inspected* substantiates that they were running the *debt schemes inspected* with similar strategy as that of Credit Risk Funds with similar portfolio of securities.

5.1.2 In its replies, the Noticee has *inter alia* submitted as under:

i. *"It is submitted that the Schemes were re–categorized in terms of the Categorization Circular; FT–MF provided a proposal to SEBI on scheme re–categorization and had strictly complied with SEBI's comments on such proposal. The Noticee had complied with its obligations by submitting a comprehensive proposal with respect to the re–categorization of its schemes for*

SEBI's review and comments. SEBI had made observations and sought clarifications from the Noticee. This was followed by further correspondence with SEBI and in-person meetings with SEBI officials in January-February of 2018. Thereafter, on June 4, 2018, the Noticee implemented the re–categorization exercise, strictly in line with SEBI's observations. It has not been alleged that any such comments provided by SEBI on the Noticee's proposal were not implemented. Therefore, it is submitted that the Noticee had every reason to conclude that the Schemes were in compliance with the Categorization Circular.

ii. *It is submitted that the re–categorization of schemes (including the six Schemes) carried out by the Noticee pursuant to the Categorization Circular was a comprehensive (and by no means superficial) exercise which was undertaken by the Noticee in good faith. This is evident from the fact that in order to comply with the new scheme categories under the Categorization Circular, the Noticee effected mergers of two of its existing schemes into a third scheme, made changes to the fundamental attributes of twenty four schemes and as a result of the aforesaid, a total of 27,03,557 unitholders were provided with an exit option at the prevailing NAV and without any exit load and 94,782 unitholders exited, which entailed an out–flow of ₹3,412.87 Crore in the aggregate.*

iii. *Reports / disclosures made to SEBI*

- ***Monthly Cumulative Report –*** *To be submitted by the Compliance Officer of the mutual fund. This includes details of new schemes launched, reporting on investments in foreign securities etc. (Paragraph 5.15 of Master Circular for Mutual Funds).*
- ***Bi-monthly Compliance Test Reports (CTRs) -*** *To be submitted by the AMC to SEBI and the Trustees. This includes details on compliance with SEBI regulations (such as investment restrictions etc.). (Paragraph 5.17 Master Circular for Mutual Funds).*
- ***Half Yearly Trustee Report –*** *To be submitted by the trustee of the mutual fund with regard to compliance systems in the fund.*
- ***Annual Statistical Report –*** *To be submitted by the AMC. This includes details of unit holding pattern (individuals, NRIs/OCBs, FIIs, corporate/institutional/others) of the mutual fund. (Paragraph 5.18 Master Circular for Mutual Funds).*
- ***Audited annual report / statement of accounts*** *including the balance sheet and the profit and loss account for the fund and separately in respect of each scheme (this is also published on the fund's website). (Regulation 57 and 58 of the Mutual Funds Regulations).*
- ***Half-yearly unaudited financial report*** *(Regulation 58 of the Mutual Funds Regulations).*

- ***Quarterly statement of movements in the net assets for each of the schemes of the fund*** *(Regulation 58 of the MF Regulations).*
- ***Quarterly portfolio statement, including changes from the previous periods, for each Scheme*** *(Regulation 58 of the Mutual Funds Regulations).*
- ***Daily Transaction Report –*** *This includes details of transactions in securities in the secondary market. (Paragraph 5.19 Master Circular for Mutual Funds).*
- ***Systems Audit Report*** *– This pertains to audit carried out once in two years on the systems and processes of the mutual fund (such as in relation to fund accounting system for calculation of NAVs, financial accounting and reporting system, funds flow process, system processes for meeting regulatory requirements, etc.). (Paragraph 6.14 and 6.17 Master Circular for Mutual Funds).*

iv. *No concerns regarding violation of the Categorization Circulars have been raised in past audits / inspections; otherwise, the Noticee would have been prompt in addressing the same.*

- *The last SEBI inspection was conducted for FY 2018–19 and the Report was submitted recently on December 15, 2020. The terms of reference for the audit (as carried out by an external auditor) included – "Compliance with respect to rationalization and categorization of all the schemes and to verify whether Macaulay Duration in Medium Duration Fund and Medium to Long Duration Fund is as per the Categorization and Rationalization of Mutual Fund Schemes Circular."*
- *The Audit/Inspection Report only records three instances of a temporary minor deviation in the Macaulay duration in Annexure 46.2, which were promptly rectified.*
- *Reference is also made to Inspection cum Surveillance of Mutual Funds of FT Mutual Fund and RTA for the month of April 2019, the findings of which were reported on January 4, 2021. No concerns on compliance with the Categorization Circular were raised.*

v. ***<u>Public Disclosures</u>***

- ***Net Asset Value (NAV) of each Scheme is disclosed publicly on a daily basis –*** *This is based on the valuations provided by independent valuation agencies for each individual security in the portfolio. (Regulation 48 of the MF Regulations)*
- *Monthly portfolio disclosures for each Scheme - This provides the security-wise composition of the portfolio, including the following particulars of each security:*
  - *a. Market value of the exposure to each security;*
  - *b. the share of the exposure in the net assets of the portfolio;*
  - *c. the credit rating of the security;*

d. the date of maturity of the security; and

e. Listed/unlisted status of the security. (paragraph 5.1 of the Master Circular for MF)

- *Half yearly portfolio disclosure (Regulation 59A of the MF Regulations and paragraph 5.1 of the Master Circular for MF).*
- *A payment default by any issuer (and any impact on credit rating or NAV) or adjustments to valuation of a security on application of principles of fair valuation is also promptly disclosed on the website of the AMC. (Regulation 60 of the MF Regulations).*
- *Half yearly unaudited financial results disclosed within one month of the close of each half year i.e., 31st March and 30th September. (Regulation 59 of the MF Regulations).*
- *Audited annual report on scheme-wise basis is disclosed. (Regulation 56 of the MF Regulations).*
- *Assets under Management (AUM) are disclosed on a monthly basis on the mutual fund's website as well as AMFI's (Paragraph 5.6 of the Master Circular for MF).*

vi. The Categorization Circulars do not provide any 'exclusive' characteristics for any of the scheme categories. On the contrary, the classification under the Categorization Circular is such that there are bound to be overlaps amongst different scheme categories. In terms of the Categorization Circular, each debt scheme has been categorised on the basis of one specific parameter, e.g., duration, without any reference to credit risk or credit risk without any reference to duration or in other cases maturity or type of instrument. Therefore, any mutual fund scheme, whose categorization is defined with respect to duration as against credit risk may overlap with either one of the two credit-risk based types of schemes. In fact, prior to issuance of the Categorization Circular, SEBI had considered including credit-rating based distinctions in duration–based schemes (as evidenced by deliberations of the MFAC sub–committee constituted by SEBI prior to issuance of the circular). However, the final circular issued provided for no such distinction. This clearly indicates the legislative intent in this regard, i.e. that credit ratings were never intended to be a point of distinction for the Schemes.

vii. The SCN does not allege any violation of features prescribed for these Schemes under the SEBI Categorization Circular; instead the allegation is premised on "similarities" between schemes. It is submitted that the appropriate standard is not "similarities" among schemes, but rather that the schemes should not be "duplications" / "minor modifications" of each other.

viii. It is clarified that the SCN does not allege that FT–MF is the only mutual fund, which has exposure to a significant percentage of AA and below rated securities in duration–based schemes. However, without prejudice to the same, it is clarified that there are in fact multiple duration–based schemes of other mutual funds, which carry significant exposure (and in many

cases over 65%) exposure to AA and below rated securities over a consistent period of time. Illustratively only, it may be noted that – (A) Nippon India Strategic Fund has consistently had exposure of well in excess of 65% to AA and below rated securities for the period from June 2018 to March 2020; (B) Kotak Medium Term Fund consistently had exposure in the region of or more than 65% for the period from June 2018 to May 2019.

ix. *Such a constricted interpretation of the Categorization Circular will have unintended consequences for the market. For instance, if these Schemes instead had a larger proportion of higher–rated corporate bonds, then the Schemes would have been comparable to a 'corporate bond' scheme (which is required to have >80% of AAA rated bonds). In other words, if such an interpretation is sustained, it would become impracticable to run a duration–based scheme without falling foul of the Categorization Circular in one way or another.*

x. *It is submitted that the SCN emphasises certain similarities while not considering other key features, on which the Schemes are differentiated as a matter of fact. Investment strategy for a scheme is not premised on one feature. Investment strategy is instead a function of multiple parameters including credit risk, maturity, duration, and yield to maturity, liquidity risk, volatility, macroeconomic trends and sectoral concentration, which interact in a complex manner.*

xi. ***<u>Further responses with respect to specific aspect of similarly high exposure to AA and below rated securities</u>:***

- *The Noticee has consistently followed a differentiated yield–oriented strategy for the Schemes. Under the regulatory framework prevailing until January 1, 2021, debt schemes could be assigned any of the following three risk levels from the lowest level of risk to the highest, to be reflected in a risk-o-meter disclosed to investors: "Low", "Moderately Low" and "Moderate" (SEBI Circular dated April 30, 2015 read with AMFI Best Practices Guidelines Circular No. 57 dated May 18, 2015). Accordingly, the risk profile of the Schemes has always been disclosed as 'moderate' (i.e. the highest risk profile for debt schemes) under the prevailing regulatory framework. Many other schemes within the same SEBI categories disclose a lower level of risk. SEBI recently vide its Circular dated 5 October 2020 (w.e.f. January 1, 2021) amended the risk disclosure framework to provide for six risk classifications for all types of schemes: "Low", "Low to Moderate", "Moderate", "Moderately High", "High" and "Very High". Under the new framework, the risk level for a debt scheme will be based on following different types of risks, each of which are to be separately assessed:*

a. Credit risk, to be assessed on the basis of credit ratings of securities in the portfolio;

b. Interest rate risk, to be assessed on the basis of Macaulay duration of the portfolio;

c. Liquidity risk, to be assessed on the basis of listing status, credit rating, structure of debt instruments, etc.

There is no allegation in the SCN that any of the above–stated regulatory requirements were not complied with.

- *Even under the recently revised SEBI requirements pertaining to 'risk–o–meter' (contained in SEBI Circular dated October 5, 2020), all scheme categories (including duration–based schemes) are required to separately compute liquidity risk, interest rate risk and credit risk. This clearly demonstrates the regulatory intent that duration–based schemes may have varied credit risk in their portfolios (including high credit risk).*
- *Under the Mutual Funds Regulations, investments must be made in 'investment grade' quality securities (i.e. **BBB**– and above). Beyond that, fund managers have flexibility to determine the credit rating composition of schemes. Regulations do not mandate thresholds/caps on the exposure to AAA or to below AAA rated securities, except for two specific categories of debt schemes i.e. Credit risk fund and corporate bond fund.*
- *The Categorization Circular does not provide stipulations with respect to credit–ratings for 'duration–based' funds. Hence, 'duration–based' Schemes may have similar exposures to AA and below rated securities.*
- *SEBI Regulations / circulars provide for the following investment limits –*

Exposure / Concentration limits	***Limit***
Exposure to a single issuer (7th Schedule, Clause 1, MF Regulations)	*10% of net assets of scheme; can be extended to 12% with board approval*
Exposure to a corporate group (Clause 12.4.3 of the 2018 Master Circular)	*20% of net assets of scheme; can be extended to 25% with board approval*
Exposure to a sector (Clause 12.4.1 of the 2018 Master Circular; amended by SEBI circular dated 1 October 2019)	*25% of net assets of scheme.* *This limit has been amended to 20% with effect from 30 June 2020.*

- *As between themselves, the Schemes are differentiated with respect to their exposure to interest rate risk, by maintaining different Macaulay durations for their portfolios, as below:*

SCHEME	*INTEREST RATE RISK EXPOSURE USING MACAULAY DURATION*
FT-UBF	*3-6 MONTHS; LEAST EXPOSURE TO INTEREST RATE RISK*
FT-LDF	*6-12 MONTHS; LESS EXPOSURE TO INTEREST RATE RISK*
FT-STIP	*1-3 YEARS; MODERATE EXPOSURE TO INTEREST RATE RISK*
FT-IOF	*3-4 YEARS; HIGHER EXPOSURE TO INTEREST RATE RISK*
FT-DAF	*FLUCTUATING INTEREST RATE RISK EXPOSURE*
FT-CRF	*NO STIPULATION AS TO INTEREST RATE RISK EXPOSURE (FLUCTUATING IN PRACTICE)*

- *The above differentiation is borne out in terms of the volatilities of the Schemes (i.e., sensitivity of the NAV of a Scheme to changes in interest rates). As discussed above, the Schemes exhibit a high degree of differentiation in this respect. In other words, the portfolios of each Scheme (taken together) demonstrably react differently to changes in interest rates in the market.*
- *As is clear from the data provided above, (a) Schemes with significant proportions of AA and below rated instruments in their respective portfolios may have substantially different reactions/ sensitivities to interest rate risks; (b) even if some of these AA and below rated securities are common across the Schemes, the divergence on interest rate sensitivity on the portfolio persists.*
- *The Notice also conflates duration (which measures interest rate risk) with credit rating (which measures credit risk). It is submitted that low duration investments do not necessarily have correspondingly low credit risk. An investor may be willing to take exposure to (or be agnostic to) greater credit risk but at the same time reduce his exposure to changing market interest rates – such an investor would choose to invest in a low duration Scheme (viz., FI–UBF, FI–LDF or FI–STIP, depending on the level of interest rate exposure he/she is willing to take on). Similarly, if such an investor was willing to take on moderate interest rate risk, he/she would choose to invest in a higher duration Scheme (viz., FI–IOF). An investor who wants to have dynamic exposure to interest rate risk would invest in FI–DAF.*
- *On the other hand, FI-CRF, which is categorized as a credit risk fund, is required under the Categorization Circular to hold at least 65% of its total assets in AA and below rated securities. In other words, investors who are focused on increasing yields with an assured exposure to securities rated below AA+ (and who may otherwise be agnostic to interest rate risk) would choose FI–CRF over the other Schemes. This is in contrast to the other Schemes, where the investor is choosing a 'duration–based' exposure and has*

no assurance that the scheme will necessarily invest close to two-thirds of its assets in higher yielding securities.

xii. *Further responses with respect to other specific similarities pointed out in the SCN.*

- ***Macaulay duration based similarity across FI–STIP, FI–DAF and FI–CRF in FY 2019–20****: For two of these three Schemes (viz., FI–DAF and FI–CRF), there is no regulatory stipulation as to Macaulay duration and therefore, the Macaulay durations of these schemes may vary at different points in time. As a consequence, Macaulay durations for FI–DAF and FI–CRF may show significant similarities or variations relative to FI–STIP in the ordinary course.*
- ***Common investments by Schemes****: Regulations do not restrict multiple schemes of the same mutual fund from acquiring or holding (even simultaneously) the same security. Common holdings of particular securities within portfolios does not necessarily amount to similarities in the performance of the portfolios as a whole. This is also demonstrated by the relative performances of the Schemes in question (viz., FI–STIP, FI–DAF, FI–IOF and FI–CRF) over the relevant period (plus the first quarter of 2020-21), which show variations.*
- ***Similarity in investment pattern****: The SCN states that a significant proportion of the assets of all Schemes comprise securities where the six Schemes together have subscribed to greater than 70% of the issuance and which are rated AA and below: Regulations do not restrict schemes of a mutual fund from subscribing to a substantial part or even 100% of the exposure of a certain issuance. Recent SEBI circular dated October 5, 2020 regarding product labelling in mutual fund schemes (Risk-o-meter) also recognizes that mutual funds may subscribe to substantial portions of single issuances. The above is consistent with market practice. It is not uncommon for a single subscriber to take large positions in bond issuances. 99.2% of corporate debt issuances were undertaken through the private placement route in 2018–19 (in 2017–18, such proportion was 95.6%). From data on the website of the Bombay Stock Exchange, out of the 74 corporate bond issuances through private placement in December 2020, 39 issuances had only one investor.*
- ***Common Fund Managers****: SEBI regulations do not restrict having common fund managers across schemes. SEBI's circulars dated August 22, 2011 and March 15, 2017, in fact, recognise that the same fund manager may manage multiple schemes. Details of the fund managers have been consistently disclosed including in the scheme information documents and the monthly fact–sheets published by the AMC. The above*

approach (on common fund managers across schemes) is consistent with the approach followed by other mutual funds as well, as detailed in our reply dated January 22, 2021.

ANALYSIS AND FINDINGS ON SCHEME SIMILARITIES:

5.1.3.1 From the Scheme Information Document ("**SID**"), the type and investment objective of the six *debt schemes inspected* of FT–MF, are as under:

TABLE X			
SR. NO.	**CATEGORY OF SCHEMES**	**INVESTMENT OBJECTIVE**	**TYPE OF SCHEME (UNIFORM DESCRIPTION OF SCHEME).**
1.	FRANKLIN INDIA ULTRA SHORT FUND/ULTRA SHORT BOND FUND (**"FI–UST"/ "FIUBF"/ "FTUBF"**).	TO PROVIDE A COMBINATION OF REGULAR INCOME AND HIGH LIQUIDITY BY INVESTING PRIMARILY IN A MIX OF SHORT TERM DEBT AND MONEY MARKET INSTRUMENTS.	AN OPEN ENDED ULTRA-SHORT TERM DEBT SCHEME INVESTING IN INSTRUMENTS SUCH THAT *MACAULAY DURATION* OF THE PORTFOLIO IS BETWEEN 3–6 MONTHS
2.	FRANKLIN INDIA LOW DURATION FUND ("**FI–LDF**").	TO EARN REGULAR INCOME FOR INVESTORS PRIMARILY THROUGH INVESTMENT IN DEBT SECURITIES.	AN OPEN ENDED LOW DURATION DEBT SCHEME INVESTING IN INSTRUMENTS SUCH THAT *MACAULAY DURATION* OF THE PORTFOLIO IS BETWEEN 6 –12 MONTHS.
3.	FRANKLIN INDIA SHORT TERM INCOME FUND ("**FI–STIP**").	TO PROVIDE INVESTORS STABLE RETURNS BY INVESTING IN FIXED INCOME SECURITIES.	AN OPEN ENDED SHORT TERM DEBT SCHEME INVESTING IN INSTRUMENTS SUCH THAT *MACAULAY DURATION* OF THE PORTFOLIO IS BETWEEN 1–3 YEARS.
4.	FRANKLIN INDIA INCOME OPPORTUNITIES FUND ("**FI–IOF**").	TO PROVIDE REGULAR INCOME AND CAPITAL APPRECIATION BY INVESTING IN FIXED INCOME SECURITIES ACROSS THE YIELD CURVE.	AN OPEN ENDED MEDIUM TERM DEBT SCHEME INVESTING IN INSTRUMENTS SUCH THAT *MACAULAY DURATION* OF THE PORTFOLIO IS BETWEEN 3–4 YEARS.
5.	FRANKLIN INDIA DYNAMIC ACCRUAL FUND ("**FI–DAF**").	TO GENERATE A STEADY STREAM OF INCOME THROUGH INVESTMENT IN FIXED INCOME SECURITIES.	AN OPEN ENDED DYNAMIC DEBT SCHEME INVESTING ACROSS DURATION.
6.	FRANKLIN INDIA CREDIT RISK FUND ("**FI–CRF**").	TO PROVIDE REGULAR INCOME AND CAPITAL APPRECIATION THROUGH A FOCUS ON CORPORATE SECURITIES.	AN OPEN ENDED DEBT SCHEME PREDOMINANTLY INVESTING IN AA AND BELOW RATED CORPORATE BONDS (EXCLUDING AA+ RATED CORPORATE BONDS).

5.1.3.2 As per the SEBI Circular dated October 6, 2017 read with Circular dated December 4, 2017 ("**Categorization Circulars**"), concerning guidelines regarding categorization and rationalization of Mutual Fund Schemes, the category of Debt Schemes relevant for the instant proceedings were as under:

TABLE XI

SR. NO.	CATEGORY OF SCHEMES	SCHEME CHARACTERISTICS	TYPE OF SCHEME (UNIFORM DESCRIPTION OF SCHEME).
1.	ULTRA SHORT DURATION FUND	INVESTMENT IN DEBT & MONEY MARKET INSTRUMENTS SUCH THAT THE *MACAULAY DURATION* OF THE PORTFOLIO IS BETWEEN 3 MONTHS–6 MONTHS.	AN OPEN ENDED ULTRA-SHORT TERM DEBT SCHEME INVESTING IN INSTRUMENTS SUCH THAT THE *MACAULAY DURATION* OF THE PORTFOLIO IS BETWEEN 3 MONTHS AND 6 MONTHS.
2.	LOW DURATION FUND	INVESTMENT IN DEBT & MONEY MARKET INSTRUMENTS SUCH THAT THE *MACAULAY DURATION* OF THE PORTFOLIO IS BETWEEN 6 MONTHS–12 MONTHS.	AN OPEN ENDED LOW DURATION DEBT SCHEME INVESTING IN INSTRUMENTS SUCH THAT THE *MACAULAY DURATION* OF THE PORTFOLIO IS BETWEEN 6 MONTHS AND 12 MONTHS.
3.	SHORT DURATION FUND	INVESTMENT IN DEBT & MONEY MARKET INSTRUMENTS SUCH THAT THE *MACAULAY DURATION* OF THE PORTFOLIO IS BETWEEN 1 YEAR – 3 YEARS.	AN OPEN ENDED SHORT TERM DEBT SCHEME INVESTING IN INSTRUMENTS SUCH THAT THE *MACAULAY DURATION* OF THE PORTFOLIO IS BETWEEN 1 YEAR AND 3 YEARS.
4.	MEDIUM DURATION FUND	INVESTMENT IN DEBT & MONEY MARKET INSTRUMENTS SUCH THAT THE *MACAULAY DURATION* OF THE PORTFOLIO IS BETWEEN 3 YEARS – 4 YEARS. PORTFOLIO *MACAULAY DURATION* UNDER ANTICIPATED ADVERSE SITUATION IS 1 YEAR TO 4 YEARS. **	AN OPEN ENDED MEDIUM TERM DEBT SCHEME INVESTING IN INSTRUMENTS SUCH THAT THE *MACAULAY DURATION* OF THE PORTFOLIO IS BETWEEN 3 YEARS AND 4 YEARS.
5.	DYNAMIC BOND	INVESTMENT ACROSS DURATION.	AN OPEN ENDED DYNAMIC DEBT SCHEME INVESTING ACROSS DURATION.
6.	CREDIT RISK FUND^^	MINIMUM INVESTMENT IN CORPORATE BONDS – 65% OF TOTAL ASSETS (ONLY IN AA*** AND BELOW RATED CORPORATE BONDS).	AN OPEN ENDED DEBT SCHEME PREDOMINANTLY INVESTING IN AA AND BELOW RATED CORPORATE BONDS (EXCLUDING AA+ RATED CORPORATE BONDS).

** WHENEVER THE PORTFOLIO DURATION IS REDUCED BELOW THE SPECIFIED FLOORS OF 3 YEARS AND 4 YEARS IN RESPECT OF MEDIUM DURATION FUND, THE AMC SHALL BE REQUIRED TO RECORD THE REASONS FOR THE SAME WITH ADEQUATE JUSTIFICATION AND MAINTAIN THE SAME FOR INSPECTION. THE WRITTEN JUSTIFICATIONS SHALL BE PLACED BEFORE THE TRUSTEES IN THE SUBSEQUENT TRUSTEE MEETING. FURTHER, THE TRUSTEES SHALL ALSO REVIEW THE PORTFOLIO AND REPORT THE SAME IN THEIR HALF YEARLY TRUSTEE REPORT TO SEBI.

^^WORDS/ PHRASES THAT HIGHLIGHT/ EMPHASIZE ONLY THE RETURN ASPECT OF THE SCHEME SHALL NOT BE USED IN THE NAME OF THE SCHEME (FOR INSTANCE CREDIT OPPORTUNITIES FUND, HIGH YIELD FUND, CREDIT ADVANTAGE ETC.).

*** EXCLUDES AA+ RATED CORPORATE BONDS.

5.1.3.3 The Categorization Circulars were issued as SEBI felt that it was desirable that different schemes launched by a Mutual Fund are clearly distinct in terms of asset allocation, investment strategy, etc. Further, there was a need to bring in uniformity in the characteristics of similar type of schemes launched by different Mutual Funds as it would ensure that an investor is able to evaluate the different options available, before taking an informed decision to invest in any scheme. For example, a Credit Risk Fund has been differentiated from duration–based Funds

– i.e. while the scheme characteristics of Credit Risk Fund is a minimum investment in corporate bonds of 65% of the total assets (investments only in AA and below rated corporate bonds), the duration–based Funds allow for Investment in Debt and Money Market instruments such that the *Macaulay duration* of the portfolio is between 3 months–7 years (as amended vide the Categorization Circular dated December 4, 2017). Further, only one scheme per category was permitted by SEBI except in cases of (i) Index Funds/ ETFs replicating/ tracking different indices; (ii) Fund of Funds having different underlying schemes; and (iii) Sectoral/ thematic funds investing in different sectors/ themes. The Categorization Circulars clearly state that Mutual Funds are advised to *strictly adhere to the scheme characteristics stated therein as well as to the spirit of the Circulars* and they must ensure that the schemes so devised should not result in duplication/minor modifications of other schemes offered by them.

5.1.3.4 In the Categorization Circular dated October 6, 2017, SEBI had advised mutual funds that words/phrases that highlight/emphasize only the return aspect of the scheme like credit opportunities fund, high yield fund, credit advantage, etc. shall not be used in the name of a Credit Risk Fund. With respect to the categorization of debt schemes as per the Categorization Circulars, the nomenclature of a Credit Risk Fund was introduced for ensuring that such scheme is differentiated from other types of debt schemes specifically with respect to the high risk involved in the scheme and further, for facilitating an investor to take an informed decision before investing in any scheme including various debt schemes. Prior to the issue of the aforementioned Circular, mutual funds were employing nomenclatures like "*credit advantage*", "*credit opportunities*", "*high yield*", etc. for schemes with a larger percentage of investments in high yielding bonds (meaning '*riskier'* investments) to obfuscate the risk element and highlight the return element. SEBI was clearly intent on giving up such terminology which would misguide the common investor and hence, in the Categorization Circulars, introduced the uniform terminology of "*Credit Risk Fund*". While the Noticee has vehemently argued that the Categorization Circulars do not provide '*exclusive'* characteristics for a scheme and there can be overlaps between the schemes, a careful reading of the Categorization Circulars negate this argument. The Categorization Circulars while elaborating the debt schemes map out each category of schemes and their characteristics either in terms of duration or credit risk element, etc. Specific schemes have also been laid out for investments in instruments of banks, financial institutions, public sector undertakings as also Government securities and floating rate papers.

5.1.3.5 The Noticee has also argued that the legislative intent of the Regulation while formulating the Categorization Circulars is to allow unlimited elbow room for corporate bond papers in the investment grade in respect of duration–based schemes. The Noticee has cited the deliberations in the Mutual Fund Advisory Committee (Sub–Committee) which had proposed credit rating–based distinctions in duration–based schemes. The Noticee has completely misread and misinterpreted the legislative intent here. It is a fact that credit–rating based further categorization of duration–based schemes was brought up for discussion in the Sub–Committee of MFAC, but SEBI was not in favour of such a proposal as the common investor has a very limited understanding of credit risk. Being very conscious of such lack of awareness on the part of the common investor, SEBI wanted only one scheme which could have a pre–dominance of credit risk and it was aptly named as "*Credit Risk Fund*".

5.1.3.6 The Noticee has further argued that the recent Circular issued by SEBI in October 2020 on "*product labelling in mutual funds: Risk–o–meter*" buttresses its position that a duration–based scheme can freely invest in credit risk papers as credit risk is also sought to be measured for the duration–based scheme by the new Risk–o–meter. While the Noticee is correct that the aforementioned Circular is a further refinement of the SEBI Circular dated October 6, 2017, in terms of risk measurement, the legislative intent of SEBI has remained the same in that while there is no prohibition on investing in AA and below rated corporate bonds in the *debt schemes inspected*, the predominance of such papers (being above 65%) can only be the unique scheme characteristic of "*Credit Risk Fund*".

5.1.3.7 The restrictions under the Categorization Circulars are on schemes devised in a manner to result in duplication/minor modifications of other schemes offered by the Noticee. The Categorization Circulars do not curtail flexibility. For example, Corporate Bond Fund is allowed to invest in at least 80% higher rated instruments and there is flexibility of duration in this scheme. Similarly, there is Credit Risk Fund which is required to invest 65% in AA and below rated papers and there is no restriction on the duration. Then there are other categories which are permitted wherein there are duration–based restrictions. To avoid duplication, these schemes can be run by building portfolios with possible combinations of securities which meet the desired scheme objectives without encroaching upon the unique characteristics of other schemes. Therefore, the Categorization Circulars restrict duplication and forces innovation.

5.1.3.8 From the material available on record, the following is observed:

a. Each of the *debt schemes inspected* had taken exposures of more than 65% of their net asset to securities rated AA and below, which is the exclusive scheme characteristic prescribed for a Credit Risk Fund such as FI–CRF, consistently for a long time (see Table I); and

b. Non–credit risk schemes (FI–STIP, FI–DAF, and FI–IOF) were taking similar risk as being taken by the Credit Risk Fund by investing in the same securities which were subscribed by the FI–CRF (see Tables IV, V, VI and VII). Similarly, the *debt schemes inspected* had similarity in investment pattern by subscribing to bonds where FT–AMC has subscribed significant portion (more than 70%) of the issue and the securities were rated AA and below (see Table VIII).

5.1.3.9 The Categorization Circulars, while specifying unique scheme characteristics, do allow enough flexibility for the fund manager within the ambit of the risk parameters. The Noticee has contended that a narrow interpretation of the Categorization framework would make it impracticable to run a duration scheme without falling foul of the regulatory requirements. To substantiate its argument, the Noticee has adverted to the hypothetical scenario where duration–based schemes being packed with AAA bonds would become similar to Corporate Bond Fund (which require more than 80% of AUM to be invested in highest rated bonds), thus blurring the dividing line between Corporate Bond Fund and a duration–based scheme. To respond to this argument advanced by the Noticee, one has to look at the fundamental objective of financial regulation. Regulation seeks to protect the investor against excessive risk taking by market intermediaries by building a regulatory framework which sets reasonable limits on risk exposures. Any deviant behaviour by market entities will warrant regulatory action to curb undue risk taking. At the other extreme, if a market intermediary errs on the side of extreme risk aversion, it is expected that market forces will act to correct such tendencies rather than the regulator stepping in. Categorisation framework for mutual funds is more a principle–based regulation, which spells out the broad regulatory norms leaving enough room for mutual funds to operate, balancing risk with prudence. Clearly, the regulatory intent here is to carve out just one–scheme category for lower rated investment grade corporate bonds leaving the mutual funds enough elbow room to operate the other scheme categories setting prudent limits for AA and below rated bonds without replicating the "*Credit Risk Fund*" category. So, as pointed out

by the Noticee, if a duration–based scheme were to be packed with AAA rated bonds (replicating the corporate bond fund category), it is more a venial breach of the Categorization framework and certainly not in the same league of breach committed by the Noticee. It is considered venial because under the investment strategy, the funds of the common investors are not exposed to a degree of risk beyond what is considered acceptable by the regulatory framework. To summarise, the regulatory intent of principle–based regulation is that the broad limits to risk–taking set by the regulator will be strictly followed by market entities fully being conscious of the regulatory intent. While some common securities between the schemes is perfectly in consonance with the Categorization Circular, five of the six *debt schemes inspected* exhibit striking similarities in terms of portfolio character and risk characteristics with Credit Risk Funds thereby undermining the regulatory objective of carving out a separate scheme category for low rated investment grade corporate bonds, which characterises the highest level of risk for common investors.

5.1.3.10 The practices of the Noticee as highlighted in the preceding paragraphs when viewed holistically had resulted in five of the six *debt schemes inspected* being run in a similar fashion contrary to the mandate of the Categorization Circulars. In view of the observations in paragraphs 5.1.3.1 to 5.1.3.9, I am of the considered view that the Noticee was running all the *debt schemes inspected* as Credit Risk Fund schemes and in a similar manner, both in terms of investment strategy and credit rating, thereby violating the Categorization Circulars, Regulations 25(1), (2) and (16) along with Clauses (2), (6), (8), (9) of the Code of Conduct as specified in the Fifth Schedule to the Mutual Funds Regulations.

5.1.3.11 I have also noted the submissions made by the Noticee that the Regulations do not impose restrictions on having common fund managers across Schemes. It would appear that the observation of common fund managers for the *debt schemes inspected* as contained in the SCN (see also Table IX) was for depicting the fact that such common fund managers were running the aforesaid schemes with a similar strategy and similar portfolio of securities as that of Credit Risk Fund, which in turn amounted to running similar schemes with minor modification. I agree with the Noticee that having common fund managers is itself not a violation of the Mutual Funds Regulations or the Categorization Circulars.

SEBI INSPECTION FOR FY 2018–19 DID NOT REVEAL ANY VIOLATION OF THE CATEGORIZATION CIRCULARS:

5.1.3.12 The Noticee has contended that an inspection was conducted for FY 2018–19 by an external auditor appointed by SEBI and the Report was submitted on December 15, 2020. The aforesaid Report did not record any adverse findings with regard to the Categorization Circulars for any of the *debt schemes inspected*. I have perused the aforementioned Report. In this regard, I note that the inspection had commenced in February 2020 and could not be completed due to lockdown restrictions during the Covid–19 pandemic and the inability on the part of the Auditor to function off–site during the said pandemic. The Report was forwarded to the Noticee by the Auditor, before discussing the observations contained therein with SEBI. The aforementioned inspection for FY 2018–19 is not yet concluded as the Auditor is also conducting an analysis of the investments of the debt schemes of FT–MF and calculation of *Macaulay duration* of schemes. The Noticee is also aware of the ongoing inspection exercise. As opposed to the aforementioned inspection, the forensic audit on the basis of which the instant proceedings was initiated, was a special–purpose focused inspection pursuant to receipt of various complaints by SEBI. In these circumstances, I am compelled to leave the issue open at this stage without drawing any conclusion.

5.2 PRACTICES RELATED TO INTEREST RATE RESET PAPERS AND CALCULATION OF *MACAULAY DURATION*.

5.2.1 The SCN has alleged that the Noticee had incorrectly calculated *Macaulay duration*, taking interest rate reset dates as deemed maturity. As incorrect date was taken as deemed maturity date, the securities were valued incorrectly. Further, the *Macaulay duration* disclosed to investors was also incorrect. By way of taking interest rate reset date as deemed maturity date, the Noticee had accommodated many long duration securities in shorter duration portfolios and had managed to run multiple schemes with similar strategy.

5.2.2 In its replies, FT–AMC had *inter alia* submitted as under:

i. *"**No breach of SEBI regulations relating to Macaulay duration and valuation:** SEBI regulations neither define, nor provide the manner of computation of Macaulay duration of the portfolio. Hence, reference must necessarily be made to its well–understood commercial and industry meaning as well as the accepted industry practices regarding valuation. Mutual Funds Regulations also do not prescribe the specific mechanism for factoring in interest reset clauses in valuation of a security. The SEBI circular cited in the Notice is limited to the effect of put/call options, which is only one mechanism to protect against interest rate risk. In the absence of any specific regulations, the Noticee has relied in good faith on well-settled commercial/industry practices, which incidentally is also consistent with the view of independent valuation agencies, and it would be unfair to impose liability on the Noticee in such circumstances. Since there is no violation of SEBI regulations in relation to the manner of computation of Macaulay duration, the question of breach of the Categorization Circulars does not arise. No concerns regarding compliance with regulations has been raised as part of regular SEBI audits.*

ii. ***No breach of applicable standards of due diligence and care:** The SCN states that the Noticee failed to pay "specific attention to the clauses of the term sheets" of certain privately placed securities, which is alleged to be in breach of SEBI's circular dated 27 July 2000. However, the same does not establish a breach of this Circular. In the present case, the appropriate standard of diligence was met:*

   ***a.** The Circular requires the AMC board to develop a mechanism to verify that due diligence is being exercised while making investment decisions and in that context, it states that "they may pay specific attention in case of investment in unlisted and privately placed securities…"*

   ***b.** The AMC board had put in place a comprehensive mechanism for diligence in investment decision-making including engaging competent and experienced personnel and implementing specific policies, processes and committees for exercising diligence in taking investment decisions and ongoing monitoring of investments. There was also a mechanism for regular review and monitoring of investment decisions, including a presentation from the CIO – Fixed Income and separately, from the Head – Risk Management at each board meeting, covering aspects relating to liquidity, concentration, credit quality etc.*

c. *Also, specific attention was in fact given to privately placed securities, as is evident from the presentations made by the Head – Risk Management to the board that specifically addressed aspects relating to investments in unlisted securities and privately placed securities.*

Given the above, it is evident that all reasonable precaution was taken in good faith and qualified and experienced fund managers were engaged in taking investment decisions for the Schemes in accordance with a comprehensive internal mechanism put in place by the board of directors of the Noticee. Accordingly, an imperfection in the documentation in a few stray instances (out of numerous investments) would not establish breach of the provisions of the above circular, which has a more general application, i.e., requiring the AMC board to put in place an appropriate mechanism for diligence in investment decisions.

iii. ***The interest reset date is the appropriate reference date for computation of Macaulay duration and valuation, even in the absence of an exit right:*** *Without prejudice to the foregoing, it is submitted that the interest reset date ought to be the reference date for computation of Macaulay duration and valuation, even in the absence of an exit right, as reasoned below.*

a. Macaulay duration is a measure of interest rate risk; accordingly, if the terms of the security provide the right to reset the interest rate on a specific date, such date is the appropriate reference date for computation of Macaulay duration –*Macaulay duration reflects the portfolio's price sensitivity to changes in market interest rates and accordingly, it is well-accepted that it is a measure of interest rate risk. In view of this, if the terms of the security provide the right to reset the interest rate on a specific date, such reset date should function as the reference date for calculation of Macaulay duration, since the interest rate risk carried by the bond is limited to that date. As a corollary, coupon rate reset dates should function as the reference date for calculation of Macaulay duration, since on such date, the interest rate risk profile of the bond changes fundamentally (i.e., after the coupon rate has been reset, the bond assumes a new interest rate risk profile, at which time the Macaulay duration would need to be re-calculated with reference to the next coupon rate reset). This point can also be illustrated alternatively as follows:*

- *If coupon rate resets were disregarded for the purpose of calculation of Macaulay duration (i.e., if the calculation assumed the maturity date as the reference date and the original coupon as a fixed coupon rate), the resulting*

value of Macaulay duration would be a (relatively) higher number, which would be indicative of (higher) interest rate risk that would correspond to an equivalent fixed coupon rate bond (without a coupon rate reset).

- *The (higher) Macaulay duration so calculated would present a misleading picture of the interest rate risk profile of the bond, since it ignores an intervening coupon rate reset, which mitigates against such interest rate risk by realigning the coupon rate with the then prevailing market interest rate.*
- *As a result, if Macaulay duration were to be calculated in the manner advocated for by SEBI, a low-duration bond would be artificially classified as a high-duration bond. At a portfolio level, this would lead to misleading disclosures regarding the risk profile of the portfolio to investors.*

b. *Movement in interest rates on offer in the market is itself ultimately governed by repo rates set by the RBI. To illustrate:*

a. *Assume a bond worth INR 100 bears an interest rate of 6% per annum (which would correspond to the market interest rate for similar bonds at the time of investment) (referred to as Bond A).*

b. *Assume that during the term of the bond, due to changes in RBI repo rate or other factors which influence market interest rate, the market interest rate for similar bonds moves up to 10%.*

c. *As a result, Bond A (which only yields 6% per annum) becomes less valuable/attractive for an investor with INR 100 to invest, since he may earn a higher rate of interest elsewhere.*

d. *However, he may be willing to invest in Bond A if it is available for sale at a cheaper rate, since in such a case, the effective yield on the bond will be higher for the investor.*

The Macaulay duration of Bond A measures the extent to which the price of Bond A would move (i.e., become cheaper or more expensive), for a corresponding change in market interest rates. Specifically, if the duration of a bond is, say, 3 years, it indicates that for a change of one percentage point in market interest rates, the price of the bond will fluctuate by 3 percentage points. The effect of Macaulay duration therefore, is that it measures the sensitivity of a bond's prices to movement in market interest rates. In other words, it is a measure of the interest rate risk inherent in a bond.

c. ***The above principle holds even if there is no exit option for the investor, so long as there is an assured right to reset the interest rate on the reset date –*** *An exit option is only one of the mechanisms to enforce a coupon reset. Even if only the issuer has an exit option, the coupon reset date ought to be used as the reference date for calculating the Macaulay duration (so long as the investor is assured of a mandatory interest reset option in case the exit option is not exercised).*

This is because even in such a case, the interest rate risk for both parties is limited to the interest reset date (and on the reset date, there may either be a new coupon rate if necessary to reflect prevailing market yields or a prepayment). It is therefore also incorrect to characterise such a provision as 'one–sided' in any manner, since it protects both parties against interest rate risk.

d. ***The same principle holds good for valuation –*** *Similarly, for computation of valuation, even if both the issuer and bond-holder do not have an exit option, so long as the bond-holder has either (a) a put option; or (b) an assured interest rate reset option at a rate acceptable to the bond-holder, the coupon reset date ought to be used as the reference date, as the bond-holder can effectively 'exit' the position on such date. Upon the rate being reset, from a valuation perspective, it is equivalent to the existing instrument ceasing to exist and a new instrument with a new interest rate taking its place.*

e. ***Presence of floor/cap ought not to detract from the above –*** *Inclusion of a floor/cap in a coupon reset clause is an outcome of commercial negotiations with the issuer and is only intended for the purpose of limited down-side protection. In other words, it is only intended to come into play in case of an extreme and unanticipated fluctuation in the market interest rates. Accordingly, the spread between the original coupon rate, on the one hand, and the floor and cap, on the other hand, tends to be quite substantial, and coupon resets generally are only called for within the broad range of the floor and cap. To that extent, the presence of a floor or cap on the interest rate ought not to detract from the above principle.*

It is reiterated that given the absence of a definition or the manner of computation of Macaulay duration under regulations, reference is being made to the well-understood commercial/industry understanding for the above, along with the view of independent valuation agencies.

The above is consistent with the position of AMFI and CRISIL (as evidenced by minutes of an AMFI Valuation Committee meeting held on June 15, 2018 and subsequent correspondence between CRISIL and multiple mutual funds).

iv. ***Non–exercise of exit option in certain cases:*** *An erroneous assumption has been made that an exit option must always be exercised. On the contrary, the decision on whether or not to exercise an option is to be taken by the investment team based on their business judgment, taking into account various competing considerations in the best interests of unitholders. A rigid rule cannot be prescribed for such an assessment and in fact, no such rule exists under regulations.*

ANALYSIS AND FINDINGS ON INCORRECT CALCULATION OF *MACAULAY DURATION.*

5.2.3 In the SCN, SEBI had identified and detailed certain concerns with respect to interest rate reset clauses in certain securities of the following Issuers* (to which *inspected debt schemes* had subscribed), namely:

i. Edelweiss Rural and Corporate Services Limited ("**ERCSL**") (formerly Edelweiss Agri Value Chain Limited) (with no floor no cap);

ii. AASAN Corporate Solutions Private Limited (a Piramal Group Company) (with no floor no cap);

iii. Piramal Realty Pvt. Ltd. (with no floor no cap);

iv. Indostar Capital Finance Limited (having floor and cap);

v. Edelweiss Commodities Services Limited (having floor and cap);

vi. JM Financial Credit Solution Limited (having floor and cap);

vii. Motilal Oswal Housing Finance Limited (having floor and cap).

*The above instances are illustrative and are relied upon for bringing out the concerns in the valuation and computation of *Macaulay duration* with respect to the securities forming part of the *debt schemes inspected.*

5.2.4 The observations with respect to interest rate reset clauses are reproduced as under:

TABLE XII	
ISSUER	**CONCERNS WITH RESPECT TO INTEREST RATE RESET CLAUSES**
i. **EDELWEISS RURAL AND CORPORATE SERVICES LIMITED**	a. Five of the *inspected debt schemes* (except FI–IOF) had invested in Non–Convertible Debentures ("**NCDs**") (ISINs - INE657N07381 and INE616U07036) issued by Edelweiss Rural and Corporate Services Limited ("**ERCSL**") on private placement basis on June 30, 2017. The actual maturity of these securities is June 30, 2027 and securities have interest rate reset clause with no floor and no cap and no call/put option. As per the interest rate reset clause Issuer has an option to propose interest rate reset at the end of 3rd year/5th year/7th year from the deemed date of allotment. Accordingly, the first instance of coupon interest rate reset at the end of 3rd year, falls on June 30, 2020 and Issuer had to propose change in interest rate, if desired, by April 30, 2020. b. From the term sheet of the securities (ISINs - INE657N07381 and INE616U07036), it was observed that as per reset mechanism, *issuer through debenture trustee has an option to propose revised interest rate to the investors via 'Interest Reset Notice' at least 60 calendar days prior to the reset date. If issuer proposes revised interest rate the investors have option to accept or reject the proposed revised interest rate and shall communicate the decision of acceptance/rejection at least 45 business days prior to the reset date.* c. It is also mentioned in the term sheet that *"NCDs held by these investors, to whom the proposed revised interest rate/ coupon rate is not acceptable, shall be mandatorily redeemed on the interest rate reset date (Early Redemption)".* *d.* Vide an email dated April 7, 2020, the Noticee had informed ERCSL that it was willing to exit on the next interest rate reset date (i.e. June 30, 2020) and had appraised the Issuer in advance to plan for the prepayment. However, the Issuer vide communication dated April 30, 2020, had informed the Noticee that under the terms of the Agreement, the discretion of issuance of interest rate reset notice is solely at the option of the Issuer and it had decided not to propose a revised rate. Therefore, in the instance wherein the Issuer does not propose interest rate reset or agree for repayment, the investor has no option to exit. Accordingly, there is no explicit exit option to investor (FT–AMC) on the interest rate reset dates and the redemptions before maturity date is not possible at the explicit option of the Noticee.

ii. **AASAN CORPORATE SOLUTIONS PRIVATE LIMITED**	a. Five of the *inspected debt schemes* (except FI–UBF) had invested in the NCDs (ISINs–NE081T08090) issued by AASAN Corporate Solutions Private Limited (having corporate guarantee of Piramal Management Services Private Limited) on private placement basis on December 14, 2016. Further, FI–UBF has invested in the NCDs (ISIN–INE081T07027) issued by AASAN Corporate Solutions Private Limited (having corporate guarantee of Piramal Management Services Private Limited) on private placement basis on March 15, 2017. The maturity of these securities were on December 13, 2019 and March 14, 2020 respectively. The coupon was 9.60% per annum payable quarterly and had interest rate reset every quarter without any floor and cap. b. The term sheet of security with ISIN–INE081T07027 contains the following interest rate reset clause: *"…With respect to those debenture holders to whom the revised coupon rate is not acceptable or the debenture holders who fail to communicate their decision within the timelines mentioned in clause (1) above ("Dissenting debenture holders"), the company shall have the right but not the obligation to redeem the debentures held by the Dissenting Debenture Holders, and pay to such dissenting debenture holders the principal amount of their debentures along with all the other amounts due, including accrued coupon on such debentures on the immediately succeeding coupon payment date…".* The aforementioned clause provides exit option to the Issuer on each interest rate reset date. However, the investor had no explicit option available to exit on the interest rate reset date. From the said clauses, it is noted that the reset clause provides option to call the security to Issuer but investor does not have the put option. c. On March 15, 2017, the terms sheet of security with ISIN–INE081T08090, that was issued on December 14, 2016, was revised and the aforesaid interest rate reset clause was added in the term sheet of this security also. These securities were subscribed by FT–AMC only and the deal was on private placement basis.
iii. **PIRAMAL REALTY PVT. LTD.**	a. Three schemes, viz. FI–UBF, FI–LDF and FI–STIP had invested in the NCDs (ISINs–INE680R07012) issued by Piramal Reality Pvt. Ltd. on March 15, 2017, on private placement basis. These securities were subscribed by the Noticee only. b. The interest rate reset clause of the said security states: *"With respect to those debenture holders to whom the revised coupon rate is not acceptable or the debenture holders who fail to communicate their decision within the timelines mention in clause (1) above ("Dissenting debenture holders"), the company shall have the right but not the obligation to redeem the debentures held by the Dissenting Debenture Holders, and pay to such dissenting debenture holders the principal amount of their*

	debentures along with all the other amounts due, including accrued coupon on such debentures on the immediately succeeding coupon payment date". The aforementioned clause provides exit option to Issuer on each interest rate reset date. However, the investor had no explicit option available to exit on the interest rate reset date.
iv. **INDOSTAR CAPITAL FINANCE LIMITED**	a. FI–UBF had invested in the NCDs (ISINs–INE896L07660) issued by Indostar Capital Finance Limited on private placement basis on November 2, 2018. As per the interest rate reset clause mentioned in the term sheet of the security, Issuer has to communicate the proposed revised spread to the debenture holders. The spread for initial three months has been agreed at 2.25% and thereafter spread has to be reset on quarterly intervals subject to floor of 2.25% and cap of 3.25%. The spread reset proposal date was May 2, 2020 and as per the agreed terms on or before April 22, 2020 debenture holder had to communicate acceptance or rejection of the revised interest rate reset to Issuer. b. From an e–mail dated April 21, 2020 of Kunal Agrawal (Fund Manager) to Santosh Kamath (Fund Manager and CIO), it is observed that the Noticee had been discussing prepayment with Indostar for a long time but the Issuer did not consider any prepayment given the market condition and agreed to give cap rate on the NCDs to the subscriber. The Noticee did not have explicit exit option. Further, the Noticee had admitted to not having right of prepayment even in terms of the commercial understanding.
v. **EDELWEISS COMMODITIES SERVICES LIMITED**	a. Four schemes viz. FI–STIP, FI–IOF, FI–DAF and FI–CRF had invested in the NCDs (ISINs–INE657N07605) issued by Edelweiss Commodities Services Limited on private placement basis on December 21, 2018. Further, two schemes namely FI–LDF and FI–UBF had invested in the NCDs (ISIN–INE657N07597) issued by ECSL on private placement basis on November 28, 2018. b. The interest rate reset clause of the term sheets of both the securities states that if the Issuer does not issue any spread interest rate reset notice for the applicable quarter, the existing spread shall be applicable for such quarter. Further, it is stated in the term sheet that <u>Debenture holders will not have an option to seek mandatory prepayments as long as the Issuer agrees to pay the revised spread</u> which will always be between initial spread and spread recap (both inclusive). c. If the Issuer does not propose a revised spread rate, there is no exit to the debenture holder. Further, the securities have a fixed cap and floor rate. Therefore, if the Issuer proposes cap rate, the investor has no option to exit and the Issuer had exclusive discretion to propose revision in rate. If the rate is agreed at floor rate and the Issuer does not propose revision in rate, as per the agreement the floor

	rate will continue till maturity. The security is akin to a security having only call option when the interest rate is at cap rate and put option when the interest rate is at floor rate and also there is no explicit exit option to investors.
vi. **JM Financial Credit Solution Limited**	a. Two schemes namely FI–UBF and FI–LDF has invested in the NCDs (ISIN–INE651J07739), issued by JM Financial Credit Solution Limited on private placement basis on July 23, 2019. The Noticee had subscribed to 98.33% of the said security's debt issuance. The tenor of the security was 5 years (maturity July 24, 2024) with quarterly reset of spread. b. The term sheets of the security included the clause: *"For the sake of complete clarity, if the Debenture holders are agreeable to continue at Benchmark+ Initial Spread, the Issuer has no option to repay/ prepay. Similarly, <u>if the Issuer is agreeable to continue at Benchmark + initial spread + 300 bps, the debenture holder will have no right to ask for repayment/prepayment</u>. If Debenture holders ask for a spread of more than initial spread (subject to a cap of spread cap), the Issuer may choose to repay/prepay the bonds in part or full".* c. These securities have cap and floor rate fixed. Therefore, if Issuer agrees to cap rate the investor has no option to exit.
vii. **Motilal Oswal Housing Finance Limited**	a. Three schemes namely FI–LDF, FI–DAF and FI–STIP had invested in the NCDs (ISIN-INE658R08149) issued by Motilal Oswal Housing Finance Limited (erstwhile Aspire Home Finance Corporation Limited) on private placement basis on September 27, 2018. The Noticee had subscribed 100% of the above mentioned securities. The maturity date is September 28, 2023 and having annual spread interest rate reset mechanism. b. The terms of investment have mention of spread for one year from the date of issuance and for subsequent years spread is agreed to be mutually decided. However, the interest rate reset clause has not addressed the instance/situation wherein the Issuer and investor does not agree to the proposed spread. In case there is no agreement on the proposed spread on the spread reset dates the on-going spread has to continue and there is no exit to the debenture holders.

5.2.5 As noted from the above Table, in respect of the aforementioned 7 securities,

i. These deals were negotiated deals where the Noticee subscribed to 100% or close to 100% of the issuance and yet had failed to pay specific attention to the term sheets of such privately placed securities.

ii. The interest rate reset clauses in the securities were drafted in a manner which provided exclusive discretion to the Issuer to propose interest rate reset of rates/spread as a result of which, in the instance of no proposal from Issuer for revision in rates/spread or where cap rate is agreed to, the investor had no exit option from the security. So even if the market interest rates moved up, in the event of the Issuer not coming up with a proposal to reset the interest rate, the investor will have to remain contented with the existing rate on the investment.

iii. Such unilateral interest rate reset clauses in the covenants/term sheets adversely affects the valuation and computation of the *Macaulay duration* as brought out in the subsequent paragraphs.

iv. The Noticee has defended its position by citing the existence of '*commercial understanding*' between itself and the Issuer but it needs to be borne in mind that a commercial understanding cannot be enforced in a Court of law in the absence of clearly documented covenants.

5.2.6 In all the above cases, the Noticee has conveniently assumed that the *Macaulay duration* of the bonds is the period upto the next interest reset date. To understand how the Noticee's assumption is not well–founded, I would like to elaborate here the concept of *Macaulay duration.* As rightly contended by the Noticee, *Macaulay duration* is a measure of the interest rate risk of a bond and indicates the weighted average pay–back period for the investor. A typical 3 year bond with an annual interest payment (also called coupon) of 10% fixed will pay annually ₹10 as interest and at the end of the 3rd year, will pay the principal of ₹100 along with interest of ₹10 for the third year. While the maturity of the bond is no doubt 3 years, the *Macaulay duration* of the bond is a little less than three years as the investor gets cash flows of ₹10 each at the end of year 1 and year 2 and ₹110 at the end of year 3. These cash flow periods when averaged with the weight of the present value of these corresponding cash flows will give the *Macaulay duration* of the bond. If this calculation leads us to a figure of say 2.5 years, it simply means that the average period of waiting for the investor to get back the money he has invested in the bonds is 2.5 years. This is also a measure of the interest rate risk in the bond. The higher the *Macaulay duration,* the higher is the interest rate risk sensitivity of the bond. Unlike the fixed rate bond (which we have considered in this example), there are bonds where, as per the contractual terms agreed between the Issuer and the Investor, the interest rate is reset in alignment with the market movement at a pre–agreed periodicity. Such bonds are called floating rate bonds or interest reset bonds. It transpires that the Noticee has invested substantial sums of the *debt schemes*

inspected in interest–reset bonds. A typical interest rate reset bond (which is also called a floating rate bond) has the following features in the pre–transaction contract signed between the Issuer and the Investor:

i. Principal amount (or the face value of the bond)/ Maturity period;

ii. Interest–reset frequency (could be 3 months/ 6 months/ 1 year, etc.);

iii. Reference benchmark [could be the 10 year Govt. of India ("**GOI**") bond yield or any other objective market rate];

iv. Spread over the benchmark (an agreed pick up over the benchmark).

5.2.7 An interest rate reset contract will clearly set out all the features indicated at paragraph 5.2.6 objectively and they are agreed to between the parties (Issuer and Investor) upfront before the investment is done. The principal objective behind such a bond is to insulate both the Issuer and the Investor from the loss arising out of the interest rate movements. By resetting the interest rate on a bond every 6 months (say), the interest rate risk will have to be borne by both the Issuer and the Investor only between two interest reset dates, which is a maximum of 6 months. So while the maturity of the interest rate reset bond may be longer, the actual interest rate risk in such bonds for both the Issuer and the Investor is only up to the next reset date. In complete contrast to the floating rate bonds as discussed above, the cases cited above at paragraph 5.2.4 (Table XII) are clear examples of contracts struck between the Issuer and the Investor (FT–MF) which are not equitable as the Issuer has a distinctive upper hand in some cases in deciding on whether to reset the interest rate or just allow the existing rate to continue. In such cases, since the interest rate reset is not automatic but at the discretion of the Issuer, the security loses the character of a floating rate bond. In some cases, the caps and floors set to the interest rate will interfere with the free movement of interest rate and hence, will not insulate the Investor from interest rate risk. Despite such fetters being placed on automatic resetting interest rates, the investor does not have the right to exit and find alternate better investment propositions. The Noticee has sought to explain away the unequal rights in contractual terms by citing the existence of a '*commercial understanding*' between the Issuer and the Investor, which is not reduced to writing. A commercial understanding not backed by a legal covenant will not be enforceable in a Court. In all such cases, in the absence of objective features as outlined in the earlier paragraph, it is totally inappropriate to assume the *Macaulay duration* as the interest reset frequency (even when there is no assurance of actual reset happening on the interest reset date). Clearly, in all such cases, *Macaulay duration* as stated earlier, will be nearer to the ultimate

maturity of the bond, which is much longer. Thus, by deliberate misapplication of shorter duration, the Noticee has been able to push the long duration papers into the shorter–duration debt schemes. While this has been resorted to for the purpose of generating a higher yield for the portfolio, the *debt schemes inspected* have been misrepresented to the investors as short duration schemes. The Noticee has vehemently contended the charge of running multiple schemes in a similar manner (thereby violating the Categorization Circulars) advancing the argument that it has not violated any regulation/Circulars in doing so. Quite on the contrary, the Noticee has committed flagrant violation of the Categorization Circulars by misrepresenting the *Macaulay duration* of several instruments, which are nothing but structured deals bearing no resemblance to pure floating rate instruments.

5.2.8 In respect of securities which have interest rate reset clauses with several restrictions as described above, it is reiterated that the *Macaulay duration* will be closer to the original maturity of the bond. Only an exhaustive audit of the portfolio of the *schemes* (and not a sample audit as done by the forensic auditor) would reveal the extent of wrong calculation of *Macaulay duration* and the resultant misclassification of such papers in shorter duration schemes. However, the sample analysed by the forensic auditor is a clear pointer to miscalculation of *Macaulay duration* and the resultant mis–categorization.

5.2.9 I note that the Categorization Circulars have segregated the duration–based debt schemes on the basis of *Macaulay duration* of the portfolio and Mutual Funds are required to describe the concept of *Macaulay duration* in the offer document of respective schemes. Further, AMCs have the sole responsibility to ensure that the calculation of the *Macaulay duration* of the portfolio is in line with the regulatory requirements even in the instances where the activity is outsourced, in terms of Regulation 25(3) of the Mutual Funds Regulations. As noted from the above, the Noticee had incorrectly calculated *Macaulay duration*, taking interest rate reset dates as deemed maturity even though the covenants were not in consonance with normal floating rate bonds. Further, as an incorrect date was taken as deemed maturity date, the securities were valued incorrectly. Further, the actual *Macaulay duration* of duration–based schemes was much higher than what was projected by the Noticee in the factsheet disclosed to investors. By way of taking interest rate reset date as deemed maturity date, I find that the Noticee had attempted to accommodate many long duration securities in shorter duration portfolios and had managed to run multiple schemes with similar strategy in contravention of the Categorization Circulars.

5.2.10 As regards the aforementioned seven securities (see paragraphs 5.2.3–5.2.5), I note that the Noticee has admitted to certain imperfections in documentation in a few stray instances; however, the Noticee has contended that the same did not establish a systemic problem or breach of the Mutual Funds Regulations relating to due diligence, computation of *Macaulay duration* and valuation and classification of Schemes, especially when the commercial understanding was clear and was adhered to by all parties. In this context, it is noted that the observations of SEBI in respect of the above mentioned seven securities, had arisen on account of the outcome of an Audit conducted for only one year in respect of the *debt schemes inspected.* Such glaring instances emanating even from a limited audit cannot be ignored especially when the Noticee itself has admitted to certain imperfections in the documentation. Further, the defence adopted by the Noticee that where documents do not provide an explicit exit option for the investor or assurance of a rate reset, the commercial understanding underlying the transactions was clear and was given effect to, i.e. the coupons were in fact periodically reset for these securities, cannot be accepted as such arrangements cannot be said to be enforceable in law unless exit options are clearly provided for in the term sheets/agreements.

5.2.11 The Principles of Fair Valuation in the Eighth Schedule of the Mutual Funds Regulations lay down the overarching principles to ensure fair treatment to all investors including existing investors as well as investors seeking to purchase or redeem units of mutual funds, in all schemes, at all points of time. True and fair valuation is the key to meet such an objective. Upon a consideration of the preceding paragraphs 5.2.3 to 5.2.10, I find that the Noticee had violated the provisions of the SEBI Circular dated September 18, 2000 and SEBI Circular dated July 27, 2000, Clauses (a), (g) & (h) of Investment Valuation Norms as specified in Eighth Schedule under Regulation 25(19) and Regulation 47 of the Mutual Fund Regulations as it had failed to conduct adequate due diligence at the time of investing in interest rate reset papers. Further, the Noticee had violated the provisions of the Categorization Circulars dated October 6, 2017 and December 4, 2017, Regulations 25(1), (2) and (16) along with Clauses (2), (6), (8), (9) of the Code of Conduct as specified in the Fifth Schedule to the Mutual Funds Regulations on account of having adopted irregular practices for meeting the requirements of *Macaulay duration*.

NON–EXERCISE OF EXIT OPTION:

5.2.12 In its replies, the Noticee has contended that the decision on whether or not to exercise an exit option is to be taken by the investment team based on their business judgment, taking into

account various competing considerations in the best interests of unitholders. It is noted that during the FY 2019–20, there were total of 33 securities in the portfolio of FI–LDF and FI–UBF having interest rate reset clause and/or put-call options. There were 45 instances and 19 instances for FI–UBF and FI–LDF respectively during FY 2019–20 where the schemes had call/put and/or interest rate reset dates; however, the Noticee exercised the option in only 3 and 2 instances in FI–UBF and FI–LDF, respectively. It is noted that the option of pre–payment was not exercised by FT–AMC in any single instance. Further, in 36 and 15 instances available for FI–UBF and FI–LDF respectively during FY 2019-20, the market yield of the security (as on put/call notice date, interest rate reset notice date by considering notice day 30 days prior to the interest rate reset date) was more than the coupon yield at the time of such notice and admittedly, the Noticee was also facing liquidity issues from October 2019 onwards. It is pertinent to point out here that the Noticee itself, in its reply dated January 22, 2021, has vividly described the emerging liquidity stress in the portfolio since October 2019. In the Noticee's own words, it is as under: "*However, signs of stress began to emerge in the portfolios of the Schemes commencing from the 24 October 2019 ruling of the Hon'ble Supreme Court of India in the AGR matter, which had serious financial repercussions for Vodafone Idea Limited (to which the Schemes had significant exposure), which ultimately culminated in the bonds being segregated from the main portfolio in January 2020. Such stress was aggravated and redemptions accelerated as a result of downgrades and defaults involving Essel Group bonds in December 2019, Yes Bank bonds in February 2020 and Reliance ADA Group bonds in March 2020. This was compounded by the fact that after 1 October 2019, the unlisted securities in the Schemes' portfolios were no longer marketable to most other market participants. These pressures were then further exacerbated by the market dislocation arising from the COVID–19 pandemic*." Considering the numerous instances where the exit option was not exercised, it is noted that the same had resulted in situations where the Mutual Fund remained invested with higher negotiated coupon rate and debenture holders could not exit from the investments on the pre–decided call/put and interest rate reset dates even when there were requirement of funds. It is also relevant to note that the *inspected debt schemes* had exposure to total illiquid securities in the range of 73% to 85% for the month of May, 2019 and in the range of 85% to 94% for the month of January, 2020. These figures presented by the Head–Risk Management highlight the illiquid nature of the portfolio of the *debt schemes inspected,* long before the Covid–19 pandemic hit the financial markets. It is not clear why the Noticee did not exercise the exit option in the face of increasing liquidity stress. The Noticee did not produce any records or documentary evidence to justify the rationale of such

decisions. I am therefore, not inclined to accept the contention of '*business judgment'*, as advanced on behalf of the Noticee.

5.3 Valuation Practices.

5.3.1 The SCN has alleged that the valuation of securities did not reflect the realisable value of the underlying securities as it was not done as per the *Principles of Fair Valuation*, in respect of the following:

a. Deferment of payment of interest/principal payment; and

b. Incorrect calculation of *Macaulay duration*.

For this purpose, some illustrations were brought out in the SCN which are elaborated hereunder.

OPJ Trading Ltd.

5.3.1.1 The irregularities observed with respect to the valuation of **OPJ Trading Ltd.** are reproduced from the SCN as under:

i. Four schemes, viz. FI–STIP, FI–DAF, FI–IOF and FI–CRF had invested in NCDs issued by OPJ Trading Ltd (ISIN – INE507R07033) on October 16, 2017 having maturity of 3 years with call and put option at the end of each year. The agreed coupon rate was 13.00% for first year, 13.50% for second year and 14.00% for third year. Post–Inter scheme transfers ("**IST**") three schemes of FT–AMC namely FI–STIP, FI–DAF, FI–CRF together held 100% of OPJ Trading Ltd. Debentures comprising of ₹175 Crore.

ii. In an unsigned amended debenture trust deed ("**DTD**") in October 2019, a new put option dated December 31, 2019 was inserted and there was revision in the rate of interest from 14% to 16% from October 16, 2019 (which was date of exercise of 2nd year put option). However, the changes in terms of securities were neither communicated to custodian nor to the valuation agency.

iii. Further, the Noticee vide email dated December 12, 2019 had negotiations with Issuer and the following was agreed:

a. On the amount that remains outstanding as on December 31, 2019, a one-time compensation fees of 1% of the outstanding amount to be paid on or before December 31, 2019.
b. An additional put option to be inserted for January 31, 2020, in terms of which the entire exposure has to be repaid.

iv. However, the DTD was amended in this regard on December 24, 2019 without mentioning that the entire exposure has to be repaid on January 31, 2020. It was observed that the put option was not exercised on January 31, 2020 and the outstanding amount was not received by FT–AMC. The DTD was again revised on January 24, 2020 inserting a new put option of February 28, 2020 and one-time fees for an amount equivalent to 0.75% of the outstanding amount on or prior to March 2020. The put option was again not exercised on February 28, 2020 and on the same day the DTD was amended and a new put option was inserted for March 31, 2020 and one-time charge of 0.75% of the total outstanding amount was agreed to be paid prior to February 29, 2020.

v. The Table below provides details of penalty/compensation/one-time charge received from Issuer to defer the put option date and resultant payment which were deposited in the schemes:

TABLE XV			
SR. NO.	**PARTICULARS**	**DATE OF RECEIPT**	**AMOUNT (₹ IN CRORE)**
1.	1% OF OUTSTANDING AMOUNT AGREED IN DTD AMENDED ON DECEMBER 24, 2019.	1.01.2020	1.80
2.	0.75% OF OUTSTANDING AMOUNT ON AGREED IN DTD AMENDED ON JANUARY 24, 2020.	31.01.2020	1.37
3.	0.75% OF OUTSTANDING AMOUNT AGREED IN DTD AMENDED ON FEBRUARY 28, 2020.	02.03.2020	1.39

vi. Issuer made payment on March 20, 2020 of ₹17.09 Crore and a query was raised by the custodian of FT-MF vide e-mail dated March 23, 2020 that the interest amount received from the Issuer is at an interest rate of 16% instead of 14% from October 2019.

vii. Thereafter, the back office of FT–AMC raised this issue with the fund manager vide e-mail dated March 23, 2020**.** In reply to the query, fund management team shared the unsigned

amended DTD dated October 2019 (date not mentioned) with the back office stating that rate of interest is 16% from the start of third year of the bond.

5.3.1.2 The SCN has alleged that the repeated deferral of the put option indicates that the Issuer was unable to pay and was under financial stress, which was not taken into account by the Noticee in the valuation of the security. By *'artificially maintaining'* a high valuation between the period from October 16, 2019 to March 23, 2020, the Noticee had violated principles of fair valuation and failed to ensure fair treatment to all investors.

5.3.1.3 The SCN further alleged that information on deferral of put option on account of the Issuer's inability to pay was not communicated by the Noticee immediately (the Noticee was the sole investor) to the valuation agencies and credit rating agencies. The SCN has also alleged that the monthly portfolio disclosure was incorrect.

Replies of the Noticee:

5.3.1.4 In its replies, the Noticee has inter alia submitted as under:

i. ***OPJ Trading Private Limited ("OPJ") –*** *It is submitted that a case for 'artificially inflating' the NAV and violation of principles of fair valuation is not made out including for the following reasons -*

a. ***Allegation rests on an erroneous assumption of fact (that the put option was deferred on account of financial stress being faced by the issuer) –*** *No evidence has been provided for this, despite a detailed forensic audit having been conducted. For instance, it is assumed that "it (OPJ Trading) could not honour its obligations on the pre-decided dates" (paragraph 8.3.1(xviii) of the Notice); however, this is not based in fact insofar as there can be no failure to honour an obligation with respect to a put option, until the put option is actually exercised. The issuer had been servicing its payment obligations regularly and was in compliance with applicable financial covenants. In fact, the issuer discharged its payment obligations in full in April 2020, as acknowledged in the Notice itself. The investment in OPJ was also secured by high quality collateral, i.e., a pledge over highly liquid listed securities (with original security cover being 2.7x, which was further increased to 3.75x in October 2019).*

b. ***Non-exercise/deferral of put option does not automatically imply financial stress in the issuer –*** *Whether or not to exercise a put option at any given point of time is an investment decision to be taken by the fund management team through the exercise of their business judgment on an analysis of complex and at times, competing considerations (i.e., in all cases, exercising the option may not always necessarily lead to superior outcomes for investors). It has been assumed that merely because the Noticee was able to leverage the put option to recover additional amounts from the issuer in lieu of deferring the option, the same implies that the issuer was under financial stress (see paragraph 8.3.1(xx)). This is based on conjecture, since there may be a number of circumstances where an issuer is financially sound but would prefer not to make a prepayment of the entire investment at a given point of time. For instance, it may be expecting a lump sum cash inflow in short order, which it may appropriate towards the prepayment.*

c. ***Valuation in good faith in accordance with principles of fair valuation*** *– In any event, without prejudice to the foregoing, OPJ was at all times valued in good faith in a true and fair manner in accordance with the principles of fair valuation, which are subjective principles and do not provide any objective standard.*

ii. ***Intimation to rating / valuation agencies*** *–*

a. ***Allegation is premised on the same erroneous assumption of fact*** *- This allegation is also premised on the incorrect factual assumption addressed above, since it proceeds on the footing that information regarding 'financial stress' in the issuer would have necessitated a change in its credit rating and should accordingly have been reported to rating/valuation agencies. As submitted above, this assumption is not correct. Also, since the Noticee in good faith did not believe that there was any financial stress in the issuer, the question of reporting the same to rating/valuation agencies did not arise.*

b. ***No loss/prejudice to investors by deferral of put options –*** *It is not established that any loss has been suffered by any unitholders on account of the roll–over of the put options. To the contrary, the facts demonstrate that the decision to defer the put option only benefitted unitholders since additional monies of ₹6,58,81,566 were realized from the issuer, and the entire exposure including the principal amount was also received in full in April 2020.*

<u>ANALYSIS AND FINDINGS ON OPJ:</u>

5.3.2 I note that the information regarding the newly inserted put options in the term sheets had to be provided to rating agencies so that the information can be reflected in credit rating of the Issuer. However, the information was held by Fund Manager and its team.

5.3.3 The Noticee has submitted that under the terms of the debentures issued by OPJ Trading Ltd., it was entitled to exercise its put option and demand prepayment on October 16, 2019. The Noticee had agreed to refrain from exercising its prepayment option exercisable on October 16, 2019, after considering that OPJ Trading Ltd. had agreed to:

- An increased rate of interest on the debentures (increase from 14% to 16%);
- Increase in cover of the exclusive pledge and
- OPJ Trading Ltd. granting the Noticee a fresh put option (prepayment option) exercisable on December 31, 2019.

5.3.4 In this regard, it is however, noted that the date of option exercise was October 16, 2019 and the amendment to the DTD was executed at New Delhi on October 25, 2019 i.e. 10 days after the option exercise date. From this, it appears that the decision of not exercising put option was under negotiation till October 25, 2019.

5.3.5 The Noticee has defended the repeated instances of deferment of put option as not a reflection of the inability on the part of the Issuer to repay. This does not stand to reason. The assertion that the Issuer had repeatedly deferred the put option at a hefty cost even when it was financially sound enough to repay, defies common logic. It appears that the *"non–exercise of put option by the investor"* is used as a cover–up to hide the financial inability of the Issuer to pay up. In the normal course, if the Issuer defaults in repayment, it gets immediately reflected in credit rating. On the other hand, non–exercise of put option looks like a ruse to avoid rating downgrade and thereby, value erosion. From the aforesaid fact, it strongly emerges that the Noticee wanted to exercise put option but the Issuer showed inability to pay on the put option exercise date. As a result, the Noticee started negotiating the revised terms with Issuer and then the amendment to the DTD was executed at New Delhi on October 25, 2019 i.e. 10 days after the option exercise date. The Noticee has itself admitted that its investment team was continuously seeking prepayment from OPJ by leveraging the put options under the terms of issue.

5.3.6 The investors in mutual fund enter and exit the scheme based on daily NAVs and the ultimate responsibility of fair valuation of securities is of the AMC. In the instant matter, the Noticee had the information which would have adversely affected the valuation of the security but yet failed to incorporate such information to reflect the fair value of the security. By artificially maintaining high NAV of the four schemes (FI–STIP, FI–DAF, FI–IOF and FI–CRF) from October 16, 2019 to March 23, 2020, the Noticee's action adversely affected the investors who entered the scheme during the said period and benefited the investors who exited from the scheme during the said period. Therefore, valuation of the security is in contravention of the Principles of Fair Valuation. I therefore, note that the Noticee has not ensured fair treatment to all investors including existing investors as well as investors seeking to purchase or redeem units of mutual fund scheme at all points of time. Further, while the facts may demonstrate that the decision to defer the put option only benefitted unitholders as the entire exposure including the principal amount was stated to have been received in full in April 2020, the non–compliance by the Noticee with the Principles of Fair Valuation cannot however, be viewed lightly having regard to the aforementioned issues highlighted.

5.3.7 As regards the allegation that the deferral of put option on account of the issuer's inability to pay was not communicated by the Noticee immediately to the valuation agencies and credit rating agencies, it is noted from the SCN that the Noticee had itself agreed that there was an omission in communicating such changes in terms of investment to the back–office team within FT–AMC and to valuation agencies. Further, it is noted that the monthly disclosure of the portfolio by the Noticee on its website also reflected 14% as interest rate instead of the revised rate of 16% during the disclosure for the month of October 2019 to February 2020. The change in interest rate in disclosure was reflected only in March 2020 portfolio. In view of the aforementioned, I note that the Noticee's disclosure with regard to monthly portfolio was incorrect during October 2019 to February 2020. I also note that as the change in terms and interest rate was not communicated to the rating agencies as well as to the valuation agency, the same were not taken into account for valuation from October 16, 2019 to March 23, 2020.

Future Group:

5.3.8 The irregularities observed with respect to the valuation of **Future Group** are reproduced from the SCN as under:

i. FT–AMC held NCDs issued by companies forming part of Future Group, the value of which totalled ₹1025.74 Crore**.**

ii. On April 13, 2020, Future group requested for moratorium/deferment of interest/principal payment on securities issued to FT–AMC citing the reason that the COVID-19 lockdown has affected their cash-flows. Four of the six *debt schemes inspected* (…) had investments in these securities of Future Group. On April 18, 2020, FT–AMC agreed internally to grant moratorium to Future Group and the same was communicated to Issuer on April 18, 2020 but to valuation agencies on April 28, 2020**.**

5.3.8.1 The SCN has alleged that:

i. The Noticee did not communicate the acceptance of the moratorium to valuation agencies till 28 April 2020, which was in breach of the Circular dated September 24, 2019.

ii. The Noticee failed to *"take into account the impact of change in cash flow on the valuation of the securities for the purpose of valuation from April 13, 2020 and the effect of change in realizable value of the security from the April 18, 2020 when the Noticee concluded that there is a need to give moratorium as there is impact on the cash flow of the company".* In doing so, the Noticee artificially maintained high NAV of the relevant schemes from April 18, 2020 till April 28, 2020 and violated principles of fair valuation.

Replies of the Noticee:

5.3.8.2 In its replies, the Noticee has inter alia submitted as under:

i. ***Moratorium was duly and promptly communicated -*** *The decision to grant moratorium was in fact duly communicated by the Noticee to the valuation agencies promptly upon it*

becoming effective. The change in the terms of the transaction did not come into effect on April 18, 2020 but instead became effective on April 27, 2020 (and was duly and promptly communicated to valuation agencies).

ii. ***Noticee acted in good faith, consistent with approach of independent valuation agencies –*** *Without prejudice to the foregoing, the Noticee acted in good faith in line with the settled practices followed by valuation agencies in this regard. In the past (30 July 2019), valuation agencies had communicated to the Noticee that changes to terms of investments cannot be processed and reflected in the valuation until formal documents reflecting the revised terms are shared. In other words, even if the Noticee had communicated the moratorium to valuation agencies on April 18, 2020, the valuation agencies would not have taken it into account until formal documents to effect the change were obtained, which only occurred on April 27, 2020; and CRISIL had also separately clarified (on September 25, 2019), with respect to SEBI's circular dated September 24, 2019, that reporting of changes to the terms of securities would need to be accompanied by formal documents.*

iii. ***No objective standard is prescribed; principles of fair valuation provide guidance in a subjective determination to be made in good faith -*** *It is submitted that the principles of fair valuation do not provide any objective standard for valuation adjustments; instead, these are general principles meant to be utilised by the Noticee for undertaking valuation of securities in good faith. In fact, it is specifically stated that these are 'overarching principles'.*

iv. ***Valuation was undertaken in good faith –*** *The above standard has been met in the facts of the case. It was the considered view of the fund management team, arrived at in good faith and after taking into account the relevant considerations, that the proposed moratorium did not call for a write-down in valuation of the investment (in terms of the principles of fair valuation).*

ANALYSIS AND FINDINGS ON FUTURE GROUP:

5.3.8.3 As stated in the SCN, in terms of SEBI Circular dated September 24, 2019, which was applicable on April 18, 2020 when the Noticee accepted the proposal of Future Group on deferment of payment by FT–AMC, in case the interest/principal amount is not received or the maturity date is extended, then the valuation agencies are required to treat the security as

'*default'* for the purpose of valuation. The Noticee was mandated to communicate the aforementioned information to the valuation agencies.

5.3.8.4 I note that the Noticee was the sole debenture holder of the aforesaid Future Group NCDs. Therefore, its decision on the proposal of Future Group was final and debenture trustee had to be informed merely for formal documentation. It is noted that the Noticee had neither communicated the acceptance of moratorium/deferment of payment proposal of Future Group to the valuation agencies till April 28, 2020, despite being the sole subscriber of these securities, nor did it reflect the financial stress of the Issuer in the valuation of securities.

5.3.8.5 Future Group had sought moratorium on April 13, 2020, citing effect on their cash flows due to the Covid–19 pandemic. On April 18, 2020, when after internal deliberation, the Noticee had concluded that there was a need to grant moratorium as there was an impact on the cash flow of the Issuer, the same should have been reflected in the valuation since there was a change in realizable value of the security. Though the formal approval of debenture trustee was not received till April 27, 2020, the Noticee should nonetheless have acknowledged the valuation impact pursuant to the moratorium given to Future Group and should have reflected the market realisable value of the NCDs considering the moratorium. However, the valuation committee had not deliberated on the valuation of Future Group securities when the Noticee had internally agreed to grant deferment of payments. Further, the Noticee had also failed to communicate the request for and acceptance of deferment of payments of Future Group to the unitholders.

5.3.8.6 Upon a consideration of the preceding paragraphs, I find that the Noticee had failed to ensure compliance with Regulation 25(19), Regulation 47 read with Clauses (a), (c), (g), (h) and (i) of the Code of Conduct as specified in the Eight Schedule to the Mutual Fund Regulations in respect of the Principles of Fair Valuations, while valuing the securities subscribed by the *debt schemes inspected*. I also find that the Noticee had failed to ensure compliance with Clause 9.1.1 of the SEBI Circular dated September 24, 2019 and Clause 1 of SEBI Circular dated November 6, 2019 read with SEBI Circular dated September 13, 2012, on account of having failed to disclose change in terms of investment immediately to valuation agencies and credit rating agencies.

5.4 **PORTFOLIO RISK MANAGEMENT**.

HIGH EXPOSURE IN UNLISTED/ILLIQUID DEBT SECURITIES:

5.4.1 Based on an analysis of the entire portfolio of the *debt schemes inspected*, the SCN has alleged that the Noticee had invested in illiquid securities without proper due diligence. Further, the SCN alleges that the Noticee had made investments which were akin to giving loans to Issuers.

5.4.2 In its replies, the Noticee has inter alia submitted as under:

i. ***Allegations around portfolio illiquidity are not supported by the facts -*** The allegations around failure to manage liquidity risks for the Schemes are not supported by the facts. The following may be noted –

a. Consistent investment strategy followed historically; the Schemes did not face any liquidity issues, until the unprecedented COVID-19-induced market dislocation.

b. ***Schemes were able to generate substantial liquidity even from October 2019 onwards to meet heightened redemptions –*** *The allegation of liquidity issues during the audit period are not supported by the facts. Between October 1, 2019 and April 23, 2020, the Schemes were able to generate ₹27,000 Crore of cash (i.e., more than 50% of their AUM) from their portfolio securities in worsening market conditions in order to meet heightened redemption demands. More than ₹17,000 Crore (i.e., 63%) was from below-AAA rated securities. More than ₹6,900 Crore was realized in this period from unlisted securities even though the marketability of such securities was substantially reduced after the changes to regulations introduced on October 1, 2019. Hence, this allegation ought to be considered in light of the fact that the Schemes were able to convert more than 50% of the AUM into cash in a span of less than seven months.*

ii. ***Noticee managed the Schemes in good faith in reliance of the regulatory framework –*** *Historically, it was quite common even for marquee corporates with good credit ratings to issue unlisted debt securities on a private placement basis (e.g., Tata Sons (ICRA AAA), Tata Realty (ICRA AA), Bharti Telecom (CRISIL AA+)) and such securities were traded, similar to listed securities. An unfortunate ancillary effect of the regulations introduced on 1 October 2019 was the drying up of liquidity in the market for unlisted bonds. Significant percentage (around 30%) of the portfolios of the Schemes comprised unlisted bonds at the time. The Noticee, as well as AMFI, made representations in this regard requesting for*

certain measures to ease such liquidity pressures, such as providing for a one-time listing window for existing unlisted securities and allowing 'grandfathered' securities to be traded amongst mutual funds, etc. After the Schemes had already been wound-up, such amendments were introduced, which goes to show the legitimacy of the concerns raised by the Noticee in this regard.

iii. ***Market realities have not been considered –*** *Market realities have not been considered as the lack of depth and low liquidity in the secondary market for corporate bonds is a well-recognised industry-wide phenomenon. For instance, a research report of the RBI dated January 2019 notes that the corporate debt to GDP ratio in India stood at 17% in June 2017 relative to 123% in the US. Given that the secondary market for corporate bonds is not very large, the Noticee has, as a strategic matter, actively looked to rely more on other means of monetisation such as scheduled maturities, coupons and prepayments/buy-backs. This is a legitimate business strategy in consonance with regulations.*

iv. ***Exercise of subjective business judgment in good faith*** *– It is not alleged that any regulations relating to investments in unlisted securities, securities where the Schemes had a large percentage of the exposure or regulations with respect to credit ratings of securities have been violated. It is submitted that fund managers have flexibility to design investment strategies and take investment decisions for schemes in the exercise of their business judgment, so long as the same are in consonance with the regulatory framework, which is the case here.*

v. ***Comprehensive liquidity management systems in place –*** *As detailed in our response, comprehensive risk mitigation and liquidity management systems were in place for the Schemes, including specific policies and specialised committees and teams comprised of management personnel and subject matter experts. The board also put in place specific exposure limits, over and above regulatory requirements, so as to mitigate risks through portfolio diversification. However, even the most comprehensive systems can only provide a reasonable level of risk management and are not an insurance policy against all types of risks.*

vi. ***No regulatory violations with respect to exposure in unlisted, below AAA, substantial exposure etc.*** *– It is not alleged that any regulation with respect to exposure to unlisted securities, securities where the Schemes had a large percentage of the exposure or securities with credit ratings below AAA have been violated.*

vii. *It is not alleged that any regulation with respect to inter-scheme transfers have been breached. Even the audit report dated 5 August 2020 (on which the Notice is based) notes*

that the requirements have been met (i.e., there was commercial justification for such ISTs from the perspective of both the buying scheme as well as selling scheme and valuation requirements were also met). In any case, the contribution of ISTs within the Schemes to liquidity was not substantial (~16% between April 2019 and March 2020), i.e., it is not established that the Schemes relied significantly on such ISTs for liquidity management.

viii. ***Inter Scheme Transfers –*** *It is also relevant to point out that SEBI's regulatory framework as well as FT's policy on inter-scheme transfers of August 2018 (which applied during the time period in question), did not restrict such transactions, so long as (a) they were in consonance with the objectives of both the selling scheme and the buying scheme; and (b) regulatory guidelines with respect to valuation were complied with. It is submitted that all inter-scheme transfers were in compliance with the aforesaid requirements. Even the audit report dated August 5, 2020 (on which the Notice is based) notes that these requirements were met: "Based on review of ISTs and available information on record, it was noted that ISTs were executed as per the prices obtained from valuation agencies. Further, there are no reasons to believe that ISTs were not executed as per the objective of the transferee schemes." Inter-schemes transfers are undertaken by Schemes in the ordinary course for a number of reasons such as portfolio rebalancing, duration rearrangement, issuer/group balancing, meeting redemption requirements, etc. This is also in line with the laddering approach followed by FT with respect to its schemes, i.e., as the duration of an underlying security reduces, the longer duration schemes holding such security will ordinarily look to sell them, and shorter duration scheme will typically look to buy them, which is consistent with the respective investment objectives and features of both the schemes. Specifically, the inter-scheme transfer mechanism is used as a means of portfolio rebalancing with respect to Macaulay duration. A specific Macaulay duration is mandated for four of the Schemes under regulations. Over time, the Macaulay duration of securities reduces and hence, longer-duration funds switch such securities for longer Macaulay duration securities, in order to maintain their target weighted average Macaulay duration. At the same time, shorter duration funds typically make newer investments in low-duration securities more frequently as their instruments mature at a faster pace.*

ix. *In any event, the liquidity generated by the six Schemes through inter-scheme transfers from April 2019 to March 2020 (across all other schemes of FTMF) was only 30.55% of the total liquidity generated by the Schemes and only 16.21% (of the total liquidity) was generated through ISTs within the six Schemes (see Annexure V1-C1.3). Similarly, in FY*

2017–18, only 36.96% of the total liquidity was generated by the Schemes through inter-scheme transfers (across all other schemes of FTMF) and only 24.10% (of the total liquidity) was generated through ISTs within the six Schemes. In FY 2018–19, only 41.42% of the total liquidity was generated by the Schemes through inter-scheme transfers (across all other schemes of FTMF) and only 25% (of the total liquidity) was generated through ISTs within the six Schemes. It is also submitted that only 1.01% (of the total liquidity) was generated by the Schemes through ISTs of securities in which the Schemes held more than 70% of issuances as of 31 March 2020, as independently analysed by FTMF (see Annexure V1-C1.15). Therefore, it is incorrect to conclude that, in cases where FTMF held more than 70% of the underlying debt issuance (where, according to the Notice, liquidity concerns were more acute), FT–MF relied on inter-scheme transfers of securities to generate liquidity.

x. ***Allegation that the investments amount to loans –*** *The import of the allegation is not clear. No specific investments which amount to loans, and the basis for the same have been identified. The Schemes have always invested in bonds in line with applicable regulatory provisions. No loans have been provided. Secondary sales have materially contributed to liquidity (which would not have been possible with loans). Customised provisions (rate resets, call/put options etc.) are present in most bond issuances as well (and are not restricted to loans). As stated above, there was no restriction on the Schemes investing in a substantial portion of a bond issuance. Hence, liability ought not to be imposed on the Noticee in such circumstances. The Schemes' investments have also been likened to provision of loans on the basis that the Schemes have (a) subscribed to a high percentage (>70%) of exposure to a single issue and incorporated customised provisions; and (b) relied mainly on maturities, coupon payments and prepayments to generate liquidity. In this context, the following is submitted:*

- *No correlation has been established between the percentages of subscription to a single issuance vis-à-vis loans. On the contrary, even in cases where a single issuer subscribes to a substantial portion of an issuance, disclosure obligations and other securities law requirements applicable to bonds are nevertheless complied with (on the understanding that these bonds may be traded subsequently unlike loans). Further, while the Schemes have ordinarily relied on maturities for principal recoupments, there have been many instances previously where securities (in which one of the Schemes originally held more than 70%) have been sold on the secondary market.*

- *Similarly, there is no restriction on having customized provisions in investment agreements. In fact, provisions such as interest rate resets, call / put options and mandatory prepayments are standard provisions which are found in a variety of bond issuances. In this context, the Notice has also alleged that such provisions have not been adequately documented. It is submitted that, barring a few instances, the commercial understanding with the issuer on these aspects was clear and adequately documented.*
- *Lastly, reliance on realisations from maturities, coupon payments and prepayments does not in any way imply that FT's investment in these securities is akin to provision of loans. SEBI Regulations do not prohibit schemes from holding securities till maturity. It is submitted that the lack of depth and low liquidity in the secondary market for corporate bonds is a well-recognised industry-wide phenomenon. For instance, an RBI research report dated January 2019 notes that the corporate debt to GDP ratio in India stood at 17% in June 2017 relative to 123% in the US. Since the secondary market for corporate bonds is not large, the Noticee has actively and with the intention to be prudent looked to rely equally on other sources of liquidity such as scheduled maturities, coupons and prepayments / buy-backs. In FY 2019–20, the total amount of money recovered from portfolio securities is ₹50,062 Crore. Out of this, ₹11,455 Crore (22.88%) was realised through secondary sales. This trend with respect to realisations can also be observed over the previous FY. In FY 2018–19, the total amount recovery from portfolio securities was ₹76,618 Crore. Out of this, ₹15,622 Crore (20.39%) was realised through secondary sales. The Notice does not identify any specific investments as amounting to loans.*

ANALYSIS AND FINDINGS:

5.4.3.1 All *debt schemes inspected* had several subscriptions wherein entire or major portions of issue size of a security issued by an Issuer was subscribed by these schemes. Further, *debt schemes inspected* also subscribed to unlisted securities. The exposure of the *debt schemes inspected* in such securities was in the range of 63%–73% as on December 31, 2019 and 63%–82% as on March 31, 2020, as shown below:

TABLE XVI – EXPOSURE OF FT–AMC SCHEMES IN UNLISTED / ILLIQUID DEBT SECURITIES										
SCHEME NAME	SECURITIES WHERE FT SCHEMES HAVE SUBSCRIBED TO MORE THAN 70% OF THE ISSUE SIZE						OTHER UNLISTED		TOTAL	
	UNLISTED % TO ABOVE		LISTED % TO ABOVE		TOTAL % ABOVE TO PORTFOLIO		% TO PORTFOLIO		% TO PORTFOLIO	
	31.12.19	31.03.20	31.12.19	31.03.20	31.12.19	31.03.20	31.12.19	31.03.20	31.12.19	31.03.20
FI–CRF	29.28%	26.03%	70.72%	73.97%	60.55%	67.13%	8.95%	9.53%	69.50%	76.66%
FI–DAF	35.41%	33.53%	64.59%	66.47%	61.49%	68.12%	10.75%	9.69%	72.24%	77.81%
FI–IOF	48.44%	39.72%	51.56%	60.28%	55.26%	58.67%	8.43%	7.82%	63.69%	66.48%
FI–LDF	39.17%	36.94%	60.83%	63.06%	65.15%	76.82%	7.89%	4.77%	**73.04%**	**81.59%**
FI–STIP	38.43%	33.48%	61.57%	66.52%	59.44%	68.73%	10.91%	12.25%	70.34%	80.98%
FI–UBF	29.85%	31.41%	70.15%	68.59%	50.48%	55.58%	12.29%	7.71%	**62.76%**	**63.29%**

5.4.3.2 Further, all *inspected debt schemes* had exposure of more than 65% of net asset of the schemes to securities rated AA and below consistently for a long time (refer to Table I at page 13).

5.4.3.3 The Head–Risk Management of the Noticee, in his presentation to the Board of FT–AMC also highlighted increase in partial liquid ('AA' rated bonds) or potentially illiquid securities ('A' and below rated bonds) and its impact on one-week liquidity. From the said presentation, it is noted that *inspected debt schemes* had exposure to total illiquid securities in the range of 73% to 85% for the month of May, 2019 and in the range of 85% to 94% for the month of January, 2020. These figures presented by the Head–Risk Management highlight the illiquid nature of the portfolio of the *debt schemes inspected,* long before the Covid–19 pandemic hit the financial markets.

5.4.3.4 In its reply, the Noticee had submitted that along with AMFI, it had made representations requesting for certain measures to ease such liquidity pressures, such as providing for a one-time listing window for existing unlisted securities and allowing '*grandfathered'* securities to be

traded amongst mutual funds, etc. After the Schemes had already been wound-up, such amendments were introduced, which showed the legitimacy of the concerns raised by the Noticee.

5.4.3.5 It is relevant, at this juncture, to throw some light into the facts that necessitated the reforms introduced in October 2019. In light of credit events since September 2018 (IL&FS default, etc.) that led to challenges in the corporate bond market, a need was felt to review the regulatory framework for Mutual Funds and take necessary steps to safeguard the interest of investors and maintain the orderliness and robustness of their investments. It was observed that unlisted debt securities, particularly bespoke securities in which only a single investor invested, suffered from both forms of opaqueness: opaqueness of structure and true nature of risk on the one hand and lack of ongoing disclosure in respect of financials of the issuer on the other. In order to address these issues and improve transparency and disclosure of investments in debt securities made by mutual funds with money entrusted to them by investors, SEBI had constituted various working groups. Working groups representing AMCs, industry and academia were set up to review the risk management framework with respect to liquid schemes and to review the existing practices on valuation of money market and debt securities. Further, an internal working group was constituted to, inter-alia, review prudential norms for Mutual Funds for investment in various debt and money market instruments. The analysis along with recommendations of the working groups was placed in a meeting of Mutual Fund Advisory Committee ("**MFAC**") held in June 2019. MFAC had made several recommendations for prudential norms for Investment in Debt and Money Market instruments by Mutual Funds including investments only in listed NCDs and Commercial Papers ("**CPs**") in the interest of greater transparency and accountability. SEBI Board after deliberations in its meetings held in August 2019, and taking into account the recommendations of MFAC *inter alia* approved the following prudential norms for investment in listed debt securities:

"Mutual Fund schemes shall be mandated to invest only in listed non-convertible debentures (NCDs) and the same would be implemented in a phased manner. All fresh investments in Commercial Papers (CPs) shall be made only in listed CPs pursuant to issuance of guidelines by SEBI in this regard. However, the mutual funds to have flexibility to invest in unlisted NCDs up to a maximum of 10% of the debt portfolio of the scheme subject to such investments in unlisted NCDs having simple structures as may be specified from time to

time, being rated, secured and with monthly coupon payments. This shall be implemented in a phased manner by June 2020."

5.4.3.6 SEBI vide a Circular dated October 1, 2019, provided a timeline to comply with the investment limits for unlisted NCDs as 15% and 10% of the debt portfolio of the scheme as on March 31, 2020 and June 30, 2020 respectively (over a year from the date of recommendations by MFAC). In addition, it permitted mutual funds to grandfather the existing investments in unlisted debt instruments (as on the date of the circular) till maturity of such instruments, so as to not disrupt the market. These dates were subsequently extended to Sept 30, 2020 and December 31, 2020, respectively in view of Covid related disruptions. It is important to note that SEBI has permitted holding and trading in unlisted debt instruments but with simple structure. Debt securities which were not with simple structure were allowed to be grandfathered by mutual funds. It is important to note that these schemes of the Noticee had concentrations of high risk, unlisted, bespoke, structured debt securities with low credit ratings and where there was supposedly commercial understanding, as per AMC, which were not reflected in the term sheets. To tackle the issue of these kind of opaque deals in the market, SEBI had restricted trading of these securities and permitted holding of securities till their maturity. These schemes were having exit option from these securities by way of exercising put option and reset clauses. However, the Noticee chose to remain invested in such illiquid securities.

5.4.3.7 It is noted that during the period of October 2019 to March 2020 there were 8 instances of put options in FI–UBF scheme which the AMC had not exercised and the total market value of that securities as on the date of put option was around ₹900 Crore. Further, 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 and the amount involved is ₹4708 Crore. Similarly, in the low duration scheme, during the period of October 2019 to March 2020 there were 4 instances of put option which were not exercised and the amount involved was ₹315 Crore. These instances of non-exercise of put option was part of the forensic audit/inspection observations also.

5.4.3.8 In my view, the Noticee's decision to remain invested in such illiquid securities is a strong pointer to the (commercial) arrangement of lending money to the issuer for the pre–decided time or until the issuer repays. The resultant failure to manage liquidity exacerbated the

redemption pressures due to Covid–19. This resulted into systemic risk which constrained the Regulator to permit the dispensation of grandfathering such securities. Prudence on the part of the Noticee should have dictated capping of such investments at a much lower level given their bespoke structure and opaqueness. The changes in the regulatory framework would have had an impact on all Mutual Fund houses. As such, the changes introduced did not affect other Mutual Funds resulting in a winding up of their debt schemes. As rightly contended by the Noticee, the illiquidity of the secondary market for corporate bonds is well known and this very fact should have weighed in the minds of the Noticee to limit the investments in such securities to a bare minimum in the interests of maintaining liquidity. The Noticee has shifted the blame for all the ills of portfolio illiquidity to the regulatory changes and Covid–related market pressures only to hide his total lack of prudence in managing the liquidity risk.

5.4.3.9 While the lack of depth and low liquidity in the secondary market for corporate bonds is well known, it is all the more necessary that the Noticee ought to have exercised utmost caution and prudence in keeping the investments in these securities to an acceptable level, so as not to cause an adverse impact on the liquidity of the portfolios of the schemes. As stated earlier, these securities were bespoke, opaque and high risk corporate bonds which were plagued by illiquidity. The covenants of these securities, as admitted by the Noticee itself, were negotiated between the Issuer and the single investor. Given these features, these investments have characteristics more in common with loans than tradable bonds. As per Regulation 44(3) of the Mutual Funds Regulations, the mutual fund shall not advance any loans for any purpose save as otherwise expressly provided under the said Regulations. Prudence on the part of the mutual funds would certainly demand that schemes are not stuffed with such investments, which are more in the nature of fair–weather friends. The Noticee cannot cover up for its imprudent investment decisions by passing the buck onto the regulator’s corrective action or a reform.

5.4.3.10 Further, the Noticee’s submission that it had a differentiated investment strategy for the Schemes with a view to deliver superior risk–adjusted returns for investors, which was in consonance with the regulatory framework at all times, is not true. It is noted that the investment strategy for the schemes may be distinguishable when compared to the investment strategy of peer group or other AMCs but internally all the schemes had similar investment strategies, which brought these schemes to the precipice in the face of mounting redemption pressures.

<u>INTER SCHEME TRANSFERS (“IST”)</u>:

5.4.4 From the SCN, it is noted that ISTs were being used for managing liquidity and details of the same are reproduced below:

TABLE XVII		
SR. NO.	**FINANCIAL YEAR**	**% OF TOTAL LIQUIDITY THROUGH IST**
1.	2017–18	36.96
2.	2018–19	41.42
3.	2019–20	30.55

5.4.4.1 It is noted that during 2019–20, the liquidity generated by the six schemes through various means is ₹50,062 Crore of which the liquidity generated through IST is approx. ₹15,295 Crore (30.55% – highest liquidity generated through IST, of the other means). Further, 46.57% of the liquidity generated is through the maturities, interest payments and pre-payments which were to be received as per the scheduled dates. It can be seen that for meeting liquidity requirement for redemptions, the Noticee has largely relied on IST and then market sale, which constituted 22.88% of the total liquidity generated.

5.4.4.2 Similarly, it is noted that during 2018–19, the liquidity generated by all the *debt schemes inspected* through various means is ₹76,618 Crore of which the liquidity generated through IST is approx. ₹31,739 Crore (41.42% which is the highest means of liquidity). Further, 31.19% of the liquidity generated is through the maturities, pre-payments/early redemptions/buy back which were to be received as per the scheduled dates and market sale which is 20.39% of the total liquidity generated. It is again quite clear that for meeting liquidity requirement for redemptions, the Noticee has largely relied on IST.

5.4.4.3 The Noticee has contended that it would be incorrect to conclude that the Noticee had relied on ISTs to generate liquidity since the liquidity generated by the *debt schemes inspected* through ISTs from April 2019 to March 2020 (across all other schemes of FT–MF) was only 30.55% of the total liquidity generated by the schemes. In this context, it may be noted that the purpose of ISTs is to save cost if two schemes under the same mutual fund wish to buy and sell the same underlying securities given that such securities are matching with the objective of schemes. However, this would not mean that a scheme with cash surplus can buy any security for assisting the selling scheme to manage its liquidity issues. Therefore, the practice of using ISTs for managing liquidity is against the principle of fair treatment to all unit holders. I find that by using

ISTs to cope with illiquidity arising out of problems in the underlying portfolio of schemes, the Noticee had failed to use ISTs in a fair manner.

5.4.4.4 It is noted that the *debt schemes inspected* are open ended schemes where unit holders enter or exit at any point of time. These schemes had huge investments in securities wherein major portions of issue size of a security was subscribed by the Noticee's schemes. Since these securities were AA or below–rated, they did not have a liquid secondary market. It is more than obvious that these factors had exacerbated the liquidity pressures in the *debt schemes inspected.*

RISK MANAGEMENT:

5.4.5 **INDEPENDENCE OF RISK MANAGEMENT FUNCTION:**

5.4.5.1 The SCN has alleged that by removing monitoring of certain risk like portfolio risk from the Business Risk Management Committee ("**BRMC**"), the FT-AMC board has acted against the requirement of the Mutual Funds Regulations. Further, the SCN has alleged that the Noticee's Board had diluted the role of BRMC where the CEO could question and satisfy himself about the risk management activities and fulfil the responsibility assigned to him. It is also noted that the responsibility assigned to the CEO could not be discharged by him due to the failure of the Noticee in complying with the Mutual Funds Regulations.

5.4.5.2 In its replies, the Noticee has inter alia submitted as under:

i. ***No specific mode of oversight prescribed -*** *There is no regulation, which is breached by virtue of the activity of monitoring of certain risks like portfolio risks being moved out from the ambit of the BRMC, so long as the risks are being adequately monitored through other means/mechanisms. As stated above, the regulations do not prescribe the specific mode of exercise of oversight by the CEO and there is no requirement that the investment risk management function be overseen necessarily through the BRMC.*

ii. ***No allegation that CEO or board exercised inadequate oversight -*** *It is not alleged that the oversight subsequently exercised by the CEO (outside the ambit of the BRMC) as well as the board over the investment risk management function was inadequate. It has been*

assumed that the fact of such monitoring being moved out from the purview of the BRMC is itself a regulatory breach, which is incorrect.

iii. ***No dilution or undermining of the risk management function has been alleged*** *- Only 'dilution' of the BRMC has been alleged. Since there is no regulatory mandate that the investment risk management function be monitored necessarily through the BRMC, there is no question of any violation on account of 'dilution' of the BRMC's functions in this regard.*

iv. ***CEO can exercise oversight to the same extent outside the BRMC -*** *The conclusion by stating that the BRMC was where "the CEO could question and satisfy himself about the risk management activities and fulfil the responsibility assigned to him" is erroneous insofar as it assumes that the BRMC was the only means through which the CEO could so satisfy himself and fulfil its responsibilities.*

FINDINGS:

5.4.5.3 The requirement under the Mutual Funds Regulations is for risk management function to be *'independent'* and *'separate from fund management'.* I note that there have been structural changes in reporting by which the overall balance between risk management functions and investment management functions seems to have shifted decisively in favour of the latter. However, upon a holistic consideration of the Noticee's submissions, I am inclined to accept that the internal changes in reporting does not point towards a breach of the Mutual Funds Regulations. It is observed that the CEO could still take charge of risk management activities without necessarily depending on BRMC.

5.4.6 Risk management presentations (July 2019 to March 2020):

5.4.6.1 As regards Risk Management Presentations by Head-Risk Management of FT-AMC, the SCN states:

A. The Head Risk Management of the Noticee made presentations to the Board of FT–AMC and Trustees on the Risk Management for equity and fixed Income schemes from time to time. The following risks were highlighted to the Board of FT–AMC during the Board meetings held on July 15, 2019, October 25, 2019, December 3, 2019 and March 6, 2020**:**

1. Concentration of securities

a. Head Risk Management in the FT–AMC Board meetings held on December 3, 2019 and March 6, 2020 presented a list of Issuers where Fixed Income schemes of FT–AMC held significant share of the Industry. Details regarding the percentage of investment were also presented to the Board**.**

b. The following risk was informed to the Boards of FT–AMC by Head-Risk Management in the aforesaid meetings:

- "*Issuers where FT holds the entire issuance/ significant share of the issuance across the industry indicates elevated concentration and liquidity risks."*
- Further, with respect to 100% of Industry holdings, Head-Risk Management presented the list of Issuers stating "*Issuers where risk recommends cautions are highlighted."*

c. No specific comments of FT–AMC board on this matter are recorded in the minutes of the meeting dated 3rd December 2019.

d. In the meeting dated March 6, 2020, the FT–AMC Board noted the following:

- *"In some instances fixed income schemes of Franklin Templeton appeared to be holding the entire issuance of certain debentures. However, this may not reflect the total borrowing of that Issuer. The Board advised that the comparison by Franklin Templeton vis–a–vis total debt of the Issuer be presented…*
- *While reviewing the total exposure to Issuers across Debt and Equity, the Board noted that there was no significant overlap. Board asked Management to continue to monitor consolidated exposure to an Issuer / group across Debt and Equity"*

e. Although the scheme names have not been mentioned in the said presentation slide, the list of securities in the slide were forming part of the *debt schemes inspected*.

f. On perusal of minutes of above mentioned meetings, it is noted that the Board of Directors of FT–AMC did not give any direction or guidance in relation to addressing concentration risks as informed by the Head - Risk Management. Rather, FT–AMC board deferred the matter of concentration risks despite the

matter being highlighted again in meeting dated March 6, 2020, after being presented in the Board meeting dated December 3, 2019.

2. Issuers under Close monitoring, Issuers displaying Early warning signals, stressed sector

    a. Head-Risk Management in the FT–AMC Board meetings held on July 15, 2019, October 25, 2019, December 3, 2019 and March 6, 2020, repeatedly presented concerns w.r.t. stressed sectors/Issuers being shortlisted in early warning signal (EWS).

    b. The concerns raised repeatedly in the aforesaid presentation inter-alia pertained to issues such as default of certain securities, NBFC/HFC Crisis and Downgrades of the securities held by schemes of FT–AMC.

    c. The Issuers which were highlighted inter-alia included Essel/Zee, ADAG, Edelweiss Group.

    d. Regarding the early warning signals observed in some securities, it is noted that, Santosh Kamath (CIO Fixed Income) clarified to the Board during the meeting dated 3rd December 2019 that investment management team have adequate investment rationale for having exposure to such securities. Kamath also advised the Board that the team is continuously monitoring the investee companies and appropriate actions are being taken on an ongoing basis.

    e. It is noted from the minutes of the Board meeting that the Board of Directors of FT–AMC did not give any direction or guidance in relation to the action on EWS, Corporate governance issues in Issuer Companies and high exposure to NBFC/ HFC, etc. even though the same were regularly brought to their notice.

3. Downgrade of securities

    a. The Head–Risk Management in the FT–AMC Board meetings held on July 15, 2019, October 25, 2019, December 3, 2019 and March 6, 2020 presented total number of Upgrade and Downgrades of securities and relevant concerns to the Board.

    b. The Head–Risk Management presented in the aforesaid meetings that "Upgrade downgrade *ratio is a concern and is worsening post the recent credit events."* From the said presentations, it is noted that number of downgrades were increasing, despite which, no action was taken by FT–AMC.

c. Details of the downgrade/upgrade during the periods are as given below:

TABLE XVIII		
PERIOD	**DOWNGRADE**	**UPGRADE**
MARCH 2019– MAY 2019	10	4
JUNE 2019–AUGUST 2019	16	2
JULY 2019–SEPTEMBER 2019	22	2
OCTOBER 2019–JANUARY 2020	21	4

d. It is noted from the minutes of the Board meetings dated October 25, 2019 that on upgrades and downgrades, management had apprised the Board that the investments in high yield securities were only by the funds which follow a strategy of investing in high yield securities. However, it is noted that no specific details, information etc., was sought by the Board or guidance given to address the downgrade risk flagged by the Head-Risk Management.

4. Liquidity issues

a. The Head-Risk Management in the FT–AMC Board meetings held on July 15, 2019, October 25, 2019 and December 3, 2019 presented liquidity related issues in debt schemes.

b. In the said presentation, Bonds rated 'A' and below were classified as "potentially Illiquid" and for these bonds it was stated that, "Liquidity might be difficult to achieve in certain fund flow environments/ market conditions."

c. From the above mentioned presentations, the following is observed:

- *For the month of May 2019, the inspected debt schemes had potentially illiquid securities as a percentage of scheme AUM ranging from 35% to 51%.*
- *For the month of August 2019, the inspected debt schemes had potentially illiquid securities as a percentage of scheme AUM ranging from 35% to 53%.*
- *For the month of September 2019, the inspected debt schemes had potentially illiquid securities* as a percentage of scheme AUM ranging from 32% to 49%.

d. It is noted from the minutes of the Board meetings that no specific comments and/or corrective steps were recommended by FT–AMC Board to address the above liquidity issues raised by Head–Risk Management.

B. As accepted by FT–AMC, its strategy was to invest in high yield papers (investing in AA and A rated papers). These high yield papers have higher inherent credit and liquidity risk. It is noted that the Board of FT–AMC had not taken any corrective steps to address the issues pertaining to concentration, downgrades, early warning signal and illiquidity.

5.4.6.2 In its replies, the Noticee has inter alia submitted as under:

a. ***The role of the board of directors under regulations and the applicable standard of diligence have not been considered*** *– It is submitted that the allegations ought to be tested against the applicable standard of due diligence, which is reasonable care and precaution. Such standard has been met in the facts of the case:*

- *The board of directors of the Noticee had implemented a robust and independent risk management framework. The board relies on specialized committees and functions as well as internal audits, statutory audits, SEBI inspections etc. for monitoring compliance with the regulatory and internal policy framework.*
- *The board was also proactive in putting in place certain guard-rails, over and above the regulatory requirements. For instance, concentration limits with respect to investments to single issuers / groups etc. which were stricter than regulatory limits, committed credit lines to mitigate unforeseen liquidity risks etc.*
- *However, in terms of the regulations, while the board is expected to provide guidance and direction, it is not expected or required to take individual investment decisions.*

b. ***No objective standard under regulations on how to respond to a specific risk; this involves subjective business judgment, which was exercised in good faith in a holistic and independent manner*** *- It is submitted that the specific manner of response to each risk involves considerable exercise of business judgment and there is no objective standard prescribed for the same under regulations. The board in this case exercised its business judgment in good faith:*

- *The board obtained inputs and updates from various teams and reporting and audit mechanisms, including the President, the CIO-Fixed Income, the fund management team and the risk management team, as well as by third party auditors.*
- *The board deliberated on and assessed these various and diverse inputs through the exercise of their independent judgment in a holistic manner and provided*

guidance to the relevant teams in a considered manner, where the same was necessary.

- *The record demonstrates that the Head-Risk Management had direct access to the boards of the AMC and the Trustee. The Head-Risk Management presented reports at every board meeting. The boards considered the Head-Risk Management's views at every board meeting and duly deliberated upon the items presented by him. The boards sought the investment team's views on these matters as well.*
- *Besides presentations made by the investment risk management function, separate presentations were also made by the fund management team, which also dealt with the same set of stressed issuers at length and detailed various mitigation measures / steps taken towards improving credit profile and recovery with respect to such issuers, which were also considered by the board.*
- *In fact, the two sets of presentations only go to show that risks were being regularly monitored and tracked in a comprehensive and holistic manner, in terms of the framework set up by the board.*
- *The board did not directly participate in individual investment decisions with respect to specific issuers. However, as part of such presentations made by the Head-Risk Management and the CIO-Fixed Income, the board was regularly apprised of developments with respect to issuers under close monitoring, issuers displaying early warning signals (EWS) / stressed sectors, upgrades and downgrades, significant exposures of the fixed income portfolio and updates on 'focus group exposure' etc. Hence, the board considered all the data and material presented to them, including the risk mitigants and steps for recovery etc. being taken. Based on these inputs, the board provided strategic direction and guidance to the management.*
- *The board at times made additional data requests or asked for the data to be presented in a different form to allow for more effective / informed analysis and review or asked the risk management team and fund management team to continue monitoring issues actively. It would be incorrect to characterize the board seeking such further information as the board having 'deferred' the matter.*
- *Therefore, individual slides from risk management presentations would not present the complete picture.*
- *In any case, it is submitted that, in each instance, the board apprised itself of the risk and provided adequate guidance in its best judgment. So long as there is a*

considered action in this manner (which may include simply monitoring the risk on an ongoing basis), it is submitted that it would not be fair for such response to be called into question on grounds that an alternative action may seem more appropriate in hindsight.

c. ***Specific risks highlighted -***

- *The presentations discussing concentration risks and liquidity issues did not convey critical or immediate concerns around the liquidity of the Schemes. In fact, each such presentation from the investment risk management function included a specific slide providing a liquidity/coverage ratio analysis of FTMF's debt funds (including the Schemes), which depicted the liquidity position to be comfortable. As the severe impact of COVID-19 came to the knowledge of the board, it took prompt and proactive steps to address the situation.*
- *Certain exposures were downgraded to below investment grade or were showing 'early warning signs' (EWS), which is an inherent risk attached to debt investments. Both the fund management team and risk management team were regularly tracking the concerns as well as the mitigation measures being taken and the same were also reported to and deliberated upon by the boards. Various mitigation measures / steps taken towards improving credit profile and recovery, with respect to the relevant issuers were presented to and deliberated upon by the board. In other words, such issues were duly considered by the board (as part of a holistic oversight process).*

ANALYSIS AND FINDING:

5.4.7 The Noticee has contended that in terms of the regulations, while the board is expected to provide guidance and direction, it is not expected or required to take individual investment decisions. In this context, it is noted that the allegation/observation in the SCN is that the Board is expected to provide guidance and direction but the same was not done even when the risk of concentration of securities was again and again highlighted.

5.4.8 As regards the contention that changes between the two versions of the presentation were limited to the form and the manner of presentation of certain information and there were no substantive changes, it is reiterated that the presentation incorporated certain concerns of Head-Risk

Management with regard to Issuers like Yes Bank, DHFL and Vodafone and it can be seen in the hindsight that unfortunately these are the Issuers which have either defaulted on their payments or delayed their payments due to the financial stress.

5.4.9 The Noticee has further contended that the record demonstrates that the Head–Risk Management had direct access to the Board of the AMC and the Trustee. The Head–Risk Management presented reports at every board meeting. The boards considered the Head–Risk Management's views at every board meeting and duly deliberated upon the items presented by him. The Board sought the investment team's views on these matters as well. In this context, it is noted that of the said presentations which are presented to the board by Head–Risk Management, one instance was observed wherein the presentation was changed and certain concerns raised by the risk management team were deleted, as required by the fund manager and its team. This instance indicates that there is no independence in reporting to the board. Further, contrary to the claim made by the Noticee that the board provided strategic direction and guidance to the management, it is observed that the same is however, not reflected in the minutes of the said meeting. As accepted by the Noticee, its strategy was to invest in high yield papers (investing in AA and A rated papers). These high yield papers have higher inherent credit and liquidity risk. These risks, which were inherent due to the investment strategy of AMC, were frequently highlighted to the Noticee's Board but the Board had not taken any corrective steps to address the issues pertaining to concentration, downgrades, early warning signal and illiquidity.

5.4.10 The Noticee's response that the Board cannot be expected or required to take individual investment decision is not acceptable. The repeated flagging of concentration and illiquidity risk of the scheme portfolio dominated by lower rated securities by the Risk Management Team have been clearly muzzled by the fund management's argument of adopting a high yield strategy. In my view, the Board should have been guided by the overarching principles of prudence and safety rather than being led by the obsession of alpha generation of the fund management team as it should be constantly weighed against the responsibility of managing public funds.

5.4.11 Upon a consideration of the preceding paragraphs 5.4.3.1–5.4.4, 5.4.7–5.4.10, I find that the Noticee had not taken any concrete steps or provided guidance in managing various risks viz. concentration, downgrades, early warning signal and liquidity issues of the securities in the portfolio even though it was reported repeatedly to its Board, in violation of the provisions of Regulations 25(1), 25(2), 25(16), 44(3) and Clauses (6), (8) and (9) of the Code of Conduct as

specified in Fifth Schedule of the Mutual Fund Regulations and the SEBI Circular dated September 30, 2002 on risk management system.

5.5 INVESTMENT RELATED DUE DILIGENCE

5.5.1 Deficient Investment Policy:

5.5.1.1 The SCN has alleged that the Noticee did not cover detailed objective criteria in IPN (Investment Process Note). Further, it is observed that the Noticee had not prescribed any periodicity regarding review of IPN, maximum subscription in particular security issued by Issuer, list of prohibited transactions and haircut based on nature of collateral etc. in the IPN.

5.5.1.2 In its replies, the Noticee has inter alia submitted as under:

i. ***Deficient Investment Policy:*** *SEBI's circular dated 27 July 2000 states that the board of the AMC 'can' prescribe the 'broad parameters for investments'. In other words, firstly, this is only an enabling provision and in any event, without prejudice to the foregoing, what is contemplated to be prescribed is 'broad parameters for investments'. It is acknowledged at the very beginning of para 8.5.1 of the Notice that "It is noted that the FT-AMC Board has prescribed broad parameters in the form of Investment Policy / Investment Process Note (IPN)".*

ii. *Basis for regulatory violation is not clear since regulations do not provide any specific format or mandate inclusion of any specific criteria in IPN.*

iii. *It is reiterated that regulations do not provide the form or manner in which such 'broad parameters' are to be specified. The concept of a specific investment process note is not even specifically recognised under regulations. There is also no requirement that the investment policy must all be housed in one document, i.e., in this case, the IPN, which is only one out of a comprehensive range of policies and processes put in place by the Noticee for investment decision-making, including a Credit Appraisal Policy, specific Investment Limits approved by the board, Valuation Policy, Charter for the Investment Committee (Debt) and Charter for the Credit Appraisal Committee. It is not clear to the Noticee as to why reference has been made only to the IPN.*

iv. *No basis has been provided for why the identified parameters ('periodicity of review of IPN', 'maximum subscription in particular security issued by issuer', 'list of prohibited*

transactions', or 'haircut based on nature of collaterals') have been chosen as needing to be incorporated in the IPN, since as stated above, there is no such requirement under regulations.

v. *Even KPMG's review of the Noticee's risk management framework in May 2019 did not identify any substantive deficiencies in the IPN.*

vi. *Even apart from the IPN, the Noticee has a number of policies and processes for risk management, such as:*
   - *Quantitative investment limits, i.e., caps on issuer-wise, group-wise, sector-wise exposure which are often stricter than the corresponding SEBI limits and are revised from time to time;*
   - *Credit Appraisal Policy & Procedures provides the main areas to be considered for taking a credit view of an issuer - Business Risk Analysis; Financial Due Diligence; Management and Promoter Due Diligence; and Transaction Structure Analysis;*
   - *Policies on specific aspects, such as Fixed Income Allocation of Investment Opportunities Policy; Inter-scheme Process Note; Policy on Creation of Segregated Portfolios, Guidelines for participation of mutual funds in repo in corporate debt securities, etc.*

vii. *IPN is regularly reviewed and updated. Such updates are approved by the boards of the Noticee and the Trustee (last three updates are dated 27 July 2018, 25 October 2019 and 6 March 2020.*

viii. *Since there is no requirement under the SEBI regulations / circulars to specifically identify prohibited transactions, the IPN does not specifically list the same.*

ix. *Decision-making on haircuts based on collateral is highly specific to individual facts and circumstances and, therefore, it is not possible to prescribe rules on this in the IPN.*

FINDINGS:

5.5.1.3 In its reply, the Noticee has submitted that SEBI's Circular dated July 27, 2000 states that the Board of the AMC '*can*' prescribe the '*broad parameters for investments'*. In other words, this is only an enabling provision and in any event, without prejudice to the foregoing, what is contemplated to be prescribed is '*broad parameters for investments'*. In this context, it is noted that the Circular reads as "*With a purpose to implement the regulation in an effective manner and to bring about transparency in investment decisions, the AMCs are hereby advised to maintain records in support of each investment decision which will indicate the data, facts and*

opinion leading to that decision. While the AMC boards can prescribe broad parameters for investments, it is important that the basis for taking individual scrip wise investment decision in equity and debt securities should be recorded." I find that the Noticee did not cover detailed objective criteria in the IPN and further, had failed to prescribe any periodicity regarding review of IPN, maximum subscription in particular security issued by Issuer, list of prohibited transactions and haircut based on nature of collateral, etc. in the IPN.

5.5.2 FAILURE IN DUE DILIGENCE AND MONITORING WITH RESPECT TO CREDIT NOTES.

5.5.2.1 The SCN has alleged that:

a. The basis for scrip-wise investment decisions were not documented in certain credit notes and in the Quantis software.
b. The Noticee's Board had not prescribed any specific content of the research report/credit note.
c. In majority of the securities, the end–use certificate, as contemplated under the transaction documents, was not collected by the Noticee.
d. The Noticee's IPN emphasises the importance of both macro and micro factors and states that micro factors include market positioning, sentiment and spread analysis. However, the credit notes do not provide any comments or reference to such micro factors. Hence, at the time of investment, micro factors were not examined in the credit notes. The Noticee had not complied with its own IPN which requires some parameters to be examined for selection of a security.
e. The Noticee had failed to produce any documents to show that credit analysis parameters of investments were monitored on an ongoing basis.
f. The Noticee had failed to produce any document projecting that all the financial due diligence was done at the time on investment and ongoing basis.
g. The Noticee had failed to produce adequate document projecting that due diligence with regard to management and promoter quality of Issuer was done at the time on investment and on an ongoing basis.

5.5.2.2 In its replies, the Noticee has *inter alia* submitted as under:

i. ***Failure in due diligence and monitoring with respect to credit notes:*** *FTMF undertakes a credit evaluation and due diligence, as specified in its IPN and credit appraisal policy and in consonance with regulatory requirements, in all cases. However, there is no regulatory stipulation as to the specific contents of individual credit notes. The Credit Appraisal Policy & Procedures lays down the factors to be considered for credit evaluation of potential investment opportunities. Credit notes contain sufficient detail as to the considerations informing each investment decision. However, each such decision necessarily involves different considerations and the relative importance of such considerations may also vary significantly from case-to-case. Therefore, credit notes for different issuers show differences, since due diligence for each investment is customized, having regard to the facts and circumstances relevant to each investment. All investments have been monitored on an ongoing basis and decisions with respect to such investments (such as response to early warning signals, downgrades, prepayments and credit events) have been taken in an informed manner and discussed with, and recorded in minutes of, the investment committee.*

ii. *Credit notes are prepared by the credit team pursuant to FTMF's Credit Appraisal Policy. Under this policy, each credit note pertains to a potential issuer and serves as the basis for evaluating all investments in that issuer within a one-year period. Credit notes contain details as to the considerations informing each investment decision (such as financial snapshot; background of the issuer/group/ guarantor/put option provider; business verticals; portfolio profile and asset quality; leverage and liquidity profile; profitability; key weaknesses/ monitorables etc.). Credit notes generally focus on the diligence on the issuer or relevant associate companies, where the investment is back-stopped by such associate companies.*

iii. *In addition to credit notes, the Noticee has maintained a record of the rationale/basis for individual scrip-wise investment decisions on its dealing software (Quantis) for the past 15 years. In the 'remarks column' of each entry in the Quantis software, various buy and sell rationales (such as 'attractive short-term yield', 'excellent credit', 'highly liquid paper', 'reducing portfolio maturity', etc.) have been recorded by the fund management team.*

iv. *Even the forensic auditor in its response dated October 9, 2020 agreed that "the credit notes given at times contains data and facts about the issuer and reasons are mentioned in Quantis application".*

v. *No concerns regarding the format of recording or the sufficiency of the investment rationale were raised as part of past audits including the SEBI-mandated KPMG audit in May 2019.*

vi. *Illustrative documents reviewed for specific investments are enclosed. These include research reports; credit approval notes (and credit update notes); information memorandums; downgrade notes; credit rating reports; financial results; auditors reports; earnings conference calls; email updates on cash flows, liquidity position; emails evidencing tracking of share cover and share price movements; corporate action updates (such as merger/ stake sale etc.); valuation reports; correspondence tracking the relevant collateral; covenant compliance certificates; documents evidencing interest payments; FT presentations (fixed income presentation, FT portfolio reviews, risk management presentations/reports etc.); FT weekly market update; email news updates from Factiva; emails evidencing discussion on put/call options, interest rate reset, etc.; email updates on meetings with the issuers; investor presentations and updates from the issuers, etc.*

vii. *Additionally, it is submitted that the fund management team regularly (A) engages with portfolio companies of the Schemes to track company performance, plans etc., tracks management commentary, etc. (sample at Annexure V2-D7 of the Response); (B) attends thematic conferences to keep up to date with the evolving industry dynamics; (C) reviews the Statement of Investments and liquidity reports available on the dealing software (Quantis); and (D) undertake credit analysis and due diligence with the help of specialised platforms (such as Factiva and ACE Equity, which also generate updates on issuers etc. Illustrative samples of Factiva updates are included.*

viii. *The Investment Committee, at its monthly meetings, is also apprised on and deliberates upon domestic and global market conditions, macro-economic data, portfolio liquidity, and credit updates. Credit notes are tabled before the Investment Committee and are discussed at length; and only after analysing all such factors the list of approved issuers is recorded by the Investment Committee.*

ANALYSIS AND FINDINGS:

5.5.2.3 As noted from the SCN, credit notes of certain Issuers wherein the subscription of FT–AMC schemes was more than 70% of the total issue size were examined wherein the following was observed:

A. **Basis of scrip-wise investment decisions not documented in credit notes:** The data, facts and opinion leading to the decision along with basis for investing in individual scrips were not recorded in the credit notes.

B. **Inconsistency in credit note format and absence of key parameters:** The Noticee had not prescribed any specific format of content of the research report/credit note.

C. **Monitoring end-use of investments:** In a majority of the securities, end–use certificates were not collected by the Noticee from the Issuer contrary to the clauses contained in the Information Memorandum.

D. **Security selection process–micro factors not analysed in credit notes:** Under the head of Security selection process of IPN of the Noticee, it is mentioned that *"Analysis of macro factors determines the duration of the portfolios whereas analysis of micro factors aids the security selection process. Micro factors include market positioning, sentiment and spread analysis. The Fund lays particular emphasis on identification of mispriced/cheap securities and endeavours to take advantage of additional spread available on those securities to generate alpha. By Corollary, securities analysed as being rich are sold."* However, from the credit notes, it is noted that no comments or reference with respect to such micro factors was observed.

E. **Detailed credit analysis not adequately documented:** The IPN of the Noticee states that credit research is done on a regular basis for corporates having investment grade rating. The credit research includes internal analysis of financial reports as well as rating rationale and other inputs for external agencies. Further, in the credit analysis paragraph of IPN, various parameters for ongoing analysis of credit risk are laid down. The Noticee had failed to produce any document evidencing proper credit analysis and an ongoing monitoring of credit risk.

F. **Financial due diligence not adequately documented:** The IPN of the Noticee under the head Financial Due Diligence requires financial statements, historical trend of financial metrics, sources of future earnings growth, financials' projections, debt maturity, diversification of debt, etc. These are some of the key inputs for arriving at the Issuer's financial strength. Further, qualitative factors like flexibility of the Issuer to raise equity and / or alternative financing in times of stress using bank lines are required to be examined. However, the Noticee had failed to produce any document evidencing the exercise of financial due diligence neither prior to or thereafter.

G. **Management and promoter quality of Issuer not analysed in credit notes:** The Noticee had highlighted the importance of management and promoter quality in the IPN stating that in addition to Issuer's ability to pay, Issuer's willingness to pay is a key parameter taken into consideration to arrive at its credit profile. Management and Promoter quality is a robust indicator of Issuer's willingness to pay. The Noticee had recorded in IPN that proper assessment of Issuer's credit quality requires evaluation of its management and promoter philosophies and strategies around business growth and financial discipline. Track record of management in debt repayments, understanding of the business, management insights regarding forecast and implementation of future plans are some of the key issues to be taken into consideration while evaluating the management and promoter quality of an Issuer. The Noticee had however, failed to produce adequate document projecting that due diligence with regard to management and promoter quality of Issuer was done at the time on investment and ongoing basis.

5.5.2.4 In its replies, the Noticee has submitted that all investments have been monitored on an ongoing basis and decisions with respect to such investments (such as response to early warning signals, downgrades, prepayments and credit events) have been taken in an informed manner and discussed with, and recorded in minutes of the Investment Committee. It is noted that the SEBI Circular dated July 27, 2000, requires AMCs to maintain records in support of each investment decision, which will indicate the data, facts, and opinion leading to that decision along with the basis for taking individual scrip-wise investment decision in equity and debt securities. However, it is observed from the credit notes that the data, facts and opinion leading to the decision along with basis for investing in individual scrip were not recorded. I therefore, find that the Noticee had not exercised due diligence and care while investing in securities as

specified above. It is noted that the Noticee had not followed/produced any document projecting that the IPN requirements are complied with.

5.5.3 **<u>Lack of Due Diligence and Monitoring of issuances of certain Issuers to which the *debt schemes inspected* subscribed:</u>**

5.5.3.1 The SCN had alleged that:

i. The Noticee had undertaken due diligence only of the Parent Company/ Group (and not the Issuer) for:

a. *Edelweiss Rural and Corporate Services Limited ("**ERCSL**");*

b. *Reliance Broadcast Network Limited ("**Reliance**");*

c. *Piramal Realty Private Limited ("**Piramal Realty**").*

ii. **OPJ Trading Private Limited**: The Noticee had failed to carry out ongoing credit research and financial diligence such as review of financial statements, credit rating analysis, etc. Particularly, no comments had been documented on losses incurred by the Issuer of ₹23.62 Crore in FY 2017–18 and ₹6.3 Crore in FY 2018–19.

iii. **Future Group:** The Noticee had neither documented nor monitored on an ongoing basis information related to cash-flows of *Issuer* – companies of Future Group. The Noticee also failed to document important parameters i.e. amount of lease payments, escalation clause, expiry terms, legal opinion on Master Lease Agreement, other terms and conditions, exception clause in the Credit Note.

iv. **Renew Group**:

a. Credit notes do not mention industry analysis, peer-group comparisons and financial projections; and focused only on parent company collateral from Renew Power Limited;

b. RPL's credit note does not refer to audit qualifications of March 2017 and March 2018, and

c. End–use certificates mention investment as *'Loan'* and are of lesser amount than the actual investment.

v. **Northern Arc Capital Limited:** The Noticee had not produced any documents evidencing financial diligence, promoter diligence, analysis of business risks or transaction structure analysis.

vi. **Reliance Big Private Limited ("Reliance Big") and Reliance Infrastructure Consulting & Engineers Private Limited ("RICE") ("Reliance ADAG"):**

a. The Noticee failed to seek mandatory prepayment and invoke collateral in February 2019 or in April 2019.

b. The Noticee had not produced any documents indicating that the decision to not invoke pledge was deliberated by the investment team and further, the Noticee had failed to exercise due diligence in taking such decision.

c. The Noticee should have disclosed such decision to unitholders.

vii. **Essel Infraprojects:** The Noticee failed to exercise due diligence in deciding not to participate in second round of stake sale offered by the promoter group in November 2019, even though certain other lenders participated. Further, the Noticee's decision to not invoke the pledge on account of a fall in share coverage ratio (in January 2019) should have been disclosed to unitholders.

ANALYSIS AND FINDINGS:

5.5.3.2 The Noticee's replies to the investment by *debt schemes inspected* along with findings in respect of the same are given in a tabular format as under:

TABLE XIX		
ISSUER	***NOTICEE'S RESPONSE***	**AUDITOR'S ANALYSIS**
EDELWEISS RURAL AND CORPORATE SERVICES LIMITED, RELIANCE BROADCAST NETWORK	*Collateral comprised group-level undertakings and promoter guarantees. In case of Reliance, the relevant Scheme also had a put option against the promoter. In any case, due diligence did extend to the Issuer in these cases. The exposures with respect to Edelweiss Rural and Piramal Realty have been repaid / serviced regularly (refer to detailed response).*	1. The Noticee's submission that due diligence of the Edelweiss Group instead of Issuer is in line with Credit Appraisal policy is not acceptable due to following reasons: *a.* An AMC is supposed to receive money from the Issuer in the form of coupon payment/Principal payment, etc. Therefore, due diligence of financials of the

LIMITED AND PIRAMAL REALTY PRIVATE LIMITED	*In case of ERCSL, each of the bonds issued were supported by a letter of comfort issued by EFSL, placing an obligation on EFSL to "ensure that the Issuer will be in a position to meet its debt service obligations to you (FTMF) from time to time in accordance with the terms of the Debentures". There is also an obligation on EFSL to "ensure that the Issuer do fulfil the said debt service obligation to you (FTMF) in respect of the debentures by using our best efforts, good office and take such pragmatic measures as may be required". Debt covenants with respect to these issuances applied at a group level, and not just at the ERCSL level. In addition to the credit analysis of the Edelweiss Group described above, the following suite of documents were analysed as well: financial results of ERCSL as well as of ESFL; credit ratings reports of Edelweiss Group companies (including ERSCL); information memoranda on ERCSL; research reports on EFSL and minutes of the meeting of the Credit Appraisal Committee wherein the Edelweiss Group's credit quality was discussed.* *In case of Reliance, the Noticee derived primary comfort from the unconditional put option which the relevant Scheme could enforce against the promoter company (RCL). This approach was also in line with the independent approach followed by credit agencies with respect to the bonds issued by Reliance. For instance, RCL was an AAA rated company at the time of the investment. Based on the unconditional put option to be fulfilled by RCL, the NCDs of Reliance were rated AAA (so) by the credit rating agency.*	Issuer for ascertaining payment capacity is a must. *b.* Additionally, analysis of Group to check back up from the Group in case of default by issuer in payment of coupon/ principal at the time of maturity is also necessary. *c.* Further, the Noticee's Credit Appraisal Policy & Procedure states: *"In cases where the issuer's creditworthiness is based on another strong operating entity of the same promoter group, investment decision will also take into consideration business risk analysis of the operating entity. In cases where creditworthiness of an issuer is derived basis the strength of guarantor/ security provider / other entity from the same group, financial analysis on the concerned entity is also taken into consideration while arriving at an investment decision."* From the aforementioned, it is noted that the requirement of due diligence extended to both the Issuer as well as the Group. However, contrary to its own policy, the Noticee had conducted due diligence only at the Group level. 2. Contrary to the Noticee's assertion, it is noted that no evidence of due diligence procedure of the Issuer Company as per the Noticee's internal policy had been documented in the credit update note.

	Piramal Realty was backed by an unconditional and irrevocable guarantee issued by Shri Krishna Trust (SKT), a Piramal family group trust which held close to 50% stake in the flagship, listed company of the group - Piramal Enterprises Limited (PEL). SKT, therefore, had a robust balance sheet which could be accessed in case the guarantee needed to be invoked. Transaction terms also stipulate a cap on borrowings by SKT to protect against erosion of its creditworthiness and ensure adequate refinancing ability.	**Findings:** In all the three cases, it is found that the due diligence exercise in respect of the Issuer Companies was not adequately carried out. While the overall Group's financial strength is relevant to be considered, the Noticee ought to have also exercised due diligence in respect of each of the Issuer entity with equal emphasis.
OPJ TRADING PRIVATE LIMITED	*Sufficient due diligence undertaken (e.g., review of financials and tracking share price movements). Collateral cover also enhanced as part of investment monitoring. In any case, group level pledge meant that the Scheme(s) were ring-fenced from financial stress at issuer, if any. This exposure has, in any case, been prepaid in full. Therefore, while the Noticee regularly tracked the financial position and performance of OPJ as well as its group entities, there was no need for specifically recording the loss incurred by OPJ in FY 2017–18 and 2018–19.*	The Noticee had failed to produce any documents for substantiating that ongoing due diligence was carried out during October 2017 to September 2019 or that it had complied with its investment policy. Further, no comments were documented / recorded by the Noticee regarding losses incurred by the Issuer during FY 2017–18 and 2018–19. **Findings:** The Noticee's explanation does not address its failure to produce and substantiate due diligence and take note of the losses sustained by OPJ in the two consecutive FYs.
FUTURE GROUP	*It is submitted that this charge is factually incorrect as the cash flows of the Issuer entities were analysed and monitored by the Noticee on an ongoing basis. Due diligence was undertaken on Master Lease Agreement (which comprised the principal cash flow of the issuer) and, accordingly, repayment terms were in fact aligned with cash-flows under the master lease. In addition, each of the DTDs with respect to FTMF's investments in Rivaaz, NuFuture Digital India Limited and Future Ideas Company Limited includes*	The Noticee's contention that the Issuers' (Rivaaz Trade Ventures Private Limited, NuFuture Digital India Limited and Future Ideas Company Limited) payment obligations under the terms of the securities were aligned with the projected cash flows from the relevant Master Lease Agreement ("**MLA**") cannot be accepted. As per the Forensic Auditor's observations in the Audit Report, no document stating the projected cash flows were derived from the MLA, were

	a negative covenant on the issuer company that it shall not, without the consent of the debenture trustee (acting on the instructions of the majority debenture holders), make any changes, amendments or modifications to the relevant Master Agreement or exercise any of its rights under the relevant Master Agreement. Further, the credit approval note dated 27 March 2018 with respect to proposed additional exposure in Rivaaz Trade Ventures contains details of the source of cash flows for servicing repayments, including the master lease.	made available. Further, there was no documentation available on important parameters i.e. Amount of lease payments, escalation clause, expiry terms, legal opinion on Master Lease Agreement, other terms and conditions, exception clause in the Credit Note. **Findings:** As the Noticee had failed to document projected cash flows/ important terms of lease etc. in Credit Notes of the above mentioned Issuers, I am of the view that this is another failure to exercise due diligence while investing in these securities as pointed out.
RENEW GROUP	*Each of these aspects were taken into account during due diligence and recorded in credit notes for the parent company. For the two subsidiary issuers, these aspects were documented in various research reports and reports from rating agencies. In any case, the subsidiary exposures were secured by collateral from the parent company (in the form of corporate guarantee / put option). All exposures have, in any case, been repaid / serviced regularly.*	It is observed that the Credit Notes of three Issuers (Renew Power Ltd., Renew Solar Power Private Ltd. and Renew Wind Energy Delhi Pvt. Ltd.) did not contain any mention of Industry analysis, peer comparison, outlook of solar energy domestic and globally, financial projection, future earning, Management and Promoter Quality, qualifications in the Standalone Financials, etc. Further, from the Chartered Accountant's ("**CA**") Certificate regarding '*End Use Certificate'* shared by the Noticee, it is noted that the certificate had mentioned the investment as "*Loan*" and the Certificate was of lesser amount only of ₹32.10 Crore than actual investments of ₹1418 Crore. The Noticee had failed to submit any documentation projecting that the above mentioned parameters were examined in credit notes.

		Findings: It is obvious that the Noticee had only focused on credit comfort from Renew Power Limited, the parent company of Renew Solar Power Private Limited and Renew Wind Energy Delhi Private Limited. There was neither adequate pre – investment due diligence of the Issuer or adequate post – issue monitoring of the investment. It also appears that the Noticee had failed to take note of the discrepancy in the 'End Use Certificate' as well as the description of the investment as 'loan'. These are glaring instances of lapses in exercise of due diligence. Accordingly, the submissions of the Noticee cannot be accepted.
NORTHERN ARC CAPITAL LIMITED	*It is submitted that the allegation is factually incorrect. Credit notes do record financial diligence (such as liquidity profile, ability to raise financing, etc.) and promoter diligence. Financial status of Issuer was monitored regularly. In any case, the Issuer has serviced all payment obligations regularly.* *Additionally, the investment team also took into account the management quality of the issuer company, as indicated by the following observation in the credit note: "The company has augmented its senior management team in the recent past, post the exit of some senior management personnel in Q1 FY 2018, by recruiting experienced personnel for key functions including risk management, IT and business development. Going forward, NACL's ability to retain talent would be critical in view of its robust growth plans."*	The credit notes or update note of the Issuer did not comment on Industry analysis, peer comparison, financial projection, future earning, Management and Promoter Quality, Flexibility of the Issuer to raise finance from alternative sources etc. The Noticee failed to provide any documentation evidencing that analysis of Business Risk, Financial Due Diligence, Management and Promoter Due Diligence were done. **Findings:** While the Noticee has submitted that the credit note does outline the details of the marquee investors in the Issuer, its ability to raise financing from various sources of borrowings and its portfolio and liquidity profile along with observations on its overall asset quality, no such comments on the aforementioned parameters were observed by the Forensic Auditor in Credit Notes or Update

		Notes. I find that the Noticee is making bald assertions without any supporting documents. Rather, only a very minor part of review of management quality seems to have been recorded.
RELIANCE ADAG	*There is no breach of any regulation. The decision of whether or not to enforce on a pledge is an investment decision involving the exercise of subjective business judgment (including an assessment of often competing considerations) by the portfolio management team. So long as the decision was taken by reference to relevant considerations and in the best interests of unitholders, it ought not to be questioned in hindsight. The decision not to invoke collateral was a considered business decision taken in the best interests of unitholders, since invocation would have resulted in under-recovery. No obligation under regulation to disclose such decision (all relevant material events with respect to the issuers/securities that were needed to be disclosed such as valuation revisions, defaults and recoveries, were disclosed).* *A deed dated May 22, 2019 was signed by the Reliance ADAG undertaking to use part of the promoter owned assets to monetize certain assets and reduce the Noticee's exposure. The Noticee took active recovery efforts (in tracking collateral cover, engaging with the issuers' management, securing prepayments, invoking share pledge, etc.). As an outcome of the meetings with the Issuers' management, the Noticee was able to secure additional collateral, prepayments and prepayment*	The Noticee failed to seek mandatory prepayment in terms of the agreement for securities even after ADA Group had failed on their commitments. Neither the existing terms of investments were complied with nor were the discussions and decisions taken by senior management reflected in the formal agreement between the Issuer and the Noticee. The Noticee has decided not to invoke pledged shares and had not produced any document projecting that the decisions was deliberated and recorded by investment team. The decision of not invoking the pledge despite fall in share coverage ratio has substantial bearing on the investment and hence, should have been disclosed to the investors. Accordingly, the Noticee failed to disclose the decisions taken based on commitments by Issuer, which were not even documented as a formal agreement. This is certainly not in line with the terms of investment between the Noticee and Issuer entered into for the protection of unit holders. The Noticee had failed to exercise due diligence & care in the aforesaid investment decisions and failed to protect the interest of investors. **Findings:** Combined with Essel Infraprojects hereunder.

	undertakings. The Noticee subsequently did invoke the share pledge as well, when the issuer defaulted. *It is submitted that SEBI regulations do not provide a list of events that are required to be disclosed to unitholders. In the present facts, no disclosure was made in February or April 2019 since there was no payment default by the issuer. Instead, there was only a reduction in the security cover. In fact, the Noticee did disclose relevant events with respect to the exposure of the Schemes to the Reliance ADA Group including on fair valuation, defaults and recovery of defaulted exposures.*	
ESSEL INFRAPROJECTS	*There is no breach of any regulation. The decision of whether or not to enforce a pledge is an investment decision involving the exercise of subjective business judgment (including an assessment of often competing considerations) by the portfolio management team. So long as the decision was taken by reference to relevant considerations and in the best interests of unitholders, it ought not to be questioned in hindsight.* *Decision to not participate in the stake sale was a considered business decision taken in the best interests of unitholders, since it would have resulted in under-recovery. No obligation under regulation to disclose such decision (all relevant material events with respect to the issuer/securities that were needed to be disclosed, such as valuation revisions, defaults and recoveries, were disclosed).*	The Noticee had failed to disclose that the decision to not invoke the pledge was taken based on arrangements with the Issuer. For recovery of the investment in debt securities of the said Issuer, the Noticee took into account the personal guarantee given by the promoter and ignored any probable value erosion due to price drop of ZEEL considering that the huge stake sale carried out may reduce the Noticee's recovery. Further, post stake sale by the promoter of Essel group, the promoters had only 5% stake left in ZEEL (flagship company about which the Noticee was optimistic), which will further reduce the debt recovery prospects for FT–MF. In view of the above, the Noticee's submission in this regard is not acceptable. In a situation where other lenders were participating in the stake sale of flagship project by the Issuer (Promoter of ZEEL), it would have been prudent on behalf of the Noticee to take part and partially reduce its exposure. Therefore, I find that the

		Noticee has failed to exercise due diligence and care in its investment decision. **Findings:** It appears that the Noticee has had some external arrangements (standstill) with the Issuers based on which it was decided not to invoke the pledge. However, changes in the financial position of the Issuer and the reason for not invoking the pledge despite such changes, are material issues relating to the schemes which needs to be documented and presented to the investors. I find that the explanation of the Noticee in this respect, is not acceptable.

5.5.3.3 Upon a consideration of paragraphs 5.5.3.1–5.5.3.2, I find that the Noticee had failed to exercise due diligence and had not ensured that critical investment parameters were analysed for individual Issuers (and not only at group level), all investment parameters mentioned in IPN are analysed in detail, adequate documentations are maintained/obtained, terms of investments (covenant) are enforced, all material information about terms of investments having a bearing on the investments are timely disseminated to unit holders. I find that the aforementioned lapses in due diligence constitute violation of the provisions of Regulations 25(1), 25(2), 25(3), 25(6A), 25(6B), 25(16), Clauses (2), (6), (8) and (9) of the Code of Conduct as specified in Fifth Schedule of the Mutual Fund Regulations and the SEBI Circular dated July 27, 2000.

5.5.4 INCONSISTENCY IN EXERCISING BUYBACK OPTION LEADING TO PREFERENTIAL TREATMENT GIVEN TO UNIT HOLDERS OF ONE SCHEME OVER THE OTHER.

5.5.4.1 The SCN had alleged that with respect to buybacks offered by three Issuers between March 20, 2020 and March 31, 2020, the Noticee did not allocate the buy-backs proportionately to the Schemes, thereby failing to ensure fair treatment to unitholders of different Schemes and failing to manage the six Schemes independently. The SCN had further alleged that the Noticee had therefore, failed to ensure appropriate policy to have pro–rata allotment of partial buy–back to all schemes.

5.5.4.2 In its replies, the Noticee contended that: *"… the prevailing regulations did not impose restrictions on the manner of apportioning buy-back offers between different schemes holding the same security. Further, this is also made clear by the fact that such regulation (i.e., that buybacks should ordinarily be allocated pro-rata amongst schemes) was only recently introduced by way of a Circular dated September 17, 2020. Moreover, even the new regulation permits disproportionate allocations of buybacks with certain internal approvals. In other words, even under the new regulations, SEBI has recognized that it may not be appropriate in all cases to apportion buy-backs proportionately. In any event, consistent with the scheme of the Mutual Funds Regulations, decisions with respect to participation in buyback offers were taken independently for each Scheme, considering the liquidity position, investment strategy and other factors applicable to such Scheme. The Noticee does have a Fixed Income Allocation of Investment Opportunities Policy, which deals with allocation of primary and secondary trades to various schemes (which would include buybacks). Such policy, in recognition of the above factors (i.e., that there can be no 'one-size-fits-all' approach for allocating investment opportunities to the Schemes) does not mandate a pro rata allocation of trades in all circumstances. This approach was fully consistent with the prevailing regulations."*

FINDINGS:

5.5.4.3 Generally each scheme at any point of time would have differing investment objectives and liquidity requirements. Further, the decision on whether or not to participate in a buy–back is an investment decision taken on the basis of an analysis of various considerations. I note that the Noticee had a *Fixed Income Allocation of Investment Opportunities Policy,* which did not mandate a pro–rata allotment of buy–back to all schemes. I note that the allegation of preferential treatment of unitholders of certain schemes over the other schemes has not been made out with specificities. In the circumstances, I am not inclined to give any adverse finding in this respect.

5.6 PROCESSING OF REDEMPTION OF AN ENTITY DEBARRED BY SEBI – FAILURE TO IMPLEMENT SEBI DIRECTIONS VIDE ORDER NO. WTM/GM/CFD/35/2019–20 DATED SEPTEMBER 17, 2019.

5.6.1 The SCN has alleged that the Noticee had allowed a SEBI debarred entity to redeem units of mutual fund.

5.6.2 In its replies, the Noticee has inter alia submitted that it has proper systems and procedure in place to prevent SEBI debarred entities from transacting in mutual fund units. However, with respect to the transaction by B. Hariharan, there was an anomalous oversight in this particular case due to a manual error and the redemption was processed erroneously.

FINDINGS:

5.6.3.1 Vide an Order no. WTM/GM/CFD/35/2019–20 dated September 17, 2019, SEBI had restrained B. Hariharan from accessing the securities market and further prohibited him from buying, selling or otherwise dealing in securities in any manner whatsoever, either directly or indirectly, till further orders.

5.6.3.2 In this regard, it is noted that B. Hariharan was permitted redemptions by the Noticee, details of which are as given below:

TABLE XX – REDEMPTIONS BY B. HARIHARAN

INVESTOR NAME	NO. OF TRANSACTIONS	AGGREGATE UNITS	AGGREGATE AMOUNT (₹IN LAKH)
B. HARIHARAN	1	1,722,715.00	476.24

5.6.3.3 It is noted that the Noticee has admitted that there was an oversight in this particular case and the redemption was processed erroneously. In this regard, it is noted that SEBI vide letter no. SEBI/HO/IMD/DOF4/OW/P/2018/19378/1 dated July 9, 2018, to AMFI had advised its members to ensure proper systems are in place to prevent SEBI debarred entities from transacting in Mutual Fund units. AMFI had further communicated the same to the Noticee vide an e–mail dated July 20, 2018.

5.6.4 In view of the above, I find that the Noticee had failed to ensure compliance with the SEBI Order dated September 17, 2019 and SEBI letter dated July 9, 2018, to AMFI. This is a serious violation and no explanation of oversight can be accepted. All the efforts in enforcement of SEBI Rules,

Regulations and other requirements got marginalised by the Noticee's conduct. This is besides the fact that an entity who was held liable for violations of securities market norms has been enabled to benefit out of such an oversight. I find the Noticee to have grossly violated the directions of SEBI and has had scant regard for the Orders of the Regulator.

CONCLUSION:

5.7 From the preceding paragraphs, it clearly emerges that the Noticee has committed serious lapses/violations with regard to

a. Scheme categorization (by replicating high–risk strategy across several schemes);
b. Calculation of *Macaulay duration* (to push long term papers into short duration schemes);
c. Non–exercise of exit options in the face of emerging liquidity crisis;
d. Securities valuation practices and
e. Risk management practices and investment related due diligence.

5.8 The serious lapses and violations appear to be a fall out of the Noticee's obsession to run high yield strategies without due regard from the concomitant risk dimensions. The Noticee ought to have realised that the past track record in respect of high–risk strategies is no guarantee against future mishaps. For a fund house which has been in this industry in India for over two and a half decades, it is surprising that its systems to monitor and manage critical risks like liquidity, credit and concentration are less than robust. The effectiveness of these systems stand compromised in the process of the Noticee's single minded pursuit of reaping high yield. The Noticee brings out the reasons of '*business judgment*' to defend questionable decisions; however, it is seen that these decisions which involve deployment of public funds are barely documented. Similarly, the terms of investment covenants were apparently not in the interest of investors and the deficiencies in the agreements were sought to be corrected through a '*commercial understanding*'. While it is easy to shift the blame for such mishaps onto black swan events, regulatory changes, etc. the Noticee needs to seriously introspect and put in place robust risk control and due diligence mechanisms, given that the rest of the industry has been able to cope with the events and survive through the crisis period of the Covid 19 pandemic, without reaching the point of winding up.

6.2 DIRECTIONS PROPOSED TO BE ISSUED UNDER SECTIONS 11(1), 11(4), 11B(1) AND SECTIONS 11(4A) AND 11B(2) OF THE SEBI ACT:

6.2.1 The proceedings against the Noticee has been initiated under Sections 11(1), 11(4) and 11B(1) of the SEBI Act proposing certain directions as stated in the SCN.

6.2.2 In addition, the SCN has also been issued invoking powers under Sections 11(4A) and 11B(2) of the SEBI Act for imposition of monetary penalty under Sections 15A(b), 15D(b), 15D(f), 15E and 15HB of the SEBI Act. Sections 15A(b), 15D(b), 15D(f), 15E and 15HB of the SEBI Act provide as under:

*"**Penalty for failure to furnish information, return, etc.***

15A. If any person, who is required under this Act or any rules or regulations made thereunder,—

(b) to file any return or furnish any information, books or other documents within the time specified therefor in the regulations, fails to file return or furnish the same within the time specified therefor in the regulations or who furnishes or files false, incorrect or incomplete information, return, report, books or other documents, he shall be liable to a penalty which shall not be less than one lakh rupees but which may extend to one lakh rupees for each day during which such failure continues subject to a maximum of one Crore rupees.

Penalty for certain defaults in case of mutual funds.

15D. If any person, who is—

(b) registered with the Board as a collective investment scheme, including mutual funds, for sponsoring or carrying on any investment scheme, fails to comply with the terms and conditions of certificate of registration, he shall be liable to a penalty which shall not be less than one lakh rupees but which may extend to one lakh rupees for each day during which such failure continues subject to a maximum of one Crore rupees.

…

(f) registered as a collective investment scheme, including mutual funds, fails to invest money collected by such collective investment schemes in the manner or within the period specified in the regulations, he shall be liable to a penalty which shall not be less than one lakh rupees but which may extend to one lakh rupees for each day during which such failure continues subject to a maximum of one Crore rupees.

Penalty for failure to observe rules and regulations by an asset management company.

15E. Where any asset management company of a mutual fund registered under this Act, fails to comply with any of the regulations providing for restrictions on the activities of the asset management companies, such asset management company shall be liable to a penalty which shall not be less than one lakh rupees but which may extend to one lakh rupees for each day during which such failure continues subject to a maximum of one Crore rupees.

Penalty for contravention where no separate penalty has been provided.

15HB. Whoever fails to comply with any provision of this Act, the rules or the regulations made or directions issued by the Board thereunder for which no separate penalty has been provided, shall be liable to a penalty which shall not be less than one lakh rupees but which may extend to one Crore rupees."

RESPONSE TO THE DIRECTIONS PROPOSED IN THE SCN:

6.2.3 The Noticee has stated:

i. *It is evident from the facts of the present situation that there is no emergent danger that necessitates any immediate preventive action in the current circumstances, and therefore the facts do not justify invocation of these specific provisions of the SEBI Act. Moreover, it is submitted that Sections 11(1), 11(4) or 11B of the SEBI Act do not cover within their ambit, the power to direct an asset management company to refund investment management and advisory fees charged for lawful services rendered.*

ii. *An order directing the asset management company to refund investment management and advisory fees presupposes that the asset management company has either not rendered such services at all or that such fees represent illegal gains made at the cost of investors. It is settled law that disgorgement can be ordered only when the gain that is made arises out of an activity which is illegal or unlawful. Under Section 11B of the SEBI Act, SEBI has the power to order disgorgement of an amount equivalent to the wrongful gains made or losses averted by engaging in any transaction or activity in breach of the SEBI Act or regulations. For such provision to apply, such 'transaction' or 'activity' must be in contravention of the provisions of the SEBI Act or regulations thereunder. In other words, the transaction or activity must be non-est or void, for the powers to disgorge under the aforementioned provision to be invoked. Such a principle cannot be said to be applicable*

to the facts of the present case, where the Noticee has undertaken all its activities as a duly licensed professional entity and has earned investment management and advisory fees in accordance with applicable law. It is submitted that the Notice does not demonstrate any "wrongful gains made" or "losses averted" by the Noticee or any form of unjust enrichment, which is a prerequisite to an order of disgorgement.

iii. *The Notice also incorrectly conflates 'fees levied' with 'wrongful gains' made by the Noticee and fails to consider that there is no quid pro quo between the investment and advisory fees and the deficiencies alleged in the Notice.*

iv. *Any such direction of refund of investment management and advisory fee or suspension of launch of new scheme would also be highly disproportionate and against the well-settled common law Wednesbury principle and principle of proportionality, which have been recognized by the Hon'ble Supreme Court not just in administrative law cases but also in cases involving penal action by government or regulatory authorities.*

v. *The Notice also calls upon the Noticee to show cause as to why monetary penalty should not be imposed pursuant to Sections 11(4A) and 11B(2) read with Sections 15A(b), 15D(b), 15D(f), 15E and 15HB of the SEBI Act. At the outset, it is submitted that since no contravention has been made out, there is no basis for imposition of any penalty. However, without prejudice to any of the submissions above, it is submitted that it is a well-settled principle that the penalty provisions are not to be mechanically applied. A penalty need not be imposed in every case even if a default were to be established and the enforcement authority may assess the relevant circumstances in order to determine whether imposition of penalty is justified in a particular case. The Hon'ble Securities Appellate Tribunal in the matter of* ***PG Electroplast Limited and Others vs. SEBI (SAT order dated August 2, 2019)*** *held as follows, while setting aside the order of the adjudicating officer imposing penalty: "If it is found that a party has not acted deliberately, then the authority has a discretion, to be exercised judicially, whether in a given case, after taking into consideration of all the relevant circumstances, as to whether a penalty should be imposed or not. Even if a minimum penalty is prescribed, the authority, after considering the circumstances of the case and other factors enumerated in Section 15J would be justified in refusing to impose penalty when there is a technical or venial breach of the provisions of the Act." In view of the above principles and given the conduct of the Noticee, it is submitted that this is a fit case for exercise of discretion by the Hon'ble Whole-Time Member in favour of the Noticee.*

FINDINGS:

6.2.4 I have considered the submissions made by the Noticee. As seen from the paragraph titled 'Conclusion', the Noticee has been found seriously wanting in so far as its conduct as an AMC is concerned. There are findings of breaches of the Mutual Funds Regulations as also the SEBI Circulars, brought out above, under various heads. Income derived out of wrongful conduct, which ultimately resulted in loss and caused hardship to the investors, in my view, is liable to be disgorged, as proposed in the SCN. For the impropriety committed while functioning as an AMC, imposition of penalty is also justified, as proposed.

6.2.5.1 I note that the SCN has proposed refund of the investment management and advisory fees to the *debt schemes inspected* from the effective date of the SEBI Categorization Circulars in respect of the said schemes. The investment management and advisory fees charged to the *debt schemes inspected* during the period from April 1, 2018 to April 23, 2020 (excluding GST), was as under:

TABLE XXI – INVESTMENT MANAGEMENT AND ADVISORY FEES FROM APRIL 1, 2018 TO APRIL 23, 2020

SR. NO.	SCHEME	INVESTMENT MANAGEMENT AND ADVISORY FEES (AMOUNT IN ₹)		
		2018–19^^	2019–20^^	2020–21++ [UPTO 23.04.2020]
1.	FRANKLIN INDIA ULTRA SHORT BOND FUND	33,17,13,000	52,89,50,000	2,01,69,000
2.	FRANKLIN INDIA LOW DURATION FUND	18,46,83,000	20,46,56,000	60,17,000
3.	FRANKLIN INDIA SHORT TERM INCOME FUND/PLAN	74,50,95,000	70,83,03,000	2,64,41,000
4.	FRANKLIN INDIA INCOME OPPORTUNITIES FUND	28,08,32,000	24,86,53,000	96,61,000
5.	FRANKLIN INDIA DYNAMIC ACCRUAL FUND	27,41,47,000	24,67,72,000	1,05,08,000
6.	FRANKLIN INDIA CREDIT RISK FUND	60,41,72,000	48,95,63,000	2,04,24,000
TOTAL		**242,06,42,000**	**242,68,97,000**	**9,32,20,000**

^^ANNUAL REPORTS FOR FINANCIAL YEAR 2019–20.
++ UNAUDITED HALF-YEARLY FINANCIAL RESULTS FOR THE PERIOD ENDED SEPTEMBER 30, 2020.

6.2.5.2 The investment management and advisory fees for the period from June 4, 2018 [date when the Noticee effected categorization as per the Categorization Circulars] till April 23, 2020 [date when the Trustees had informed the concerned unitholder(s) of their decision to wind up the *debt schemes inspected* of FT–MF] amounts to ₹**451,63,17,660,** which amount has been calculated as under:

TABLE XXII – INVESTMENT MANAGEMENT AND ADVISORY FEES FROM JUNE 4, 2018 TO APRIL 23, 2020					
SR. NO.	**SCHEME**	**INVESTMENT MANAGEMENT AND ADVISORY FEES (AMOUNT IN ₹)**			
		2018–19 [4.06.18–31.03.19]	**2019–20**	**2020–21 [1.04.20–23.04.20]**	**TOTAL [A + B + C] = D**
		A	**B**	**C**	
1.	FRANKLIN INDIA ULTRA SHORT BOND FUND	27,35,49,624	52,89,50,000	2,01,69,000	**82,26,68,624**
2.	FRANKLIN INDIA LOW DURATION FUND	15,23,00,227	20,46,56,000	60,17,000	**36,29,73,227**
3.	FRANKLIN INDIA SHORT TERM INCOME FUND	61,44,48,205	70,83,03,000	2,64,41,000	**134,91,92,205**
4.	FRANKLIN INDIA INCOME OPPORTUNITIES FUND	23,15,90,224	24,86,53,000	96,61,000	**48,99,04,224**
5.	FRANKLIN INDIA DYNAMIC ACCRUAL FUND	22,60,77,389	24,67,72,000	1,05,08,000	**48,33,57,389**
6.	FRANKLIN INDIA CREDIT RISK FUND	49,82,34,991	48,95,63,000	2,04,24,000	**100,82,21,991**
TOTAL					**451,63,17,660**

6.2.5.3 As the Noticee had failed to follow the Categorization Circulars w.e.f. June 4, 2018, I find it appropriate to disgorge the investment management and advisory fee from such date and direct the same to be refunded to the *debt schemes inspected* which have suffered losses due to such mismanagement. Further, I also find it reasonable and necessary to levy an interest on the disgorgement amount at the rate of 12% simple interest per annum from April 24, 2020 till the date of this Order, which has been computed as under:

TABLE XXIII – INTEREST COMPUTATION ON INVESTMENT MANAGEMENT AND ADVISORY FEES FROM JUNE 4, 2018 TO APRIL 23, 2020				
SR. NO.	**SCHEME**	**INVESTMENT MANAGEMENT AND ADVISORY FEES (AMOUNT IN ₹)**		
		FY 2018–21 [4.06.18–23.04.20]	**INTEREST 12% PER ANNUM***	**TOTAL [C + D]**
		D	**E**	**F**
1.	FRANKLIN INDIA ULTRA SHORT BOND FUND	82,26,68,624	11,08,91,223	93,35,59,847
2.	FRANKLIN INDIA LOW DURATION FUND	36,29,73,227	4,89,26,802	41,19,00,029
3.	FRANKLIN INDIA SHORT TERM INCOME FUND	134,91,92,205	18,18,63,716	153,10,55,921
4.	FRANKLIN INDIA INCOME OPPORTUNITIES FUND	48,99,04,224	6,60,36,405	55,59,40,629
5.	FRANKLIN INDIA DYNAMIC ACCRUAL FUND	48,33,57,389	6,51,53,928	54,85,11,317
6.	FRANKLIN INDIA CREDIT RISK FUND	100,82,21,991	13,59,02,800	114,41,24,791
TOTAL		**451,63,17,660**	**60,87,74,874**	**512,50,92,534**
Interest calculated on unlawful gains made during the period April 24, 2020 till June 7, 2021.				

6.2.5.4 Considering the violations made out in the preceding paragraphs, I am of the considered view that the amount disgorged by way of this Order shall be utilised to make restitution/repayment of the unitholders of the six *debt schemes inspected* in terms of Section 11B(1) read with sub–regulation (3) of Regulation 5 of the SEBI (Investor Protection and Education Fund) Regulations, 2009 ("**IPEF Regulations**")

6.2.5.5 Accordingly, in terms of Sections 11(1), 11(4) and 11B(1) of the SEBI Act read with Regulation 5(3) of the IPEF Regulations, I am of the view that the Noticee be directed to credit the amount charged from the six *debt schemes inspected* along with simple interest at the rate of 12% per annum, as computed at paragraph 6.2.5.3 (**Column F**), back to the respective *schemes,* within a period of 21 (twenty one) days from the date of this Order, for utilization towards repayment of the concerned unitholders. Further, in the event of failure to comply with the aforementioned direction, the Noticee shall pay simple interest at the rate of 12% per annum, which shall commence from the date the amount becomes payable.

6.2.6.1 I note that the SCN has proposed imposition of monetary penalty under Sections 15A(b), 15D(b), 15D(f), 15E and 15HB of SEBI Act. I note that while imposing penalty under the aforementioned provisions, the factors enumerated in Section 15J of the SEBI Act are to be taken into consideration. Section 15J of the SEBI Act states:

*"**Factors to be taken into account while adjudging quantum of penalty.***

***15J.** While adjudging quantum of penalty under 15-I or section 11 or section 11B, the Board or the adjudicating officer shall have due regard to the following factors, namely:*

(a) the amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default;

(b) the amount of loss caused to an investor or group of investors as a result of the default;

(c) the repetitive nature of the default.

Explanation. —

For the removal of doubts, it is clarified that the power to adjudge the quantum of penalty under Sections 15A to 15E, clauses (b) and (c) of section 15F, 15G, 15H and 15HA shall be and shall always be deemed to have been exercised under the provisions of this section."

6.2.6.2 As detailed in the preceding paragraphs, the Noticee has been found to have violated the provisions of the Mutual Funds Regulations and also the SEBI Circulars mentioned at

paragraph 2.3 of this Order. As a result of the irregularities in the running of the *debt schemes inspected,* loss has been caused to the investors. The Noticee was under a statutory obligation to abide by the provisions of the Mutual Regulations and Circulars issued thereunder, which it failed to do. Accordingly, the same has been kept in mind while issuing the following direction.

6.2.6.3 Each of the provisions contained in Sections 15A(b), 15D(b), 15D(f), 15E and 15HB of the SEBI Act mandate a maximum penalty of ₹1 Crore. Accordingly, I am of the view that a monetary penalty of **₹5 (Five) Crore** be imposed under Section 15I of the SEBI Act read with Rule 5 of the SEBI Inquiry Rules, on the Noticee for the violations made out in the preceding paragraphs.

6.2.7.1 The above mentioned directions, in my view, are reasonable and are commensurate with the breach of laws/Regulations/Circulars committed by the Noticee.

6.2.7.2 In addition, the findings in the instant proceedings have brought on record several irregularities in the running of the *debt schemes inspected,* contrary to the interests of the unitholders in such *schemes.* As brought out above, the irregularities also extend to failures to exercise adequate due diligence, carry out valuation of securities as per the *Principles of Fair Valuations* and ensuring a robust risk management framework. In my view, the employees of FT–AMC may be liable for the aforementioned irregularities arising during the course of business of the Noticee. From the records made available before me, I note that SEBI has initiated adjudication proceedings against certain employees of FT–AMC including the Chief Executive Officer, Chief Compliance Officer and the Directors.

ORDER:

7.1 In view of the foregoing, I, in exercise of the powers conferred upon me under Section 19 read with Sections 11(1), 11(4), 11B(1) read with Regulation 5(3) of the IPEF Regulations and Sections 11(4A), 11B(2) read with Section 15I of the SEBI Act and Rule 5 of the SEBI Inquiry Rules, hereby direct as under:

7.1.1 The Noticee i.e. FT–AMC, shall be prohibited from launching any new debt scheme(s) for **two years** from the date of this Order. Further, in respect of the category of the six *debt schemes inspected* under winding up, the prohibition on launching of new debt scheme(s) shall come

into effect from the date on which the said *schemes* cease to exist as per Regulation 42 of the Mutual Funds Regulations.

7.1.2 The Noticee shall refund the investment management and advisory fees collected from June 4, 2018 till April 23, 2020 with respect to the six *debt schemes inspected* along with simple interest at the rate of 12% per annum, as computed at paragraph 6.2.5.3 (**Column F**), to the respective *schemes,* within a period of 21 (twenty one) days from the date of this Order, for utilization towards repayment of the concerned unitholders. In the event of failure to comply with the aforementioned direction, the Noticee shall pay simple interest @ 12% per annum, which shall commence from the date the amount becomes payable.

7.1.3.1 The Noticee shall be liable to pay a monetary penalty of **₹5 (Five) Crore,** within a period of forty–five (45) days, from the date of this Order, by way of demand draft in favour of *"SEBI–Penalties remittable to Government of India"*, payable at Mumbai, or by online payment through following path on the SEBI website: www.sebi.gov.in/ENFORCEMENT → Orders → Orders of Chairman / Members → Click on PAY NOW or at the link https://siportal.sebi.gov.in/intermediary/AOPaymentGateway.html. In case of any difficulties in payment of penalties, the Noticee may contact the support at portalhelp@sebi.gov.in. The Noticee shall forward details of the demand draft or online payment made (in the format as given in the table below) to the "*The Division Chief, IMD–II/DoF4, Securities and Exchange Board of India, SEBI Bhavan, Plot no. C-4A, 'G' Block, Bandra Kurla Complex, Bandra (E), Mumbai–400051*".

7.1.3.2 The Noticee shall provide the following details while forwarding the demand draft/payment information:

Case Name:	
Name of Payee:	
Date of Payment:	
Amount Paid:	
Transaction No.:	
Bank Details in which payment is made:	
Payment is made for:	*Penalty*

7.1.4 This Order shall come into force with immediate effect.

7.1.5 A copy of this Order shall be served on the Noticee and SBI Funds Management Pvt. Ltd.

7.1.6 A copy of this Order shall also be served on recognized Stock Exchanges, Depositories, Registrar and Transfer Agent(s) and Banks for necessary action.

Place: Mumbai
Date: June 7, 2021

G. MAHALINGAM
WHOLE TIME MEMBER
SECURITIES AND EXCHANGE BOARD OF INDIA