To,

Shri. S.V. Murlidhar Rao

Executive Director

Securities and Exchange Board of India

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Subject: Concerns related to the SEBI circular on asset allocation of multi-cap funds and request for introduction of a scheme category titled 'Flexi-cap fund'

Ref:

1. SEBI Circular dated September 11, 2020 on asset allocation of multi-cap funds ("Circular")

2. SEBI's Clarification dated September 13, 2020, issued pursuant to the Circular ("Clarification")

Dear Sir,

On September 11, 2020, SEBI issued a Circular modifying the scheme characteristics of multi-cap funds, mandating the said schemes to invest a minimum of 75% of the total assets under management **("AUM")** in equity and equity related instruments, with a minimum investment of 25% of the AUM each in equity and equity related instruments of large-cap companies, mid-cap companies, and small-cap companies. As per the Circular, all existing multi-cap funds are required to comply with the provisions of the Circular within one month of the publication of next list of stocks by Association of Mutual Funds in India **("AMFI")**, i.e by January 2021.

This is a departure from the provisions applicable for multi-cap funds, as provided in the guidelines regarding categorization and rationalization of mutual fund schemes, issued by way of a circular dated October 06, 2017 ("**2017 Circular**"). In the 2017 Circular, the multi-cap funds had the flexibility in terms of asset allocation to equity and equity related instruments of large-cap companies, mid-cap companies, and small-cap companies, subject to the requirement that at least 65% of the AUM would be invested in equity and equity related instruments.

Pursuant to this Circular, SEBI issued the Clarification on September 13, 2020, wherein it is stated that the 2017 Circular sought to achieve the objectives of ensuring that the schemes are 'true to label' and are compared with an appropriate benchmark. Since it was observed that the portfolios of multi-cap schemes are skewed in favour of large-cap companies, with near zero or insignificant asset allocation to small-cap companies, SEBI issued the Circular. SEBI clarified that in order to comply with the provisions of the Circular, the multi-cap schemes have the option of, in addition rebalancing their portfolios, merging with a large-cap scheme or converting into a scheme of another category.

While the intent behind issuing the Circular, i.e. achieving the twin objectives of schemes staying 'true to label' and ensuring comparison with appropriate benchmark, is appreciated, by bringing forth a new parameter for multi-cap funds, the Circular causes unintended hardship to the investors as discussed in detail herein below.

I. Categorization of multi-cap funds and Benchmarking:

The 2017 Circular defines a multi-cap fund as a scheme with a minimum investment of 65% in equity and equity related instruments. With no specified minimum levels of investment in large-cap, mid-cap and small-cap companies, the fund managers have utilized the flexibility afforded by the multi-cap scheme to invest in companies across all three capitalization categories.

At this juncture, it is pertinent to draw your attention to the following categorization of listed companies based on market capitalization (Based on average market capitalization from January to June 2020 – provided by AMFI):

Buckets based on market capitalization rank	Total Market Capitalization (in Rs. Cr)	Percentage
Large-cap: 1-100 companies	1,01,25,722	74.00 %
Mid-cap: 101-250 companies	21,26,829	15.55 %
Small-cap: 251-4,978 companies	14,29,949	10.45 %
	1,36,82,500	**100.00 %**

As is evident from the above table, the share of market capitalization of the large-cap companies in the total market capitalization is at 74%, while that of the mid-cap and small-cap companies is merely around 15% and 10% respectively. In light of this data, it is not surprising for the fund managers of multi-cap schemes to allocate a large proportion of their AUM to large-cap companies. While the mandate of a multi-cap scheme, as laid down by the 2017 Circular, is to invest across the three sectors, the fund managers cannot ignore the reality of market capitalization to arbitrarily allocate a disproportionate amount of the AUM to mid-cap and small-cap companies. Investing disproportionately in mid-cap and small-cap companies will also mean that the fund managers are not staying true to the benchmark of BSE 500 or Nifty 500, which also has similar market-cap percentages across the three categories.

Therefore, based on the characterization of multi-cap funds provided under the 2017 Circular, most of the multi-cap funds have been complying with the appropriate asset allocation and have been comparing their returns against appropriate benchmarks.

II. Substantial change in risk to investors and increased costs:

An investor invests in a particular mutual fund scheme based on the characteristics of the scheme and as per their risk-taking ability. At the time of their investment, the investors understood that the characteristics of a multi-cap fund, as provided in the 2017 Circular, clearly allow the fund manager of a multi-cap fund to allocate assets between large-cap, mid-cap and small-cap companies as per the fund manager's sole discretion, subject to investing at least 65% of the AUM in equity and equity related instruments. The investors had invested in multi-cap funds acknowledging this discretion and accepting the risks associated with it. Therefore, redefining the characteristics of a multi-cap fund at this stage would not ensure that the fund is 'true to label', but instead would lead to a new characterization of the fund, such that the current characteristics are in dissonance with the characteristics of the fund at the time of investment by the investors.

As noted by SEBI in the Circular and the Clarification, the allocation of most of the multi-cap schemes is skewed in favour of large-caps, which carries with it lesser risk when compared to investment in small-caps or even mid-caps. The investors in multi-cap schemes would have invested after taking into consideration the risks associated with these schemes. A change in the allocation structure of a multi-cap fund based on the mandatory conditions specified in the Circular will substantially increase the risk of investment in the multi-cap funds. Multi-cap funds will be obligated to increase their exposure to equity and equity related instruments of mid-cap and small-cap companies. This will unequivocally increase the risks associated with a multi-cap fund. Such an increase in risk might be above the risk appetite of investors and they will be forced to withdraw their investments or transfer their investments into other schemes. This will lead to unnecessary transaction costs and capital gains taxation. Further, a transfer of investment into other equity schemes will re-start the exit load period.

It should be noted that it is not prudential for fund managers to invest in small-cap companies with very low market capitalization. Therefore, ideally, the fund managers would restrict their investments to the top 500 stocks by market capitalization, of which small-cap companies are ranked between 251-500. A mandatory asset reallocation of the multi-cap funds would compel the fund managers to concentrate their substantial investments in these small-cap companies ranked between 251-500, which would lead to a short-term increase in valuations. An unnatural increase in the valuations of mid-caps and small-caps would hurt retail investors, as these prices would normalize over time, depressing returns. Further, this reallocation will also affect the liquidity and net-asset-value of the fund, as substantial sale of stocks of such small-cap, and even certain mid-cap, companies will entail a high impact cost.

Therefore, a mandatory asset reallocation of the multi-cap funds based on the provisions of the Circular may not be beneficial to the investors.

RECOMMENDATION

To summarise, most of the multi-cap funds largely follow the proportion of market capitalization of large-cap, mid-cap and small-cap companies in the benchmarks that are used to compare their performance, i.e. BSE 500 or Nifty 500. A reallocation of the AUM of such schemes in favour of a larger proportion towards small-cap and mid-cap companies might hurt the performance of the schemes to the detriment of the investors. Further, such reallocation will greatly increase the risk to the investors of the multi-cap schemes. This will cause an outflow of investments, leading to transaction costs and taxation on capital gains for investors.

In light of the adverse consequences of the proposed reallocation, SEBI is requested to introduce a new category called 'flexi-cap' funds, and allow recategorization of the current multi-cap funds into flexi-cap funds. The characteristics of the flexi-cap fund can be similar to the characteristics of the multi-cap fund provided under the 2017 Circular and it may be defined as follows: an open-ended scheme with minimum investment of 65% of the total AUM in equity and equity related instruments, ***with flexibility to invest*** across large-cap, mid-cap and small-cap stocks.

SEBI's contention that the multi-cap funds are not being 'true to label' arises from an understanding that the multi-cap funds are required to mandatorily invest a substantial, if not equal, proportion of the AUM of the scheme across the three categories of stocks. However, the fund managers of the multi-cap funds have operated under the presumption that they have the flexibility to invest across the three categories of stocks in any proportion they choose to. In order to mitigate the harm caused to investors on account of such different interpretations of the scheme characteristics of multi-cap funds, introducing a new 'flexi-cap' scheme category and allowing the current multi-cap funds to recategorize as 'flexi-cap' funds will ensure that the schemes are being true to label. Further, at the same time, the investors of multi-cap funds are not inconvenienced.

This is also in line with the Clarification provided by SEBI, which stated that the multi-cap funds may convert into a scheme of any other category. However, in light of the present allocation of the AUM of the multi-cap funds, it will not be appropriate for many multi-cap funds to convert into/recategorize themselves as any of the other existing scheme categories. Any such recategorization might lead to an asset reallocation, which will invariably harm the investors. In view of this, a separate category will ensure that the investors are not harmed, and at the same time ensure that the schemes are being 'true to label'. With respect to the benchmarks, in consultation with AMFI, SEBI may choose to assign an appropriate benchmark to these flexi-cap schemes.

We humbly request SEBI to consider our request and introduce a 'flexi-cap' scheme category. Further, we would also submit that existing multi-cap schemes have the flexibility to rename themselves as flexi-cap schemes after due process. This step will greatly benefit the investors and put to rest the confusion prevailing in the market. We also seek that SEBI extend the timelines for implementation.

Yours sincerely,

Dhruv Mehta
Chairman

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