



PANDEMIC HIT MUTUAL FUNDS MARKET: AN ANALYSIS OF THE FRANKLIN TEMPLETON SAGA

Anurag Shah¹ and Vijay Tarshit²

Abstract

Mutual funds industry which was already grappling with an economic slowdown and value deterioration of a number of industries and asset class, has been served with a yet another blow in the form of COVID-19 pandemic. The struggle for the mutual funds; which are considered “safe” against market fluctuations, is apparent from the news of Franklin Templeton India opting to wind up six of its debt schemes. The winding up led to a legal saga involving three major players – Franklin Templeton, investors and the Securities Exchange Board of India. Each of these players was on the upfront to ensure that their interests are protected in the scenario that was going on. The paper tries to chalk down what led to the present crisis in the mutual fund industry of India and the legal saga that followed. The paper also tries to proffer the most suitable way out of this crisis that would ensure proper justice to all the parties.

Keywords – Mutual Funds, COVID-19, Franklin Templeton, Winding-Up.

¹ School of Law, Christ (Deemed to be University).
Email: anurag.shah1750@gmail.com

² School of Law, Christ (Deemed to be University).
Email: vijay.nekkanti@law.christuniversity.in



Introduction

The onset of the Covid-19 pandemic and the resultant nationwide lockdown fanned out across an array of sectors and industries.³ The pandemic has led to a bearish financial market and toppling of the economy of major countries across the globe. This effect has not left the debt-equity market out of its ambit as well.⁴ In general, an adverse event such as a global pandemic leads to decreased spending by the public, and therefore, the market becomes sluggish. A similar impact can be observed in the Mutual Funds Industry in India.⁵

A nationwide lockdown, coupled with a decrease in the trust of the investors has led to severe troubles for the once considered safe form of Investment. The truth is that the pandemic just played the role of a catalyst in increasing the already high redemption pressure in the Indian Mutual Funds Industry. The whole issue came to public light once one of India's major mutual fund company *Franklin Templeton* decided to wind up six of its debt fund schemes amidst the nationwide lockdown in April 2020.⁶

Franklin Templeton and The Six Funds

Franklin Templeton India cites reasons such as liquidity shortage behind winding up of these funds. These six funds are-Franklin India Low Duration Fund, Franklin India Dynamic Accrual Fund, Franklin India Credit Risk Fund, Franklin India Short Term Income Plan, Franklin India Ultra Short Bond Fund and Franklin India Income Opportunities Fund. This move has led to the locking up of a whopping amount of Rupees 30,000 Crores of investor's money.

³ Deloitte India Report , 'Flattening the curve: Impact on the Indian banking and capital market industry', available at <https://www2.deloitte.com/in/en/pages/financial-services/articles/in-fs-flattening-curve-impact-on-indian-banking-and-capital-market-industry.html>, last accessed on October 19th, 2020.

⁴ S&P Global Ratings, 'Covid-19 Impacts on Debt Market', 18th June, 2020. Available at: <https://www.spglobal.com/ratings/en/research/articles/200204-coronavirus-impact-key-takeaways-from-our-articles-11337257>, last accessed on October 19th, 2020.

⁵ Rao, Dabbeeru Neelakanteswar and Bushra, Seema and Gulati, Krity, 'Emerging Challenges and Strategic Implications for Indian Mutual Fund Industry in Post Covid-19 Regime', 14th June, 2020, available at SSRN: <https://ssrn.com/abstract=3626711>, last Accessed on October 19th, 2020.

⁶ Franklin Templeton India Notice of winding up available at <https://www.franklintempletonindia.com/downloadsServlet/pdf/notice-of-winding-up-final-230420-k8lf815l>, last accessed on October 19th, 2020.



However, these six credit risk schemes have been facing redemption before the pandemic came to India. The funds suffered a loss of Rupees 16,804 Crores under the assets under management (AUM) category between August 31st, 2018, and March 31st, 2020.⁷ The cause for this soaring redemption pressure directly co-relates with the liquidity crunch in the Indian Markets. As the economy was taking hits from the Covid-19 pandemic, the liquidity crunch forced Corporates and High Net worth Individuals (HNIs) to redeem these funds vigorously and recoup their cash shortages.⁸

Franklin Templeton could not cope up with such an enormous redemption pressure because it had invested these funds in high-risk instruments rated AA or lower. The issue with these high-risk instruments is that to compensate for such low credit ratings, the borrowers pay higher interests and thereby ensure higher yields. However, this then translates into a higher risk for the lender because of the fear of default. Now, amidst an economic slowdown and a pandemic, papers that are rated AA or lower would rarely find any takers in the financial markets.

After exhausting its available liquidity to absorb the redemption pressure, Franklin Templeton could not possibly, in the present scenario, use the instruments to create further liquidity. Therefore, on April 23rd, 2020, Franklin Templeton released a notice citing 'dramatic and sustained fall in liquidity' in the corporate bond market due to the COVID 19 and the resultant lockdown.

⁷ FAQs and Myths Debunked on winding up of 6 Mutual Funds, Franklin Templeton India, Market Insight Available at: <https://www.franklintempletonindia.com/investor/market-insights/winding-up-of-6-yield-oriented-fixed-income-schemes-myths-debunked-and-faq>, last accessed on October 19th, 2020.

⁸Renu Yadav, 'Franklin Templeton shuts six debt funds: What does it mean for debt fund investors', Livemint, 24th April, 2020., available at: <https://www.livemint.com/money/personal-finance/franklin-templeton-shuts-six-debt-schemes-what-does-it-mean-for-debt-investors-11587704326401.html>, last accessed on October 19th, 2020.



The Regulatory Framework Pertinent to Winding up of Mutual Fund Schemes

The SEBI Mutual Fund Regulations of 1996 (**MF Regulations**) encompass the preliminary regulations dealing with the winding up of the Mutual Fund Scheme.⁹ Under the said regulations, 39, 40 & 41 prescribe the circumstances and due procedure to be followed when winding up a said Mutual Fund scheme.¹⁰ In this regard, considering that the six schemes under consideration are of open-ended nature, Regulation 39(2) of the MF Regulations prescribes that such mutual fund may be wound up, after repaying the amount due to the Unitholders in any of the following circumstances viz: -

- On the happening of any event where the trustees, require that the scheme be wound up or
- If seventy-five percent of the Unitholders of a scheme pass a resolution to wind up the scheme or
- If the Board so directs in the interest of the Unitholders

Having enumerated the circumstances therein, Regulation 39(3) of the MF Regulations prescribes for the issuance of a Notice disclosing the details for winding up the scheme to the Board, two national papers, and a vernacular newspaper in circulation at the place of issue of the Mutual Fund. After ascertaining the circumstances, Regulation 40 of the MF Regulations prescribes that on and from the date of publication of the notice mentioned above, the trustee or the asset management company shall cease to carry on any business activities, create or cancel any units and issue or redeem any units related to the wound-up scheme therein. Subsequently, as per Regulation 41 of the MF Regulations, the trustee shall call for a meeting of the Unitholders to approve the decision of winding up by way of a simple majority, this compliance, however, is not necessary in cases wherein the winding up of such scheme is at the end of the maturity period of the said scheme.

⁹ Securities and Exchange Board of India (Mutual Funds) Regulations, 1996.

¹⁰ R.M. Kamble, 'Mutual Funds and SEBI Regulations', International Journal for Computational Engineering, Volume 3, Issue 5, 2013, available at: http://www.ijceronline.com/papers/Vol3_issue5/Part.1/E0351023027.pdf, last Accessed on October 19th, 2020.



Upon passing the resolution, the trustee or the authorized person shall dispose of the assets in the best interests of the Unitholders. Upon realizing the assets, the utilization of proceeds of the sale shall be towards discharging liabilities due and payable, in meeting the expenses connected with winding up, after that if any balance proceeds are available, the payment to unitholders shall be in proportion to their interest in the assets of the scheme.

Subsequently, the trustees shall bear the responsibility of forwarding a report to the Board based on explaining the utilization of the assets in the process of winding up the scheme. However, it is safe to peruse that, throughout the process of winding up, the disclosure requirements pertinent to furnishing half-yearly reports and annual reports shall stand to be unfettered.

Comparison of the Situation with the Winding up of Funds of M&G Investments in UK

Even though the incident of winding up of mutual funds is happening for the first time in India, the same has been a trend across the globe. Recently in 2019, M&G Investments, a fund management arm of the UK Insurance Giant - 'Prudential' wound up one of its open-ended mutual funds.¹¹ This was not a solitary incident for M&G as well, as in the same year they had also wound up their direct property fund.¹²

M&G stated that the portfolio was suspended owing to the "unusually high and sustained outflows" triggered by Brexit-related political uncertainty and ongoing structural shifts in UK Financial sector. The reason is somewhat similar to the Indian context as well, the reason cited by Franklin Templeton was high redemption pressure and the same can be attributed to the pandemic.

¹¹ Nick Corbishley, 'Another UK Mutual Fund Leaves Investors Twisting in the Wind', Wolf Street, December 4th, 2019, available at: <https://wolfstreet.com/2019/12/04/another-uk-mutual-fund-leaves-investors-twisting-in-the-wind/>, last accessed on 29th October 2020.

¹² M&G Investments, 'M&G Property Portfolio — Important information on the suspension of dealings', October 6th, 2019, available at <https://www.mandg.co.uk/investor/articles/property-portfolio-temporary-suspension/>, last accessed on 29th October 2020.



However, the major difference is that unlike the Indian scenario, where the investor money is still stuck due to the regulatory imbroglio, in the UK case M&G was able to sell assets in the portfolio and raise enough money to pay back the investors with a loss of one-third of their remaining principal. The reasons they were able to do so was because the investments were made in assets which were highly liquid, unlike those in which Franklin Templeton had invested.¹³ When the assets are high-yield bonds, loans, large positions of thinly traded small-cap stocks, or commercial real estate that can take days, weeks, or even months to sell.

The Events that Followed the Winding up

With the announcement of the decision to wind up the said debt schemes, the mutual fund industry as a whole received many speculations that had created a siege over the investor confidence in the market. In order to instill confidence and provide a sense of security, the Reserve Bank of India, vide its circular dated 27th April 2020 announced a Special Liquidity Facility for Mutual Funds (**SLF-MF**) amounting to 50,000 Crores, which came in as a breather for the dampened spirits of the Mutual Fund holders.¹⁴ The RBI's move is primarily aimed at assuring investors that adequate money is available to meet redemption demands and to help the asset managers avoid distressed sales of holdings by mutual funds. Subsequently, Securities and Exchange Board of India (**SEBI**) vide its Press Release dated 7th May 2020 stated that, “*despite the recommendations made by the Mutual Fund Advisory Committee constituted in 2019 to address the risks involved in investing in the unlisted debt securities, Franklin Templeton chose to act in derogation by investing in securities that are unlisted and opaque encompassing low credit ratings and high risk portfolio.*”¹⁵ In light of this observation, SEBI had directed Franklin Templeton to immediately focus on returning money to the investors.

¹³ M&G Fund Suspension FAQs, Fidelity Internation, available at: <https://www.fidelity.co.uk/mg-fund-suspension/>, last accessed on: October 29th, 2020.

¹⁴ Reserve Bank of India, Press Release, April 27th, 2020, available at: https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=49728, last accessed on October 19th, 2020.

¹⁵ Securities Exchange Board of India, circular, May 2nd, 2020, available at: https://www.sebi.gov.in/media/press-releases/may-2020/sebi-advises-franklin-templeton-mutual-fund-to-focus-on-returning-money-to-investors_46654.html, last accessed on October 29th, 2020).



However, Franklin Templeton did not pay much heed to the claim of SEBI and started setting a ground towards obtaining the unitholders consent for the initiation of winding-up through the mode of E-voting in consonance with regulations as mentioned above.¹⁶ However, certain aggrieved investors had moved to the Gujarat High Court to obtain a Stay Order on the E-voting process as an interim measure.

Perspectives on the Gujarat High Court Judgement

The Stay Order issued by the Gujarat High Court on June 3rd, 2020,¹⁷ regarding the conduct of the e-voting process was appealed by Franklin Templeton to be vacated by way of a writ petition in the Gujarat High Court. The learned High Court delivered its judgment on the petition in the case of *Franklin Templeton Trustee Services Pvt Ltd v. Areez Phirozsha Khambatta*.¹⁸ There were two issues for the Court to decide.

The first was, whether such a writ petition would be maintainable against the company provided that it was not a 'state' under Article 12 of the Constitution.¹⁹ While, the second dealt with the vacating of the Stay Order issued against the e-voting process to get the consent of the unitholders on the ground that it would only delay the winding-up process. In light of the first issue, the respondents argued on the premise that Franklin Templeton was not a state under Article 12 of the Constitution and therefore the petition was not maintainable.

¹⁶ Franklin India Ultra Short Bond Fund, Notice for E-Voting and meeting of unitholders, March 28th, 2020, available at: <https://www.franklintempletonindia.com/downloadsServlet/?docid=kakkg2b4>, last accessed on October 19th, 2020).

¹⁷ Rohit Jain, Gujarat High Court stays Franklin Templeton's notice on Asset Monetisation, BloombergQuint, June 3rd, 2020, available at: <https://www.bloombergquint.com/business/gujarat-high-court-stays-franklin-templetons-notice-on-asset-monetisation>, last accessed on October 29th, 2020.

¹⁸ Civil Application (for vacating interim relief) No. 1 of 2020 in R/Special Civil Application No. 7201 of 2020, available at: <https://media-exp1.licdn.com/dms/document/C561FAQGrdO1GDzUrlw/feedshare-document-pdf-analyzed/?e=1603198800&v=beta&t=haGVYJHnxxck54SZMM3pxoib0jgMq2BDWtjUy86QE>, last accessed on October 29th, 2020.

¹⁹ Article 12, Constitution of India, 1949.



In substantiating the same, the learned counsel relied upon the case of *Federal Bank Ltd. v. Sagar Thomas and Others*,²⁰ wherein the Court held that the regulatory provisions enacted to ensure discipline in the business or commercial activity carried on by private bodies, shall not confer any status or any obligation upon it, to be enforceable under Article 226 of the Constitution.

However, this argument was disregarded by the Court since in the case of *Anandi Mukta Sadguru Shree Muktajee Vandas Swami Suvarna Jayanti Mahotsav Smarak Trust and Ors. v. V.R. Rudani and Others*²¹, it was held that the term "authority" used in Article 226, in the context, must receive a liberal meaning unlike the term in Article 12 of the Constitution. The form of the body concerned is not very relevant under Article 226 of the Constitution.

What is relevant is the nature of the duty imposed on the body. The perusal of such duty must be in the light of positive obligation owed by the person or authority to the affected party. Therefore, as the company owed an obligation of discharging financial functions towards the public, a writ of Mandamus was held to be maintainable.

For the second issue, relying on the provisions of SEBI Mutual Fund Regulations of 1996, the Court observed that the practice of obtaining the consent of the unitholders before the winding-up of the scheme would vest them with the power to either approve or discard the resolution.²² However, all of this relies upon the fundamental premise that the unitholders would make an informed choice.

However, in the light of the present scenario, coupled with allegations upon the AMC for misrepresentation of funds and fraud, conducting e-voting would likely impact the decision making of the unitholders. For the unitholders to make an informed choice, they must know all the facts, and this would be possible only if the Forensic Audit Report, prepared by SEBI incorporating the integrity of the representations made by the AMC is made Public. Therefore, the Court denied vacating the Stay on the e-voting process, stating that the unitholders should first be made aware of the Forensic Audit report, and then the e-voting should be conducted.

²⁰ Federal Bank Ltd. v. Sagar Thomas and Others, (2003) 10 SCC 733.

²¹ Anandi Mukta Sadguru Shree Muktajee Vandas Swami Suvarna Jayanti Mahotsav Smarak Trust and ors. V. V.R. Rudani and others, AIR 1989 SC 1607.

²² Ibid: Note 11.



Conclusion: Impact of the Judgement and the Way Ahead

The judgment created a new conundrum in the Mutual Funds Industry as, for the first time, the Forensic Audit Report, which as per SEBI, was an 'internal' document, was ordered to be released as a public document. The judgement further delayed the conduct of the winding-up process, which would have been seamless had it been conducted as per the Regulations prescribed by the SEBI. The impact of delaying a winding-up process of a mutual fund can be disastrous.²³

It is a well-known fact that the reasoning behind winding up the schemes was because of an increase in the redemption pressure. Delaying the winding-up process would lead to a further deterioration in the value of the bonds the AMC holds. Furthermore, such a delay would cause grave harm and prejudice to more than 3 Lacs unit-holders of the scheme, including various small & retail investors, as the intervention of the Court deprives the investors of an expeditious return of their investments. Therefore, the Court should also keep this factor into consideration while trying to ensure a just winding-up process.

Further an appeal against the Gujarat High Court order has been filed in the Supreme Court claiming that the Forensic Audit Report is an internal document and not a public document and as such, the permission cannot be granted.²⁴ It is noteworthy that the securities regulator in India; SEBI, has been on the upfront to solve the crisis for the investors. On June 23rd, SEBI came up with an operational framework for transactions in defaulted debt securities post maturity date/ redemption date.²⁵

²³ Jash Kriplani, 'Repayments may get delayed if unitholders don't authorise trustees: FTMF', Business Standard, May 15th, 2020, available at: https://www.business-standard.com/article/companies/repayments-may-get-delayed-if-unitholders-don-t-authorise-trustees-ftmf-120051500531_1.html, last accessed on October 29th, 2020.

²⁴ S Jayshree P. Upadhayay, 'SEBI moves against stay order in Gujarat HC, says delay in winding up will hurt Franklin investors', Livemint, June 17th, 2020, available at: <https://www.livemint.com/companies/news/sebi-appeals-against-stay-order-says-delay-in-winding-up-will-hurt-ft-investors-11592398432715.html>, last accessed on October 29th, 2020.

²⁵ Securities Exchange Board of India, Operational framework for transactions in defaulted debt securities post maturity date/ redemption date under provisions of SEBI (Issue and Listing of Debt Securities) Regulations, 2008. Available at: https://www.sebi.gov.in/legal/circulars/jun-2020/operational-framework-for-transactions-in-defaulted-debt-securities-post-maturity-date-redemption-date-under-provisions-of-sebi-issue-and-listing-of-debt-securities-regulations-2008_46912.html.



This enabled the investors to sell defaulted debt securities and eventually brighten their prospects. However, until and unless all the players, including the judiciary, work in a conjunct manner considering investor welfare, this issue could be further delayed. The process of winding up will be delayed unless the unit holders provide their votes. In case the judiciary does not vacates the stay, the same would delay the winding up process. This in turn would deprive the investors from the amount they have invested in these six funds.

The whole Franklin Templeton saga must also serve as a wake up call for the SEBI to step up and overhaul the system that serves as the regulatory bedrock for mutual funds in India. The existing regulations fall short of accounting for market vicissitudes. There are certain provisions that need to be defined better in order to make the MF Regulations less ambiguous. For example, Regulation 39 of the MF Regulations provides for winding up but does not state anything about a scenario when the majority cannot be reached related to the winding up of the funds.

Furthermore, it is very important for SEBI to allow the mutual funds to undertake their own credit risk assessment and not to follow the ratings by the credit rating agencies. This would make it easy for the mutual funds to make informed choices. This would also mean that the mutual funds can be held responsible for investing in any low rated bonds. Therefore, it becomes imperative that the securities regulator must look into the regulatory system for mutual funds and try to strengthen it for the sake of protection of investors.
