

**CONSULTATION PAPER ON REVIEW OF REGULATORY FRAMEWORK ON
ALIGNMENT OF INTEREST OF THE DESIGNATED EMPLOYEES OF THE ASSET
MANAGEMENT COMPANY (AMC) WITH THE INTEREST OF THE UNITHOLDERS**

1. Objective

1.1. The objective of this consultation paper is to seek comments/suggestions from public on the proposals related to review of regulatory framework on alignment of interest of the designated employees of AMC with the interest of the unitholders to ensure ease of compliance.

2. Background

2.1. Mutual Funds are regulated through SEBI (Mutual Funds), Regulations, 1996 (“MF Regulations”) and circulars issued thereunder including Master Circular dated June 27, 2024 (‘MF Master Circular’).

2.2. As a continuous process, SEBI constituted working groups to recommend measures to simplify and ease compliances under various SEBI Regulations. Accordingly, a working group (‘EODB working group’) was formed to review the present framework under MF Regulations and recommend measures to promote the ease of doing business for Mutual Funds.

2.3. The EODB working group *inter-alia* provided its recommendations on the requirement of alignment of interest of the Designated Employees of AMC with the interest of the unitholders (‘skin in the game’).

2.4. This consultation paper seeks suggestions of the public on the proposals with respect to skin in the game requirements.

3. Proposals

3.1. Minimum investment amount

3.1.1. Current requirements:

- In terms of Clause 6.10.1.1 of the MF Master Circular, AMC's are required to invest a minimum of 20% of the salary/ perks/ bonus/ non-cash compensation (gross annual cost to company (CTC)) net of income tax and any statutory contributions (i.e. PF and NPS) of the designated employees of the AMC's in units of mutual fund schemes in which they have a role/oversight. In terms of Clause 6.10.1.8 of the MF Master Circular, CTC shall include all non-cash benefits and perks at the perquisite value as per the Form 16 under Income Tax Act, 1961. However, superannuation benefits and Gratuity paid at the time of death/retirement are not included in the CTC.
- Designated Employees of the AMC include Chief Executive Officer (CEO), Chief Investment Officer (CIO), Chief Risk Officer (CRO), Chief Information Security Officer (CISO), Chief Operation Officer (COO), Fund Manager(s), Compliance Officer, Sales Head, Investor Relation Officer(s) (IRO), heads of other departments, Dealer(s) of the Asset Management Companies ('AMCs'), direct reportees to the CEO (excluding Personal Assistant/Secretary), Fund Management Team and Research teams, other employees as identified & included by AMC and Trustees.

3.1.2. EODB working group highlighted that mandating investment of 20 percent of the salary, reduces the in hand salary of the Designated Employees significantly. The impact of lower in hand salary may be higher for the Designated Employees, who have CTC below 25 lakhs per annum, than for the Designated Employees with CTC above 25 lakhs. Since the mandatory investment is locked-in for 3 years, the same is not readily available for any urgent needs of the Designated Employees. It may also have an impact on the asset allocation of the Designated Employees, as the investment objective of the scheme may not be in line with the risk appetite of the Designated Employees.

3.1.3. EODB working group also deliberated on the applicability of skin in the game requirement for non-cash component including Employee Stock Ownership Plan (ESOP) and noted the operational challenges faced by the AMC's. The challenges faced by AMC's with respect to ESOPs, as discussed by the EODB working group, were as under:

- a) ESOPs are granted with vesting period over 4-5 years to senior employees. Thus, there is a large portion of compensation which is already deferred, further lock-in of 3 years under skin in the game requirement may delay such compensation by almost 7-8 years.
- b) When an employee exercises the ESOPs, normally a loan is taken to pay the taxes and for buying the shares at exercise price. If a further 20% is to be invested in own funds at the time of exercise, the borrowing will go up by 20%. This is a huge burden on the employee who is already taking a loan for the ESOP exercise.
- c) In addition, after inclusion of Mutual Funds units under the ambit of SEBI (Prohibition of Insider Trading) Regulations, 2015, sale of units will also create further challenges for the employee on the amount he/she can sell.

3.1.4. **Recommendations of EODB working group:**

EODB working group recommended as under:

- a) The minimum mandatory investment amount may be reduced from 20 percent and made applicable slab-wise, based on the CTC of the employees.
- b) Non-cash compensation including ESOPs may be excluded from the calculation of minimum mandatory investment amount for the designated employees.

3.1.5. Non-cash component of CTC

- a) At the industry level, an analysis of data¹ for the last three financial years indicated that 6 out of the total 47 AMCs had paid higher than 20 percent of the CTC as non-cash component to the designated employees. For all 47 AMCs, the average percentage of non-cash component paid was around 7 percent of

¹ The data for the last three financial years (FY22, FY 23 and FY 24) was analyzed and observations made are based on the average non-cash component paid as part of the annual CTC.

the total CTC of the designated employee. Maximum percentage of non-cash components paid by any AMC as part of CTC was 45 percent.

- b) If the non-cash component is excluded from the calculation of skin in the game requirement, the minimum investment amount (MIA) as percentage of the net CTC (net of income tax and statutory contributions) would decrease as under:

Percentage of Non-cash component in CTC	Percentage reduction in minimum investment amount (Considering 20% requirement of minimum investment amount)
0 percent	0 percent ((Effective MIA 20 percent of net CTC)
5 percent	1 percent (Effective MIA 19 percent of net CTC)
10 percent	2 percent (Effective MIA 18 percent of net CTC)
15 percent	3 percent (Effective MIA 17 percent of net CTC)
20 percent	4 percent (Effective MIA 16 percent of net CTC)
25 percent	5 percent (Effective MIA 15 percent of net CTC)
35 percent	7 percent (Effective MIA 13 percent of net CTC)
45 percent	9 Percent (Effective MIA 11 percent of net CTC)

- c) Thus, if the calculation of minimum investment amount excludes non-cash component of the CTC, in case of 45 percent of non-cash component in the CTC, the effective minimum investment amount may reduce by nine percent (from 20 to 11 percent). Such significant reduction in the minimum investment amount is not desirable. However, for lower percentage of non-cash component of the CTC (i.e., lower than 20 percent), the exclusion of non-cash component in calculation of minimum investment amount shall not reduce the minimum investment amount by more than 4 percent of the net CTC.
- d) Considering the challenges faced by the AMCs with respect to the non-cash component of the CTC primarily with respect to ESOPs as highlighted at para 3.1.3 above, it can be explored to give AMC an option to exclude the non-cash component in calculation of minimum investment amount, if, the non-cash component is less than 20 percent of the CTC. Further, to compensate for the exclusion of non-cash component, the revised slab wise minimum percentage required to be invested under skin in the game requirements may be increased.

- e) When the non-cash component is significant part of CTC (i.e., more than 20 percent), the same may be included in calculation of the minimum investment amount.

3.1.6. Based on the recommendation of the EODB working group and further internal deliberations, the following is proposed:

- Proposed slabs:

Slabs based on annual CTC (In INR)	Minimum percentage required to be invested with inclusion of non-cash component	Minimum percentage required to be invested with exclusion of non-cash component, if the non-cash component is less than 20 percent of the CTC
Slab 0 (Gross CTC below 25 lakhs)	Nil	Nil
Slab 1 (Gross CTC above 25 lakhs but below 50 lakhs)	10% of gross annual CTC net of income tax and any statutory contributions.	12.5% of gross annual CTC net of non-cash compensation, income tax and any statutory contributions.
Slab 2 Gross CTC > 50 lakhs but less than 1 crore	14% of gross annual CTC net of income tax and any statutory contributions.	17.5% of gross annual CTC net of non-cash compensation, income tax and any statutory contributions.
Slab 3 (Gross CTC above 1 crore)	18% gross annual CTC net of income tax and any statutory contributions	22.5% gross annual CTC net of non-cash compensation, income tax and any statutory contributions.

- For designated employees with more than 20 percent non-cash component of the CTC, the non-cash component shall be included in the calculation of minimum investment amount and the respective slabs shall be applicable based on CTC.
- Non-cash compensation including ESOPs may be excluded from the calculation of minimum mandatory investment amount for the designated

employees only when non-cash component of the CTC is less than 20 percent of the annual CTC.

3.1.7. The abovementioned slabs are proposed so as to reduce the minimum investment requirement for designated employees with gross CTC below INR 25 lakhs (Slab 0), from present 20 percent to 0 percent. For designated employees with gross CTC above INR 25 lakhs but below INR 50 lakhs (Slab 1), the minimum investment amount has been proposed to be reduced from present 20 percent to 10 percent. In addition, to further ease the compliances, the minimum mandatory investment requirement for mid-level employees, with gross CTC between INR 50 lakhs and INR 1 crores (Slab-2), is also proposed to be reduced from present 20 percent to 14 percent.

3.1.8. The proposed slabs shall reduce the minimum mandatory investment requirement for the designated employees, especially with lower in-hand salary.

3.1.9. Consultation/ Proposal 1:

- a) Whether the recommendations of the EODB working group at para 3.1.4 above are appropriate.
- b) Whether the slabs proposed at para 3.1.6. (a) above are appropriate.
- c) Whether the non-cash component should be excluded from the calculation of minimum investment amount under skin in the game requirements based on the slabs proposed at para 3.1.6. (a) above.

3.2. Applicability on Designated Employees

3.2.1. Current requirements:

- a) Designated employees of the AMC include Chief Executive Officer (CEO), Chief Investment Officer (CIO), Chief Risk Officer (CRO), Chief Information Security Officer (CISO), Chief Operation Officer (COO), Fund Manager(s),

Compliance Officer, Sales Head, Investor Relation Officer(s) (IRO), heads of other departments, Dealer(s) of the Asset Management Companies ('AMCs'), direct reportees to the CEO (excluding Personal Assistant/Secretary), Fund Management Team and Research teams, other employees as identified & included by AMC and Trustees.

3.2.2. EODB working group highlighted that instead of having the same percentage of contribution for all designated employees at the same level, such employee who are not part of investment management function and are included in the designated employee definition, may be subjected to a lower percentage of mandatory investments.

3.2.3. Accordingly, the employees who are not part of investment management function, may be subject to a lower slab i.e., Slab 1 as proposed at para 3.1.6. above, irrespective of the CTC of such employees.

3.2.4. Recommendations of EODB working group:

a) The following slabs may be made applicable:

Employees	Proposed Slab
<ul style="list-style-type: none"> • CEO • CIO • Fund Managers • Investment Research team • Dealers • All the members of the Investment Committee 	Slab applicable based on the CTC of the employee as proposed at para 3.1.6 (a) above.
<ul style="list-style-type: none"> • Chief Risk Officer (CRO) • Chief Information Security Officer (CISO) • Chief Operation Officer (COO) • Compliance Officer • Sales Head • Investor Relation Officer(s) (IRO) • Heads of other departments • Direct reportees to the CEO (excluding Personal Assistant / Secretary) 	Slab 1

3.2.5. Further, from the list of employees who are not related to direct investment management function, it is observed that some of the employees such as CISO, COO, Sales Head, Investor Relation Officer, and Heads of other departments are

only responsible for operational aspects of the AMC and are not related in any manner with the functioning of the scheme. For such employees, having mandatory investment in mutual fund units under skin in the game requirement may be onerous. Accordingly, for such employees, it is proposed that based on the activity being handled by the employees, AMCs may be empowered to decide if such employees should be required to comply with Slab 1 or Slab 0 of skin in the game requirements as proposed at para 3.1.6 (a) above.

3.2.6. Further, Chief Risk Officer and Compliance Officer play important role in management of risk and legal compliance of the schemes. Accordingly, for Chief Risk Officer and Compliance Officer, it is appropriate to have slabs applicable based on the CTC of the employees.

3.2.7. Based on the recommendations of the EODB working group and discussion above, the following slabs are proposed:

Employees	Proposed Slab
<ul style="list-style-type: none"> • CEO • CIO • Fund Managers • Investment Research team • Dealers • Chief Risk Officer (CRO) • Compliance Officer • All the members of the Investment Committee 	Slab applicable based on the CTC of the employee as proposed at para 3.1.6 (a) above.
<ul style="list-style-type: none"> • Direct reportees to the CEO (excluding Personal Assistant/Secretary) 	Slab 1 i.e., 12.5%/10%, irrespective of the CTC
<ul style="list-style-type: none"> • Chief Information Security Officer (CISO) • Chief Operation Officer (COO) • Sales Head • Investor Relation Officer(s) (IRO) • Heads of other departments 	Slab 0 or Slab 1 as decided by AMC based on the activity being performed by the employee.

3.2.8. Consultation/ Proposal 2:

- Whether the slabs proposed at para 3.2.7 above are appropriate.

3.3. Liquid fund schemes

3.3.1. Currently, while overnight fund schemes investing in overnight securities having maturity of one day, have been exempted from compliance with requirements

under skin in the game, liquid fund schemes, investing in debt and money market securities with maturity of up to 91 days, are covered under its ambit.

3.3.2. Further, as per Clause 6.10.1.5 of Master Circular, with a view to allow the designated employees to diversify their unit holdings, in case of dedicated fund managers managing only a single scheme / single category of schemes, 50% of the aforementioned compensation shall be by way of units of the scheme/category managed by the fund manager and the remaining 50% can, if they so desire, be by way of units of schemes whose (a) risk value as per the risk-o-meter is equivalent or higher than and (b) whose underlying portfolio is of similar nature as, the scheme managed by the concerned fund manager.

3.3.3. Therefore, for fund managers managing only liquid fund schemes, at least 10 percent of the CTC net of income tax and any statutory contributions, has to be deployed in liquid fund schemes under skin in the game requirements.

3.3.4. EODB working group noted that the liquid fund schemes have similar features as overnight fund schemes as both schemes are meant for short-term parking of funds and short investment horizon. Also, both the schemes (liquid and overnight) have similar cut off timings in determining applicable NAV.

3.3.5. Therefore, EODB working group was of the view that mandating a fund manager, managing a liquid fund scheme, to remain invested for a period of 3 years in liquid funds, may not be desirable, as the personal asset allocation of such employees can get affected adversely.

3.3.6. Recommendations of the EODB working group:

- a) For designated employees associated with liquid fund schemes, Slab 1 as proposed at para 3.1.6 (a) above may be considered irrespective of the CTC of the employee, for compliance with skin in the game requirements.

- b) Further, to reduce the impact on asset allocation, 75 percent of the minimum investment amount may be allowed to be invested in schemes, managed by the AMC, with higher risk as compared to liquid fund schemes.

3.3.7. The requirement of lock-in was put in to continuously align the interest of the employees with the unit holders. In view of the same, the requirement of lock-in of 3 years for investment in liquid schemes may not be relaxed.

3.3.8. Accordingly it is proposed as under:

- a) For designated employees associated with liquid schemes, Slab 1 as proposed at para 3.1.6 (a) above may be considered irrespective of the CTC of the employee, for compliance with skin in the game requirements.
- b) Further, to reduce the impact on asset allocation, 75 percent of the minimum investment amount may be allowed to be invested in schemes, managed by the AMC, with equivalent or higher risk as compared to liquid schemes.

3.3.9. **Consultation/ Proposal 3:**

- a) Whether the proposals at para 3.3.8 (a) and (b) above are appropriate.
- b) Whether the proposed relaxations should be given even though liquid fund schemes carry credit risk.

3.4. **Lock-in after resignation or retirement of the employee**

3.4.1. Currently, redemption of units is not permitted during the lock-in period in case of resignation or retirement of an employee before attaining the age of superannuation. However, in case of retirement on attaining the superannuation age, such units can be released from the lock-in and the designated employee is free to redeem the units, except for the units in close ended schemes where the units shall remain locked in till the tenure of the scheme is over.

3.4.2. EODB working group highlighted that after the resignation or retirement of the employee before attaining the superannuation age, the role/oversight of the employee in the scheme of that AMC ceases to exist. In view of the same, having a lock in period of 3 years in such cases, may be onerous. However, it was agreed that actions taken by an employee during his/her tenure with AMC may have impact on the scheme in future and thus, it is important that the interest of the employee who has resigned/retired from the AMC continues to be aligned with the interest of the investors of the scheme for a reasonable period.

3.4.3. Therefore, for a designated employee who resigns or retires before attaining the superannuation age, an appropriate period of lock-in less than 3 year may be considered.

3.4.4. Recommendation of the EODB working group:

- Once the employee has resigned or retired from the AMC before attaining the age of superannuation as defined in the AMC service rules, the requirement of lock-in period, for the investments made in compliance with the applicable requirements, may be reduced to 1 year from the end of the employment or completion date of 3 year lock-in period, whichever is earlier.

3.4.5. Consultation/ Proposal 4:

- a) Whether the recommendations of EODB working group at para 3.4.4 above are appropriate.
- b) Whether the lock-in period of 3 years should be retained for schemes with higher risk such as equity schemes, credit risk debt fund etc.

3.5. Disclosure of aggregate amount

3.5.1. Current requirement:

- As per the present regulatory framework, every scheme is required to disclose the 'compensation, in aggregate, mandatorily invested in units for the Designated Employees', on the website of their AMC. Such disclosure is required to be made on monthly basis at aggregate level showing the total investment across all relevant employees in that specific scheme.

3.5.2. In this regard, with a view of promoting ease of doing business and ease of compliance while achieving the objective, EODB working group highlighted that the frequency of disclosure may be reduced.

3.5.3. Recommendation of the EODB working group:

- a) The frequency of disclosure of the investments made under skin in the game requirements, may be reduced from end of every month to end of every quarter.
- b) The above disclosure may be made within 15 days from the end of each quarter.

3.5.4. Further, under the SEBI (Prohibition of Insider Trading) Regulations, 2015, AMCs is required to disclose the details of holdings in the units of its mutual fund schemes, on an aggregated basis, held by their Designated Persons, trustees and their immediate relatives on the platform of Stock Exchanges or in any other manner, as may be specified by the Board.

3.5.5. As per the recommendation of the EODB working group, the disclosure requirement for skin in the game may be made quarterly instead of monthly. Further, since the disclosures would be required to be made quarterly, the same may be aligned with the quarterly disclosures required to be made under PIT Regulations and the AMC may be required to disclose the investments, under the requirement of skin in the game, on the platform of Stock Exchanges instead of on AMC's website within a time period as may be specified for disclosure of holdings of Designated Persons under PIT Regulations.

3.5.6. Consultation/ Proposal 5:

- a) Whether the recommendations of EODB working group at para 3.5.3 above are appropriate.
- b) Whether the proposal at para 3.5.5 above is appropriate.

3.6. **Clawback:**

3.6.1. Current requirement:

- Units allotted to the Designated Employees under skin in the game requirement are subject to clawback in the event of any violation of Code of Conduct under the MF Regulations, fraud, gross negligence by them, as determined by SEBI. Upon clawback, the units are required to be redeemed and amount is required to be credited to the scheme.

3.6.2. Recommendation of the EODB working group:

- In case of any non-compliance with the Code of conduct, the Nomination and Remuneration Committee of AMC should be empowered to take decision based on the facts of the case.

3.6.3. Complete delegation to Nomination and Remuneration Committee of AMC may not be possible. Hence, it is proposed that for the requirement of claw back for violation of the provisions of the code of conduct for mutual funds, Nomination and Remuneration Committee of AMC may be empowered to do the preliminary examination and provide recommendations to SEBI for consideration. For AMCs where Nomination and Remuneration Committee is not formed, an equivalent body under the Board of AMC may be empowered to do the preliminary examination and provide recommendations to SEBI for consideration.

3.6.4. Consultation/ Proposal 6:

- Whether the proposal at para 3.6.3 above is appropriate.

3.7. Restriction on redemption of lock-in units after the expiry of lock-in period

3.7.1. Current requirements:

- a) In terms of Clause 6.10.2 of the MF Master Circular, after the expiry of the mandatory lock-in period of 3 years, Designated Employees can redeem their units in open ended schemes twice in a financial year, with the prior approval of the Compliance Officer of AMC.
- b) No redemptions of the units are allowed during the lock-in period. However, AMCs may decide to have a provision of borrowing from the AMCs by Designated Employees against such units, in exigencies such as medical emergencies or on humanitarian grounds, as per the policy laid down by the AMCs.
- c) Where the concerned Designated Employee is in possession of any material information, which is not yet communicated to investors and which could materially impact the NAV / interest of unitholders, such Designated Employee is not allowed to make application for redemption or submit redemption request during such period. Further, where the AMC is in possession of any material information, which is not yet communicated to investors and which could materially impact the NAV / interest of unitholders, Compliance Officer is required to not grant an approval for such application.

3.7.2. The requirements related to alignment of interest of the Designated Employees with the interest of the unitholders were introduced in the year 2021. SEBI vide amendments dated November 24, 2022, amended the SEBI (Prevention of Insider Trading) Regulations, 2015 ('amended PIT Regulations') to include mutual funds units under the ambit of the said regulations.

3.7.3. The EODB working group discussed that as mutual fund units are included under the ambit of amended PIT Regulations, the restrictions on investments under skin in the game requirements may be aligned with the requirements under the amended PIT Regulations.

3.7.4. Recommendations of the EODB working group:

- a) After the expiry of the lock in period of 3 years under skin in the game requirements, the restrictions on redemption of such investments may be aligned with the requirements under the amended PIT Regulations. Accordingly, the Designated Employee should be free to redeem the units at any time and any number of times, subject to the requirements as applicable under amended PIT Regulation.
- b) Existing investments made under the skin in the game requirements, where 3 years lock-in period have elapsed, may be permitted for set off against the new investment required to be made under the skin in the game.

3.7.5. In view of the recommendations of the EODB working group, the following changes are proposed to the requirements applicable for transactions in mutual funds units under skin in the game:

- The requirement of restriction on number of redemption requests in a financial year and approval from compliance officer may be relaxed for redemption transactions after the expiry of the lock-in period. However, the restrictions applicable under amended PIT Regulations (i.e., restriction on trade in closure period and the requirement of pre-clearance from compliance officer when closure period is not applicable) may be made applicable for such transactions.

3.7.6. Further, as per Clause 6 of Schedule B1 of amended PIT Regulations, transactions in mutual funds units *inter alia* require pre-clearance by the Compliance Officer. However, for transactions in mutual funds units pursuant to subscription/investment under skin in the game requirements, it is stated that the details shall be as specified by the Board.

3.7.7. In this regard, it is proposed that for mandatory subscription/investment in the units of mutual funds under skin in the game requirements, relaxation may be provided from the requirements specified under Clause 6 of Schedule B1 of amended PIT Regulations.

3.7.8. Consultation/ Proposal 7:

- a) Whether the recommendations of EODB working group at para 3.7.4 (a) and (b) above are appropriate.
- b) Whether the proposals at para 3.7.5, 3.7.6 and 3.7.7 above are appropriate.

3.8. Stress testing of all mutual fund schemes

3.8.1. In terms of Clause 2.3.2.1 (iii) of Annexure 1 of the MF Master Circular, stress testing is required to be conducted mandatorily for all schemes (excluding close ended and interval schemes) appropriately at least on monthly basis.

3.8.2. Presently, disclosure of the results of stress test for small cap fund and mid cap fund schemes of the Mutual Funds has been made mandatory. The disclosures are required to be made on Association of Mutual Funds in India (AMFI) and AMC websites.

3.8.3. Notwithstanding the relaxations from the requirements of 'skin in the game' as proposed above, it would be prudent that the investors are aware of the risks associated with all mutual fund schemes. Accordingly, it is proposed to mandate disclosure of stress testing results of all mutual fund schemes (excluding close ended and interval schemes) for the investors to make informed decision. This would also align with the recommendations of Financial Stability Board (FSB) in the report dated December 20, 2023 on 'Revised Policy Recommendations to Address Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds'.

3.8.4. Consultation/ Proposal 8:

- Whether all mutual fund schemes (excluding close ended and interval schemes) should be mandated to disclose the results of stress testing.

3.9. Any other suggestion:

3.9.1. Consultation/ Proposal 9:

- Any other suggestions regarding the overall proposed framework regarding skin in the game requirements.

4. Public Comments on this Consultation Paper

4.1. Public comments are invited for the proposals at paragraph 3.1, 3.2, 3.3, 3.4, 3.5, 3.6, 3.7, 3.8 and 3.9 above. The comments/ suggestions should be submitted through the following link by November 21, 2024:-

<https://www.sebi.gov.in/sebiweb/publiccommentv2/PublicCommentAction.do?doPublicComments=yes>

4.2. In case of any technical issue in submitting your comments through web based public comments form, you may contact the following through email with a subject " Consultation paper on review of requirements of alignment of interest of the Designated Employees of the AMC with the interest of the unitholders":

- a) Mr. Peter Mardi, DGM (peterm@sebi.gov.in)
- b) Mr. Tarun Kumar Garg, Manager (tarung@sebi.gov.in)

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(End of Consultation Paper)