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Examining the Impact of Regulation on Equity Multi-Cap Funds in India

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ABSTRACT
Economic growth is facilitated by a sound financial system. "Mutual funds are one of the main sources of capital flows to emerging economies". "The Securities and Exchange Board of India (SEBI) is the highly powerful capital market regulator in the country and it regulates mutual funds". The regulatory mechanism for mutual funds is quite strong in India. 11th September 2020 is a significant day for equity multi-cap funds in India. SEBI came out with a circular on that day for equity multi-cap funds. The present study endeavours to critically assess the impact of that circular on equity multi-cap funds. The study is exploratory and uses secondary data. The number of equity multi-cap funds reduced drastically after the regulatory circular. Nevertheless, one notable thing is that many fund houses launched schemes under the category of equity multi-cap funds even after this circular. The results reveal that the AUM of the two big funds (Nippon India Multi-Cap Fund and ICICI Pru Multi-cap Fund) has increased and the expense ratio has decreased in February 2022 in comparison to December 2020. The returns generated by these funds were spectacular also. As such, the impact of the circular should not be treated as a negative one for equity multi-cap funds.

Keywords: *financial system, multi-cap funds, mutual funds, regulator, sebi*

I. INTRODUCTION AND BACKDROP

India's financial system is relatively stable and safe in comparison to many nations of Asia. A sound financial system facilitates economic growth. "Financial institutions, financial markets, financial instruments, financial services and financial regulators are the main components of the Indian financial system".

"Mutual funds are key contributors to the globalization of financial markets and one of the main sources of capital flows to emerging economies (Agarwal, 2011)". "A mutual fund is nothing but a diversified portfolio of stocks, bonds, or other securities, which is managed by a professional money manager or by a management team (Fredman & Wiles, 1997)". "Mutual funds are institutions mobilizing resources from the small investors and these are institutional devices to bridge the gap between the supply and demand of capital in the market (Rao, 1998)".

The regulatory system in India centres on statutory provisions. "The Securities and Exchange Board of India (SEBI) is the highly powerful capital market regulator in the country". The emphasis is on correction through control. Further, "strong emphasis is laid on ex-post investigation and disciplining of mutual funds through financial penalties". Enough disclosure provisions also exist. So, the regulatory mechanism for mutual funds is quite strong in India (Sadhak, 2003).

11th September 2020 is a very important day for equity multi-cap funds in India. "The capital market regulator SEBI (Securities and Exchange Board of India) came out with a circular on that day for equity multi-cap funds. Before this circular, equity multi-cap funds can invest at least 65% of their corpus in equity and equity-related instruments". It implies that the fund managers had the liberty to invest in the stocks of large, medium and small companies according to their discretion after considering various factors. As per regulation, large companies are such listed companies in the stock exchanges which rank between 1 and 100 in terms of market capitalisation. Similarly, mid-size companies rank between 101 and 250 and the rank of small companies begins from 251. "The list containing the names of all such companies is available on the website of the Association of Mutual Funds in India (AMFI). But the SEBI circular on 11.09.2020 has brought about a sea change in the arena of equity multi-cap funds in India". Two noteworthy things in the circular are: (1) the minimum investment in equity and equity-related instruments has been raised from 65% to 75%, and (2) the introduction of the 25:25:25 formula for investing in large, medium and small companies.

II. OBJECTIVE OF THE STUDY

The study endeavours to examine the impact of SEBI Regulation dated 11th September 2020 on equity multi-cap funds in India.

III. DATA SOURCE AND METHODOLOGY

The study is exploratory and uses secondary data. The sources from where these secondary data have been collected include articles in periodicals and dailies, reports, web materials etc. Based on these data, the impact of the SEBI Regulation dated 11th September 2020 on equity multi-cap funds in India has been critically analysed.

IV. DISCUSSION

There are arguments and counter-arguments for this regulatory measure. According to the Regulator, the following incidents have necessitated this measure:

(1) Every mutual fund has a benchmark against which its performance is measured. But there is a mismatch between the scheme composition and the benchmark selection. Equity multi-cap funds are usually benchmarked against NIFTY 200 or NIFTY 500. But it was noticed that many such funds are tilted heavily towards large-cap companies and accordingly their benchmark should be NIFTY 50.

(2) It was observed that many equity multi-cap funds were not adequately diversified because of their heavy inclination toward large-cap stocks. Exposure to large-cap stocks was more than 80% in such funds. At the same time, exposure to small companies is negligible (<10%) in these funds. As such, there exists a lack of diversification.

(3) Some schemes ("HDFC Equity Fund and the Motilal Oswal Multi cap 35 fund") completely lacked diversification in the sense that the exposure of these schemes to large-cap companies was more than 85% with practically negligible investment in medium and small companies. Accordingly, the name of the scheme is not commensurate with the nature of its investment.

There are counter-arguments also from the Asset Management Companies (AMCs).

(1) NIFTY 500 should be an ideal benchmark for equity multi-cap funds. But a look at the composition of NIFTY 500 reveals that large-cap stocks accounted for around 78%, followed by midcap stocks (17%) and small-cap stocks (5%). As such, the AMCs were of the view that the SEBI logic of inappropriate benchmark selection was not proper.

(2) In the opinion of the fund houses, flexibility is most important for multi-cap funds. The flexibility of moving from one category of stocks (say small cap) to another category (say large-cap) may be beneficial for the investors in the long run in terms of wealth creation. Market condition, valuation of stocks and future outlook are the factors based on which the fund managers switch over from one category of stocks to another category. As such, diversification is not compromised.

(3) The fund houses assert that the difference in the fund name and the fund objective, as stated by the regulator, is not tenable. The focus should be on the flexible character of such funds and not on names.

The regulator has given the AMCs two options. These are:

(i) Merger of equity multi-cap funds with other funds like large-cap funds or large and midcap funds, and

(ii) Rebalancing the portfolio based on the 25:25:25 formula.

The deadline for complying with the SEBI circular was January 2021. According to experts, most AMCS would follow the first option because rebalancing the portfolio as per the SEBI formula is a herculean task that would also impact the risk-return profile of the funds. The funds may become riskier if the funds have to offload stocks of large companies and invest such funds in mid and small size companies. Investors have options like redemption of units, switching over to another category of fund, stopping SIP (Systematic Investment Plan) investment, waiting for the decision of the AMCs or remaining invested irrespective of the outcome. Investors were advised by the experts to go slow and follow the 'wait and watch strategy.

If the AMCs follow the guidelines mentioned in the circular, offloading of stocks of large companies will be inevitable for many equity multi-cap funds. As a result, there will be a significant drop in the stock price of those companies due to a huge outflow of funds. Conversely, stock prices of some medium and small companies (where the funds will invest) will witness a big surge because of the inflow of funds. As such, the short-term impact on the capital market is expected to be substantial. Judging the possibility of such impact and the concerns of many investors, fund houses and AMFI came out with the suggestion that a new category of fund with the nomenclature of 'Flexi-cap Fund' may be introduced. SEBI accepted that suggestion and notified the launch of the Flexi-cap category of mutual funds on 9th

November 2020. Such funds can invest at least 65% of their corpus in equity and equity-related instruments. Further, the regulator notified that there will be no minimum ceiling of investment across large-cap, mid-cap and small-cap stocks. It implies that the erstwhile flexibility of equity multi-cap funds has been shifted to equity Flexi-cap funds. Now, the fund managers can invest even 90% of the corpus in either large-cap, midcap or small-cap stocks in Flexi-cap funds. It is a welcome move by the regulator. AMCs not desirous of rebalancing their portfolio can simply take the conversion path and convert their multi-cap schemes to Flexi cap schemes. However, it is also argued that there is no need for such a move and without introducing a new category of fund (Flexi cap) the regulator should have changed the name of the existing category of fund (multi-cap).

The number of equity multi-cap funds reduced drastically after the regulatory circular of the SEBI. In December 2020, there were sixty-five (65) equity multi-cap funds. However, in January 2021, the number of equity multi-cap funds was reduced to ten (10) only. It clearly exhibits how the regulatory measure can have an enormous impact on the category of funds. Only two big equity multi-cap funds existed in January 2021. These were Nippon India Multi-Cap Fund and ICICI Pru Multi-cap Fund with AUM of more than Rs. 6,000 crore. These two funds still survived as of April 2022. Notable amongst the other survivors include Invesco India Multi-cap Fund, Quant Active Fund, Sundaram Multi-Cap Fund etc. One encouraging thing is that many fund houses launched schemes under the category of equity multi-cap funds even after this circular. These are “Aditya Birla Sun Life Multi-Cap Fund”, Kotak Multicap Fund, “IDFC Multi-Cap Fund”s, HDFC Multi-Cap Fund, Axis Multicap Fund and SBI Multicap Fund.
Table 1 shows the returns generated by the two big funds:

Table 1: Returns Generated by the Two Big Funds (%)

Fund	**1-year**		**3-year**		**5-year**		**10-year**	
	Jan 2021	**Mar 2022**	**Jan 2021**	**Mar 2022**	**Jan 2021**	**Mar 2022**	**Jan 2021**	**Mar 2022**
ICICI Pru Multi-cap Fund	9.2	23.2	4.5	14.2	11.5	11.6	11.6	15.3
Nippon India Multi Cap Fund	-1.6	34.4	-0.7	14.9	7.3	13.6	10.9	15.3

Source: valueresearchonline.com, Mutual Fund Insight (March, 2021) and Mutual Fund Insight (May, 2022)

It is evident from Table 1 that the funds performed better in March 2022 in comparison to January 2021. It implies that though the number of equity multi-cap funds reduced to a great extent the impact on fund performance is not adverse. Fund managers were successful in delivering fantastic returns even after following the 25:25:25 formula.
Table 2 reveals the AUM and expense ratio of the two big funds.

Table 2: AUM and Expense Ratio of the Two Big Funds

Fund	**AUM (Rs. Crore)**		**Expense Ratio (%)**	
	Dec 2020	**Feb 2022**	**Dec 2020**	**Feb 2022**
ICICI Pru Multi-cap Fund	6,095	6,255	1.11	1.07
Nippon India Multi Cap Fund	8,506	11,285	1.37	1.25

Source: valueresearchonline.com, Mutual Fund Insight (March, 2021) and Mutual Fund Insight (May, 2022)

A look at Table 2 shows that AUM has increased and the expense ratio has decreased in February 2022 in comparison to December 2020. Both are positive for the investors. Increased AUM implies that the confidence of the investor exists and the reduced expense ratio signifies more returns for the investors.

V. CONCLUSION

SEBI Circular dated 11.09.2020 relating to equity multi-cap funds had a big impact on all stakeholders. Investors were facing decision problems as to whether they should switch over to other funds or redeem the units or stay invested. AMCs presented their views and representations before the regulator. Paying attention to such representations, the regulator permitted AMCs to launch the Flexi Cap category of funds. Many AMCs decided to merge their existing equity multi-cap funds with other funds like large-cap funds or large and midcap funds. Others chose to change the name from equity multi-cap funds to equity Flexi Cap funds. However, some fund houses decided to follow the 25:25:25 formula set by the regulator and rebalanced their portfolio accordingly. Over time, it is observed that equity multi-cap funds generated good returns with increased AUM and decreased expense ratio. So the impact of the circular should not be treated as a negative one for equity multi-cap funds.

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