SEBI's New Rules on Liquid Funds

Why in news?

The Securities and Exchange Board of India (SEBI) proposed new rules related to liquid funds, in its recent Board meeting.

What is a liquid fund?

- **Liquid fund** is a category of mutual fund which invests primarily in money market instruments like certificate of deposits, treasury bills, commercial papers and term deposits.
- **Mutual Fund** (MF) is an investment vehicle made up of a pool of moneys collected from public investors.
- The pooled money is used to buy other securities by professional money managers.
- It gives small or individual investors access to professionally managed portfolios of equities, bonds and other securities.

What are the benefits of liquid funds?

- Liquid funds invest in securities with a residual maturity of up to 91 days.
- Liquid funds have the lowest interest rate risk among debt funds as they primarily invest in fixed income securities with short maturity.
- Lower maturity period of these underlying assets helps a fund manager in meeting the redemption demand from investors.
- Liquid funds do not have a lock-in period (period during which a loan cannot be paid-off earlier than scheduled without incurring penalties).
- So assets invested are not tied up for a long time.
- Withdrawals from liquid funds are processed within 24 hours on business days.

What are the new rules?

- The new rules come in light of the redemption risks faced by liquid schemes after the Infrastructure Leasing & Financial Services (IL&FS) crisis.
- **Valuation** - SEBI tightened the valuation methodology for liquid mutual

funds (MFs).
- SEBI's new rule requires debt funds to use the more transparent mark-to-market valuation rather than the amortisation method to value debt securities.
- [Amortisation is an accounting term that refers to the process of allocating the cost of an intangible asset over a period of time.
- Mark-to-market is an accounting practice that involves recording the value of an asset to reflect its current market levels.]
- **Open offer** - [An open offer can take place if any of the promoters of a company want to increase the stake or if non-promoters increase the stake to 15% or the company is going to de-list from the stock exchange.
- So open offer is nothing but the exit route given to the existing shareholders by the acquirer of shares, through a public announcement.
- The price is fixed based on the average price for the last 6 months and usually the price is higher than the prevailing market price.
- This works as a motivation to current shareholders to sell their shares.]
- Earlier, SEBI had the power to grant exemption from the obligation to make an open offer for acquiring shares.
- The target company shall file an application with the SEBI, giving details of the proposed acquisition and the grounds on which the exemption has been sought.
- SEBI has now done away with the open offer exemption given to those seeking to acquire assets of firms undergoing resolution plan under the Insolvency and Bankruptcy Code (IBC).
- It has restricted open offer exemptions to only scheduled commercial banks and financial institutions in debt restructuring cases.
- SEBI also said that only a court or a tribunal is allowed to provide any such exemptions.
- Open offer exemption already given to companies undergoing resolution plan under IBC will continue in supervision of the National Company Law Tribunal (NCLT).
- **Maturity** - All debt papers with maturity of 30 days or more (earlier 60-day maturity) has to be marked to market.
- This is to make sure that liquid schemes reflect the underlying portfolio risks.

What would the impact be?

- Liquid funds are a major source of short-term borrowings for Indian companies.
- If mutual funds now demand 30-day paper in place of 60-day or 90-day instruments, companies may be forced to roll over their debt more

frequently.

- Holding shorter-maturity papers means more transactions and more portfolio turnover.
- This along with the stamp duty will significantly increase the transaction costs for liquid schemes.
- The changes are thus likely to make managing liquid schemes a costly affair for MFs.
- Besides, the returns for liquid schemes could moderate as shorter-duration papers typically have lower yields.
- The move on open offer exemption would increase the cost of acquisition for those buying listed stressed firms.

Source: Business Standard, BusinessLine