Consultation Paper on permitting Mutual Funds and Portfolio Managers to participate in Commodity Derivatives Market

1. Objective:

1.1. The objective of the consultation paper is to seek comments / views from the public on the proposal of permitting Mutual Funds (MFs) and Portfolio Managers (PMs), who are authorized under an agreement to invest on behalf of their clients, for participation in exchange traded commodity derivatives and to determine an ideal regulatory framework for the proposal.

2. Background:

2.1. The Indian Commodity Derivatives Market has been running without any institutional participation thereby lacking the desired liquidity and depth, which is one of the key elements for the efficient price discovery and price risk management. In past, various committees have recommended for participation of institutional investors in the commodity derivatives markets, which would help in improving the quality of price discovery, thereby leading to better price risk management.

2.2. SEBI constituted an advisory committee known as Commodity Derivatives Advisory Committee (CDAC) to advise SEBI for effective regulation and development of the commodity derivatives market. CDAC has advised that the commodity derivatives market should be opened up to institutional participation i.e. both domestic as well as international in a phased manner.

2.3. Recently, SEBI has permitted Category-III Alternative Investment Funds (AIF), to participate in the Commodity Derivatives Market.

2.4. SEBI has also held series of meetings with various stakeholders to discuss the issues relating to participation by MFs and PMs in the Commodity Derivatives Market.

3. Commodities as an Asset Class:

3.1. Commodity derivatives provide a new asset class to the investors, thereby may benefit them with effective portfolio diversification. Adding commodities in the portfolio would typically increase some risk, but the overall risk adjusted return of the portfolio may improve.

3.2. Addition of commodities to a hybrid portfolio can lower the overall volatility of the portfolio, since historically returns from commodities have not been highly correlated with returns from equities and fixed income asset classes as highlighted in Table under Para '4.1' below.

3.3. A substantial number of investors (including retail investors) are not able to directly access the Commodity Derivatives Market due to lack of knowledge and expertise. MFs and PMs can act as conduits to commodities markets for such investors.

3.4. Taking into account the aforementioned benefits and based on the recommendations of CDAC and feedback received from various stakeholders, it may be considered to allow participation of Mutual Funds and Portfolio Managers in the Commodity Derivatives Market.

4. Correlation Matrix:

4.1. The Correlation Matrix between spot and future prices of various commodities for the period Jan, 2011 to Sep, 2017 is given as under:

Correlation Matrix (Jan 2011 to Sept 2017)								
	NIFTY Index	**i-COMDEX**	**Gold Spot**	**Crude Spot**	**Copper Spot**	**Gold Futures**	**Crude Futures**	**Copper Futures**
NIFTY Index	1							
iCOMDEX	-0.84	1						
Gold Spot	-0.27	0.3	1					
Crude Spot	-0.69	0.92	0.26	1				
Copper Spot	-0.53	0.82	0.32	0.81	1			
Gold Futures	-0.26	0.28	0.98	0.2	0.28	1		
Crude Futures	-0.7	0.92	0.27	1	0.81	0.2	1	
Copper Futures	-0.54	0.82	0.32	0.81	0.99	0.28	0.81	1

Source: Bloomberg

5. Mutual Funds

5.1. Introduction:

5.1.1. Mutual funds are investment vehicles which pool money from investors by issuing units to them and invest the money thus collected in asset classes and securities in accordance with the investment objectives as disclosed in scheme offer documents of various schemes. In India, MF schemes generally invest in equity or debt instruments of companies, govt. securities, money market instruments, etc.

5.1.2. In addition to the above, there are specific schemes such as Gold Exchange Traded Funds (ETFs) which invest in gold or gold related instruments (gold related instruments includes gold deposit scheme/ gold monetization scheme) and Gold Fund of Funds (FoF) schemes which invests mainly in units of Gold ETFs.

5.1.3. At present, except Gold ETFs there are no other category of mutual fund schemes having exposure to Commodities market.

5.1.4. Operation of MFs in India are being governed and regulated by SEBI (Mutual Funds) Regulations, 1996 and various circulars and guidelines issued there under from time to time.

5.2. Existing Provisions & Schemes:

5.2.1. Regulation 43(1) of SEBI (Mutual Funds) Regulations, 1996 allows a mutual fund to invest moneys collected under any of its schemes in various instruments including 'Securities' as defined under Securities Contracts (Regulation) Act 1956.

5.2.2. 'Derivatives' are already covered under 'Securities' definition as per Securities Contracts (Regulation) Act 1956 and definition of 'Derivatives' includes 'Commodity Derivatives'.

5.2.3. As per Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012, a Commodity Derivatives Exchange means a recognized stock exchange which assists, regulates or controls the business of buying, selling or dealing only in commodity derivatives.

5.2.4. Existing regulatory provisions applicable for mutual funds, allows mutual funds to launch only one kind of commodity mutual fund scheme i.e. Gold ETFs which invest in gold and gold related instruments. Gold related instruments include gold deposit scheme and gold monetization scheme.

There are few Gold Fund of Fund schemes investing only in units of Gold ETFs. Gold ETFs are required to invest at least 95% of the asset under management in gold and gold related instruments. As on 31st October, 2017 the total asset size of Gold ETF is around Rs. 5,017 cr. (i.e. around 0.23% of the total industry Asset under Management (AUM)) with 3,55,085 folios.

5.3. **Matters for consideration:**

5.3.1. Whether MFs can be permitted to participate in commodity derivatives?

5.3.2. What can be the appropriate route through which Mutual Funds may participate in commodity derivatives? In this respect, whether the following routes can be considered:

5.3.2.1. Through separate dedicated schemes (a new scheme) based on commodity derivatives:

5.3.2.1.1. ETFs based on Commodity Derivatives: Can dedicated ETFs be considered on certain commodities or a basket of commodities as permitted by SEBI from time to time?

5.3.2.1.2. Open-Ended Schemes (Passive/Active) based on Commodity Derivatives: Can open ended schemes be considered which intend to invest majority of the AUM in exchange traded commodity derivatives as permitted by SEBI from time to time? Such scheme could be launched either as an index fund or could be actively managed.

5.3.2.1.3. Commodity Arbitrage Funds: Can commodity arbitrage funds be considered, where the scheme intends to benefit from the arbitrage opportunity available between cash and derivatives market in commodities as permitted by SEBI from time to time?

5.3.2.1.4. Any other Category of Schemes.

5.3.2.2. Through investing part of the AUM (of the existing/ new schemes) in Commodity Derivatives:

5.3.2.2.1. Hybrid Schemes / Multi-Asset Scheme: Can MFs be permitted to invest certain percentage of the AUM of existing hybrid/ multi-asset schemes in commodity derivatives?

5.3.2.2.2. Gold ETFs: Can MFs, in case of existing Gold ETFs, be permitted to invest in exchange traded commodity derivatives with gold as underlying as part of gold related instruments to a certain extent?

5.3.2.2.3. Gold Fund of Fund (FoF) Schemes: Can MFs, in case of Gold Fund of Fund Schemes, be permitted to invest certain percentage of the AUM in Commodity Derivatives?

5.3.3. It may be noted that while investing in commodity derivatives, the cumulative gross exposure through equity, debt and derivative positions (including commodity derivatives) should not exceed 100% of the net assets of the scheme.

5.3.4. Whether there is a need for investment restrictions to be placed on MF schemes which invest only in commodity futures?

E.g. whether for portfolio diversification in a particular scheme, the MFs can be permitted to invest in exchange traded commodity derivatives, not more than ten percent of the net Asset under Management (AUM) of the scheme in one underlying commodity.

5.3.5. Any other concerns or suggestions relating to participation of MFs in exchange traded commodity derivatives.

6. Portfolio Managers

6.1. Introduction

6.1.1. Portfolio Managers provide a customized service of advising or managing the portfolio of securities or funds of their clients. Such services are provided pursuant to an agreement between the client and the Portfolio Manager, which governs the nature and scope of the services.

6.1.2. PMs provide the following services:

6.1.2.1. Discretionary Portfolio Management Services

6.1.2.2. Non-Discretionary Portfolio Management Services

6.1.2.3. Advisory Services

6.1.3. PMs are required to segregate the securities of all their clients availing Discretionary and Non-Discretionary Portfolio Management Services.

6.2. **Existing Provisions**

6.2.1. 'Derivatives' are already covered under definition of 'Securities' as per Securities Contracts (Regulation) Act 1956 and 'Commodity Derivatives' have been covered under the definition of 'Derivatives' vide Finance Act 2015.

6.2.2. Regulation 16(3) of SEBI (Portfolio Managers) Regulations, 1993 allows a Portfolio Manager to invest funds of clients in money market instruments or derivatives or as specified in the contract. However, SEBI, vide its circular dated September 27, 2016 in line with the stipulation by erstwhile FMC, stated that PMS would not be permissible in Commodity Derivatives Market.

6.3. **Proposal**

6.3.1. In view of the benefits that investing in commodity derivatives may provide, it is proposed to rationalize the SEBI (Portfolio Managers) Regulations, 1993 and SEBI Circulars to enable participation by PMs in Commodity Derivatives market. Further, during the deliberation with stakeholders, it was suggested that:

6.3.1.1. Leveraging of portfolio may be permitted in respect of investment in derivatives, which is presently not permitted.

6.3.1.2. Investing in high value commodity derivative contracts from individual clients' accounts can lead to concentration risk. Therefore, pooling of investments may be permitted in respect of transactions in exchange traded commodity derivatives, which is presently not permitted.

6.4. **Matters for consideration:**

6.4.1. Whether PMs can be permitted to participate in commodity derivatives market?

6.4.2. Whether PMs can be permitted to leverage the portfolio of their clients for investing in commodity derivatives? If yes, then:

6.4.2.1. What can be the optimum extent of leveraging?

6.4.2.2. What mechanisms can be put in place to safeguard the interests of clients?

6.4.2.3. What disclosures can be included in the Disclosure Document to adequately disclose the enhanced risk of portfolio leveraging?

6.4.3. Whether PMs can be permitted to pool the investments in commodity derivatives? If yes, then:

6.4.3.1. Who should maintain such pool?

6.4.3.2. What mechanisms can be put in place to safeguard the interests of clients?

6.4.3.3. What disclosures can be included in the Disclosure Document to adequately disclose the enhanced risk caused by pooling of commodity derivatives?

6.4.4. In case, portfolio leveraging and pooling of commodity derivatives is permitted, should the participation in Commodity Derivatives be restricted only to the clients beyond a certain threshold?

6.4.5. Any other concern / suggestion regarding participation of PMs in exchange traded commodity derivatives.

7. Public Comments:

7.1. Comments from public are invited on the proposal contained in this paper specifically as brought out under Para 5.3 and 6.4. The comments should reach SEBI latest by December 31, 2017.

The comments regarding **Mutual Funds** may be sent by email to mfcomments@sebi.gov.in and the comments regarding **Portfolio Manager**s may be sent to pms@sebi.gov.in.

7.2. Comments/ suggestions may kindly be provided in the format given below:

Name of the Entity/ Person:			
Sl. No.	Reference para of the consultation paper	Suggestions	Rational