



**CIRCULAR**

**SEBI/HO/IMD/DF2/CIR/P/2017/109**

**September 27, 2017**

**All Mutual Funds/ Asset Management Companies (AMCs)/  
Trustee Companies/ Boards of Trustees of Mutual Funds**

Sir/Madam,

**Sub: Review of norms for participation in derivatives by Mutual Funds**

1. Please refer to SEBI circulars No.MFD/CIR/15/19133/2002 dated September 30, 2002, No.SEBI/MFD/CIR No.03/158/03 dated June 10, 2003, No.DNPD/CIR-29/2005 dated September 14, 2005 and No.IMD/DF/11/2010 dated August 18, 2010 on investment in derivatives by mutual funds and disclosures thereof.
2. In order to enable mutual funds to hedge the debt portfolio from interest rate volatility, SEBI held a series of meetings with various stakeholders of the mutual fund industry. Accordingly, it has been decided to implement the following:

**Exposure Limits**

3. In addition to the existing provisions of SEBI circular No.IMD/DF/11/2010 dated August 18, 2010, the following are prescribed:
  - i. To reduce interest rate risk in a debt portfolio, mutual funds may hedge the portfolio or part of the portfolio (including one or more securities) on weighted average modified duration basis by using Interest Rate Futures (IRFs). The maximum extent of short position that may be taken in IRFs to hedge interest rate risk of the portfolio or part of the portfolio, is as per the formula given below:

$$\frac{(\text{Portfolio Modified Duration} * \text{Market Value of the Portfolio})}{(\text{Futures Modified Duration} * \text{Futures Price} / \text{PAR})}$$



- ii. In case the IRF used for hedging the interest rate risk has different underlying security(s) than the existing position being hedged, it would result in imperfect hedging.
- iii. Imperfect hedging using IRFs may be considered to be exempted from the gross exposure, upto maximum of 20% of the net assets of the scheme, subject to the following:
  - a) Exposure to IRFs is created **only for hedging** the interest rate risk based on the weighted average modified duration of the bond portfolio or part of the portfolio.
  - b) Mutual Funds are permitted to resort to imperfect hedging, without it being considered under the gross exposure limits, if and only if, the correlation between the portfolio or part of the portfolio (*excluding the hedged portions, if any*) and the IRF is atleast 0.9 at the time of initiation of hedge. In case of any subsequent deviation from the correlation criteria, the same may be rebalanced within 5 working days and if not rebalanced within the timeline, the derivative positions created for hedging shall be considered under the gross exposure computed in terms of Para 3 of SEBI circular dated August 18, 2010. The correlation should be calculated for a period of last 90 days.

*Explanation: If the fund manager intends to do imperfect hedging upto 15% of the portfolio using IRFs on weighted average modified duration basis, either of the following conditions need to be complied with:*

- i. The correlation for past 90 days between the portfolio and the IRF is at least 0.9 or*
- ii. The correlation for past 90 days between the part of the portfolio (excluding the hedged portions, if any) i.e. at least 15% of the net asset of the scheme (including one or more securities) and the IRF is at least 0.9.*
- c) At no point of time, the net modified duration of part of the portfolio being hedged should be negative.



- d) The portion of imperfect hedging in excess of 20% of the net assets of the scheme should be considered as creating exposure and shall be included in the computation of gross exposure in terms of Para 3 of SEBI circular dated August 18, 2010.
- iv. The basic characteristics of the scheme should not be affected by hedging the portfolio or part of the portfolio (including one or more securities) based on the weighted average modified duration.
- Explanation: In case of long term bond fund, after hedging the portfolio based on the modified duration of the portfolio, the net modified duration should not be less than the minimum modified duration of the portfolio as required to consider the fund as a long term bond fund.*
- v. The interest rate hedging of the portfolio should be in the interest of the investors.
4. Mutual Fund schemes may imperfectly hedge their portfolio or part of their portfolio using IRFs, subject to the following conditions:
- i. Prior to commencement of imperfect hedging, existing schemes shall comply with the provisions of Regulation 18 (15A) of SEBI (Mutual Funds) Regulations, 1996 and all unit holders shall be given a time-period of at least 30 days to exercise the option to exit at prevailing NAV without charging of exit load.

The risks associated with imperfect hedging shall be disclosed and explained by suitable numerical examples in the offer documents and also needs to be communicated to the investors through public notice or any other form of correspondence.

- ii. In case of new schemes, the risks associated with imperfect hedging shall be disclosed and explained by suitable numerical examples in the offer documents.

#### **Disclosure of Derivative Positions**

5. In addition to the existing provisions, the mutual funds shall also make the following disclosures:



- i. Separately disclose the hedging positions through IRF (both perfectly and imperfectly) in respective debt portfolios as per the format prescribed in para-13 of SEBI circular no.IMD/DF/11/2010 dated August 18, 2010,
- ii. Investment in interest rate derivatives (both IRS/IRF) shall also be disclosed in the monthly portfolio disclosure as per para-H of SEBI Circular No. CIR/IMD/DF/21/2012 dated September 13, 2012 and
- iii. Disclosure of the details of interest rate derivatives (both IRS/IRF) used for hedging along with debt and money market securities transacted on its website and also forwarded to AMFI as per para-B(3) of SEBI Circular No.Cir/IMD/DF/6/2012 dated February 28, 2012.

**Applicability**

6. The aforesaid circular stands modified to the said extent from the date of this circular and all other provisions of the above mentioned circulars remains unchanged.
7. This circular is issued in exercise of powers conferred under Section 11 (1) of the Securities and Exchange Board of India Act, 1992, read with the provisions of Regulation 77 of SEBI (Mutual Funds) Regulations, 1996, to protect the interests of investors in securities and to promote the development of, and to regulate the securities market.

Yours faithfully,

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