CIRCULAR

SEBI/HO/IMD/DF4/CIR/P/2019/102 September 24, 2019

All Mutual Funds/ Asset Management Companies (AMCs)/
Trustee Companies/ Boards of Trustees of Mutual Funds/
Association of Mutual Funds in India (AMFI)

Sir / Madam,

Sub: Valuation of money market and debt securities

1.0 **Review of existing provisions on valuation of money market and debt securities:**

1.1 SEBI vide various circulars prescribed the guidelines on valuation of money market and debt securities. In order to align these guidelines with best market practices and improve the robustness of valuation of these securities, the following has been decided:

1.1.1 <u>Definition of non-traded, thinly traded and traded money market / debt security:</u>

Reference: Point 3 under "Guidelines for valuation of securities for Mutual Funds" in SEBI Circular No. MFD/CIR/8/92/2000 dated September 18, 2000, Paragraphs 1 and 2 of SEBI Circular No. MFD/CIR No.14/442/2002 dated February 20, 2002

1.1.1.1 In line with the current industry practice, the present definition of traded and non-traded money market and debt securities needs to be updated.

Accordingly, traded and non-traded money market and debt securities shall be defined as follows:

a. A money market or debt security shall be considered as traded when, on the date of valuation, there are trades (in marketable lots) in that security on any recognized Stock Exchange or there are trades reported (in marketable lots) on the trade reporting platform of recognized stock exchanges or The Clearing Corporation of India Ltd. (CCIL). In this regard, the marketable lots shall be defined by AMFI, in consultation with SEBI.

b. A money market or debt security shall be considered as non-traded when, on the date of valuation, there are no trades (in marketable lots) in such security on any recognized Stock Exchange or no trades (in marketable lots) have been reported on any of the aforementioned trade reporting platforms.

1.1.1.2 As the valuation methodology for thinly traded debt securities is same as non-traded debt securities, a separate definition of thinly traded debt securities is not required and stands deleted as provided in aforementioned circular.

1.1.2 <u>Valuation of money market / debt securities, Government Securities, investments in short term deposits (pending deployment) and OTC derivatives:</u>

1.1.2.1 <u>Valuation of money market and debt securities with residual maturity of upto 30 days:</u>

Reference: Paragraph 2 (I) of SEBI Circular No. SEBI/IMD/CIR No.16/193388/2010 dated February 02, 2010 read with Paragraph B (2) of

SEBI Circular No. Cir/IMD/DF/6/2012 dated February 28, 2012 and Paragraph 1.0 of SEBI Circular No. SEBI/HO/IMD/DF4/CIR/P/2019/41 dated March 22, 2019

a. In partial modification to the aforesaid circulars, the following has been decided:

   i. Amortization based valuation is permitted for money market and debt securities including floating rate securities, with residual maturity of upto 30 days. Further, the amortized price shall be compared with the reference price which shall be the average of the security level price of such security as provided by the agency(ies) appointed by AMFI for said purpose (hereinafter referred to as "valuation agencies"). The amortized price shall be used for valuation only if it is within a threshold of ±0.025% of the reference price. In case of deviation beyond this threshold, the price shall be adjusted to bring it within the threshold of ±0.025% of the reference price.

   ii. In case security level prices given by valuation agencies are not available for a new security (which is currently not held by any Mutual Fund), then such security may be valued on amortization basis on the date of allotment / purchase.

   iii. Further, with effect from April 01, 2020 onwards, amortization based valuation shall be dispensed with and irrespective of residual maturity, all money market and debt securities shall be valued in terms of paragraph 1.1.2.2 below.

1.1.2.2 Valuation of money market and debt securities with residual maturity of over 30 days:

Reference: Paragraph 2 (II) of SEBI Circular No. SEBI/IMD/CIR No.16/193388/2010 dated February 02, 2010 read with Paragraph B (2) of SEBI Circular No. Cir/IMD/DF/6/2012 dated February 28, 2012 and Paragraph 1.0 of SEBI Circular No. SEBI/HO/IMD/DF4/CIR/P/2019/41 dated March 22, 2019

a. In partial modification to the aforesaid circulars, the following has been decided:

   i. All money market and debt securities including floating rate securities, with residual maturity of over 30 days shall be valued at average of security level prices obtained from valuation agencies.

   ii. In case security level prices given by valuation agencies are not available for a new security (which is currently not held by any Mutual Fund), then such security may be valued at purchase yield on the date of allotment / purchase.

1.1.2.3 Valuation of Government Securities:

Reference: Paragraph 6 of SEBI Circular No. MFD/CIR No.14/442/2002 dated February 20, 2002

a. It is clarified that irrespective of the residual maturity, Government Securities (including T-bills) shall be valued on the basis of security level prices obtained from valuation agencies.

1.1.2.4 Valuation of other money market / debt securities, short-term deposits with banks (pending deployment) and OTC derivatives:

a. The valuation of bills purchased under rediscounting scheme shall be as per the guidelines mentioned for valuation of money market instruments, at paragraphs 1.1.2.1 and 1.1.2.2, as the case may be.

b. Investments in short-term deposits with banks (pending deployment) and repurchase (repo) transactions (including tri-party repo i.e. TREPS) with tenor of upto 30 days, shall be valued on cost plus accrual basis.

c. In order to have uniformity in valuation methodology, prices for all OTC derivatives and market linked debentures shall be obtained from valuation agencies.

1.1.3 Valuation of securities with Put / Call Options:

Reference: Provisions for “Valuation of securities with Put / Call options” in SEBI Circular No. MFD/CIR/ 8 / 92 / 2000 dated September 18, 2000

1.1.3.1 The existing provisions for valuation of securities with call option and securities with put option remain the same. However, in partial modification to the provision on valuation of securities with both put and call options in the aforementioned circular, it has been decided that:

a. Only securities with put / call options on the same day and having the same put and call option price, shall be deemed to mature on such put / call date and shall be valued accordingly. In all other cases, the cash flow of each put / call option shall be evaluated and the security shall be valued on the following basis:

i. Identify a ‘Put Trigger Date’, a date on which ‘price to put option’ is the highest when compared with price to other put options and maturity price.

ii. Identify a ‘Call Trigger Date’, a date on which ‘price to call option’ is the lowest when compared with price to other call options and maturity price.

iii. In case no Put Trigger Date or Call Trigger Date (‘Trigger Date”) is available, then valuation would be done to maturity price. In case one Trigger Date is available, then valuation would be done as to the said Trigger Date. In case both Trigger Dates are available, then valuation would be done to the earliest date.

1.1.3.2 If a put option is not exercised by a Mutual Fund when exercising such put option would have been in favour of the scheme, in such cases the justification for not exercising the put option shall be provided to the Board of AMC and Trustees.

1.1.4 <u>Deletion of various provisions:</u>

1.1.4.1 Considering that valuation has evolved from a matrix based approach to security level pricing, the following provisions in existing circulars stand deleted:

a. The phrase “The approach in valuation of non traded ……. account for illiquidity risk” under point no. (ii) (b) contained in “Guidelines for valuation of securities for Mutual Funds” in SEBI Circular No. MFD/CIR/ 8 / 92 / 2000 dated September 18, 2000

b. Paragraphs 3, 4 and 5 of SEBI Circular No. MFD/CIR No.14/442/2002 dated February 20, 2002

c. Paragraph 2 (V) of SEBI Circular No. SEBI/IMD/CIR No.16/193388/2010 dated February 02, 2010

2.0 **Waterfall approach for valuation of money market and debt securities:**

It is decided that for arriving at security level pricing, a waterfall approach shall be followed for the valuation of money market and debt securities.

2.1 AMFI shall ensure that valuation agencies have a documented waterfall approach for valuation of money market and debt securities. The said waterfall approach shall be documented in consultation with SEBI.

2.2 The following broad principles should be adopted as part of the aforesaid waterfall approach, for arriving at the security level prices:

2.2.1 All traded securities shall be valued on the basis of traded yields, subject to identification of outlier trades by the valuation agencies.

2.2.2 Volume Weighted Average Yield (VWAY) for trades in the last one hour of trading shall be used as the basis for valuation of Government Securities (including T-bills). Valuation of all other money market and debt securities (including Government securities not traded in last one hour) shall be done on the basis of VWAY of all trades during the day.

2.2.3 An indicative list of exceptional events shall form part of the documented waterfall approach mentioned above. In case of any exceptional events on a day, only VWAY of trades post such event may be considered for valuation. Further, all exceptional events along-with valuation carried out on such dates shall be documented with adequate justification.

2.2.4 All trades on stock exchanges and trades reported on trade reporting platforms till end of the trade reporting time (excluding Inter-scheme transfers), should be considered for valuation on that day. Towards this end, the timing for disclosure of Net Asset Value (NAV) on website of respective AMCs and AMFI, stands extended as per paragraph 3.0 below.

2.2.5 Considering the importance of polling in the valuation process, guidelines shall be issued by AMFI on polling by valuation agencies and on the responsibilities of Mutual Funds in the polling process, as part of the aforesaid waterfall approach. These guidelines shall *inter-alia* include the following:

2.2.5.1 Valuation agencies shall identify the Mutual Funds who shall participate in the polling process on a particular day, taking into account factors such as diversification of poll submitters and portfolio holding of the Mutual Funds. Mutual Funds who are identified by the valuation agencies shall necessarily participate in the polling process. However, in case any Mutual Fund does not participate in the polling process, detailed reason for the same shall be recorded and made available during SEBI inspections.

2.2.5.2 The minimum number of polls to be considered for valuation along-with the operational modalities of polling, shall be specified.

2.2.5.3 AMCs shall have a written policy, approved by the Board of AMC and Trustees, on governance of the polling process. The aforesaid policy shall include measures for mitigation of potential conflicts of interest in the polling process and shall identify senior officials responsible for polling.

2.2.5.4 AMCs shall ensure that participation in the polling process is not mis-used to inappropriately influence the valuation of securities. The officials of the AMC who are responsible for polling in terms of paragraph 2.2.5.3 above, shall also be personally liable for any mis-use of the polling process.

2.2.5.5 AMCs shall maintain an audit trail for all polls submitted to valuation agencies.

2.3 The aforesaid waterfall approach shall form part of the valuation policy of individual AMCs which is uploaded on their respective websites. AMFI shall ensure that the said waterfall approach is also available on the website of the valuation agencies.

3.0 **Extension of time for disclosure of NAV:**

Reference: SEBI Circular No. SEBI/IMD/CIR No. 5/63714/06 dated March 29, 2006

3.1 In order to enable consideration of all trades during a day for valuation, it has been decided to extend the present timeline upto 11:00 p.m. for uploading the NAVs of all schemes (except Fund of Fund schemes) on the website of AMFI and respective AMCs.

4.0 **Deviation from valuation guidelines:**

4.1 As per the Principles of Fair Valuation specified in Eighth Schedule of SEBI (Mutual Funds) Regulations, 1996, AMCs are responsible for true and fairness of valuation and correct NAV. Considering the same, in case an AMC decides to deviate from the valuation price given by the valuation agencies, the detailed rationale for each instance of deviation shall be recorded by the AMC.

4.2 The rationale for deviation along-with details such as information about the security (ISIN, issuer name, rating etc.), price at which the security was valued vis-a-vis the price as per the valuation agencies and the impact of such deviation on scheme NAV (in amount and percentage terms) shall be reported to the Board of AMC and Trustees.

4.3 The rationale for deviation along-with details as mentioned under paragraph 4.2 above shall be disclosed immediately and prominently, under a separate head on the website of AMC.

4.4 Further, while disclosing the total number of instances of deviation in the monthly and half-yearly portfolio statements, AMCs shall also provide the exact link to their website for accessing the information mentioned at paragraph 4.3.

5.0 **Valuation of money market and debt securities rated below investment grade:**

Reference: Paragraph 2.0 of SEBI Circular No. SEBI/HO/IMD/DF4/ CIR/P/2019/41 dated March 22, 2019 on valuation of money market and debt securities rated below investment grade

5.1 In order to ensure uniformity in classification of securities as below investment grade or default and in the treatment of accrual of interest & future recovery (if any) with respect to such securities, the following has been decided:

5.1.1 <u>Definition of below investment grade and default:</u>

5.1.1.1 A money market or debt security shall be classified as “below investment grade” if the long term rating of the security issued by a SEBI registered Credit Rating Agency (CRA) is below BBB- or if the short term rating of the security is below A3.

5.1.1.2 A money market or debt security shall be classified as “Default” if the interest and / or principal amount has not been received, on the day such amount was due or when such security has been downgraded to “Default” grade by a CRA. In this respect, Mutual Funds shall promptly inform to the valuation agencies and the CRAs, any instance of non-receipt of payment of interest and / or principal amount (part or full) in any security.

5.1.2 Treatment of accrued interest, future interest accrual and future recovery:

5.1.2.1 The treatment of accrued interest and future accrual of interest, in case of money market and debt securities classified as below investment grade or default, is detailed below:

a. The indicative haircut that has been applied to the principal should be applied to any accrued interest.

b. In case of securities classified as below investment grade but not default, interest accrual may continue with the same haircut applied to the principal. In case of securities classified as default, no further interest accrual shall be made.

5.1.2.2 The following shall be the treatment of how any future recovery should be accounted for in terms of principal or interest:

a. Any recovery shall first be adjusted against the outstanding interest recognized in the NAV and any balance shall be adjusted against the value of principal recognized in the NAV.

b. Any recovery in excess of the carried value (i.e. the value recognized in NAV) should then be applied first towards amount of interest written off and then towards amount of principal written off.

6.0 **Review of provisions referring to Non-Performing Assets:**

6.1 Considering that as per the Principles of Fair Valuation, valuation has to be reflective of the realizable price, the concept of Non-Performing Assets (NPAs) may not be relevant for the Mutual Fund industry. It has thus been decided to appropriately modify all regulatory provisions referencing NPAs. Accordingly, the following modifications are made to extant SEBI circulars:

6.1.1 The guidelines for identification and provisioning for Non-Performing Assets (Debt securities) for Mutual Funds in terms of SEBI Circular No. MFD/CIR/8 /92/2000 dated September 18, 2000 and SEBI Circular No. MFD/CIR/14/088/2001 dated March 28, 2001 stand deleted.

6.1.2 The term “NPA” as per SEBI Circular No. MFD/CIR/6/73/2000 dated July 27, 2000 shall be replaced with “securities classified as below investment grade or default”. Further, the term “NPA” as per SEBI Circular No. SEBI/MFD/CIR No.05/12031/03 dated June 23, 2003 shall be replaced with “exposure to securities classified as below investment grade or default”.

6.1.3 Paragraph 2 of SEBI Circular No. MFD/CIR/05/432/2002 dated June 20, 2002 shall be modified as follows:

Treatment and disposal of illiquid securities or securities classified as default at the time of maturity / closure of schemes

In case of close-ended schemes, some of the investments made by Mutual Funds may become default at the time of maturity of schemes. Further, at the time of winding up of a scheme, some of the investments made by Mutual Funds may become default or illiquid. In due course of time i.e. after the maturity or winding up of the schemes, such investments may be realised by the Mutual Funds. It is advised to distribute such amount, if it is substantial, to the concerned investors. In case the amount is not substantial, *it may be used for the purpose of investor education. The decision as to the determination of substantial amount shall be taken by the Trustees of Mutual Funds after considering the relevant factors including number of investors, amount recovered, cost of transferring funds to investors; among others.*

6.1.4 In the format of the abridged scheme-wise annual report format prescribed vide SEBI Circular No. SEBI/IMD/CIR No.8/132968/2008 dated July 24, 2008, under notes to accounts, the term "NPA" shall be replaced with "securities classified as below investment grade or default".

6.1.5 With respect to the notes below the portfolio format prescribed vide SEBI Circular No. MFD/CIR/9/120/2000 dated November 24, 2000, the modifications shall be as under:

a. In point 2, the term "NPA" shall be replaced with "below investment grade or default".

b. Point 4 (a) shall be replaced as follows:

If a security is in default beyond its maturity date, then disclosure to this effect shall be provided. Such disclosure shall include details of the security including ISIN, name of security, value of the security considered under net receivables (i.e. value recognized in NAV in absolute terms and as % to NAV) and total amount (including principal and interest) that is due to the scheme on that investment. Further, this disclosure shall continue till the value of the security recognized in the NAV is received or for a period of 3 years from the date of maturity of security, whichever is later.

7.0 **Use of own trade for valuation:**

7.1 Various instances have come to notice wherein Mutual Funds have used their own trades of relatively small quantity in order to value the entire holding of such security.

7.2 In order to address possible mis-use as mentioned above, Mutual Funds shall not use their own trades for valuation of debt and money market securities and for Inter-scheme transfers.

8.0 **Inter-scheme transfers (IST):**

8.1 With respect to Inter-scheme transfers, it has been decided that:

8.1.1 AMCs shall seek prices for IST of any money market or debt security (irrespective of maturity), from the valuation agencies.

8.1.2 AMFI, in consultation with valuation agencies shall decide a turn-around-time (TAT), within which IST prices shall be provided by the agencies.

8.1.3 If prices from the valuation agencies are received within the pre-agreed TAT, an average of the prices so received shall be used for IST pricing.

8.1.4 If price from only one valuation agency is received within the agreed TAT, that price may be used for IST pricing.

8.1.5 If prices are not received from any of the valuation agencies within the agreed TAT, AMCs may determine the price for the IST, in accordance with Clause 3 (a) of Seventh Schedule of SEBI (Mutual Funds) Regulations, 1996.

9.0 **Changes in terms of investment:**

9.1 While making any change to terms of an investment, Mutual Funds shall adhere to the following conditions:

9.1.1 Any changes to the terms of investment, which may have an impact on valuation, shall be reported to the valuation agencies immediately.

9.1.2 Any extension in the maturity of a money market or debt security shall result in the security being treated as “Default”, for the purpose of valuation.

9.1.3 If the maturity date of a money market or debt security is shortened and then subsequently extended, the security shall be treated as “Default” for the purpose of valuation.

9.1.4 Any put option inserted subsequent to the issuance of the security shall not be considered for the purpose of valuation and original terms of the issue will be considered for valuation.

10.0 **Valuation and disclosure of upfront fees:**

10.1 Guidelines for valuation of any upfront fee (or any other consideration, by whatever name called) received in a Mutual Fund scheme, shall be issued by AMFI, in consultation with SEBI.

11.0 **Guidelines for investments in partly paid debentures**

11.1 Guidelines for investment by Mutual Funds in partly paid debentures shall be issued by AMFI, in consultation with SEBI.

12.0 **Guidelines to be issued by AMFI:**

12.1 The guidelines to be issued by AMFI, in consultation with SEBI under paragraphs 1.1.1.1.a, 2.1, 10 & 11 above shall necessarily be followed by all

Mutual Funds / AMCs. Any future changes to these guidelines shall be made by AMFI in consultation with SEBI, prior to implementation.

12.2 Further, AMFI shall submit the aforementioned guidelines to SEBI, within 15 days from date of issuance of this circular.

13.0 **Applicability:**

13.1 Paragraphs 1 (other than para 1.1.2.4 (c) and 1.1.3), 3, 4, 5, 6, 7, and 9 shall be applicable with immediate effect.

13.2 Paragraphs 1.1.2.4 (c), 1.1.3 and 8 shall be applicable within 90 days of issuance of this circular.

14.0 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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