

SEBI's Revised Categorization and Rationalization of Mutual Fund Schemes

INTRODUCTION

The Securities and Exchange Board of India (SEBI) has significantly overhauled the framework for classification of mutual fund schemes through its circular on “Categorization and rationalization of mutual fund schemes” dated February 26, 2026 (“February 2026 Circular”). The February 2026 Circular modifies Clause 2.6 of Chapter 2 of the Master Circular for Mutual Funds dated June 27, 2024 (“MF Master Circular”) and updates several related provisions. Together, these changes reshape how schemes are categorised, how their portfolios are constructed, and how overlaps and residual portions are handled.

Until SEBI issued the February 2026 Circular, the MF Master Circular broadly classified mutual fund schemes into five buckets:

- Equity Schemes
- Debt Schemes
- Hybrid Schemes
- Solution Oriented Schemes
- Other Schemes

The above classification of mutual fund schemes has been modified through the February 2026 Circular, as follows:

- Equity Scheme – schemes predominantly investing in equity and equity-related instruments
- Debt Scheme – schemes predominantly investing in debt and debt-related instruments
- Hybrid Scheme – schemes investing in a mix of asset classes, i.e., equity, debt, infrastructure investment trusts (InvITs) and commodities-related instruments, as permitted by SEBI
- Life Cycle Funds – a new, separate category; and
- Other Schemes – including fund-of-funds schemes and passive schemes such as index funds and exchange traded funds (ETFs)

The February 2026 Circular retains the idea of broad buckets but refines them and clarifies definitions by defining what “equity” and “debt” schemes predominantly invest in and a structural change, by introducing Life Cycle Funds as a distinct category and pruning away the old “Solution Oriented Schemes” category. The changes brought about by the February 2026 Circular is explored in detail below.

EQUITY SCHEMES

Under the MF Master Circular, equity schemes included multiple sub-categories such as dividend yield funds, value funds, contra funds, focused funds and sectoral/thematic funds. Key features relevant here included:

- Dividend Yield Fund:
 - Required to predominantly invest in dividend-yielding stocks; and
 - Minimum 65% of total assets in equity.

- Value Fund:
 - Required to follow a value investment strategy; and
 - Minimum 65% of total assets in equity and equity-related instruments.
- Contra Fund:
 - Required to follow a contrarian investment strategy; and
 - Minimum 65% in equity and equity-related instruments.
- Focused Fund:
 - Focused on a limited number of stocks (maximum 30); and
 - Minimum 65% in equity and equity-related instruments.
- Sectoral/Thematic Funds:
 - Categorised jointly under a single entry “Sectoral/Thematic”; and
 - Minimum 80% of total assets in equity and equity-related instruments of a particular sector or theme.
 - There were no specific provisions dealing with the residual portion in equity schemes or detailed rules on portfolio overlap among similar equity schemes.

The February 2026 Circular tightens the minimum equity allocation for certain equity categories and prescribes the following:

- Dividend Yield Funds must now invest at least 80% of total assets in equity;
- Value Funds must now invest at least 80% of total assets in equity and equity-related instruments; and
- Contra Funds must now invest at least 80% of total assets in equity and equity-related instruments.
- Focused Funds similarly see the minimum equity and equity-related instruments limit increased to 80% of total assets, while continuing to be restricted to a maximum of 30 stocks.

SECTORAL AND THEMATIC FUNDS

Previously, sectoral and thematic funds were clubbed together in a single category. Under the revised framework, Sectoral Funds and Thematic Funds are now treated as separate scheme types. Going forward, mutual funds must launch sectoral and thematic funds in conformity with a list of sectors and themes that will be published and updated by the Association of Mutual Funds in India (AMFI) in consultation with SEBI on a half-yearly basis. This standardises the available sectors/themes and is intended to reduce arbitrary or overlapping scheme offerings. Further, the 80% rule continues to be in force and Sectoral Funds and Thematic Funds are required to have a minimum of 80% of their total assets in equity and equity-related instruments of the relevant sector or theme. SEBI has clarified in the February 2026 Circular that a theme may be a combination of two or more sectors, giving AMCs flexibility to design broader thematic mandates (such as “consumption” or “financialization of savings”) while remaining within the regulatory framework.

Portfolio overlap limits for sectoral/thematic equity schemes:

- The February 2026 Circular introduces detailed portfolio overlap requirements for sectoral and thematic equity schemes. Specifically, for any scheme offered in the sectoral/thematic equity category, AMCs must ensure that no more than 50% of the scheme’s portfolio overlaps with:
 - other equity schemes in the sectoral/thematic category; and
 - other equity scheme categories (except for large cap schemes).

- The overlap condition is to be computed on a quarterly basis using daily portfolio overlap values – i.e., by averaging daily overlap over a quarter, in line with a detailed methodology set out in Annexure A to the February 2026 Circular.
- Existing sectoral and thematic schemes are given a glide path to align with the new portfolio overlap limits. Compliance must be achieved within three years from the date of the circular. Schemes that are unable to meet the portfolio overlap criteria within this period will be mandatorily merged with other schemes in accordance with applicable provisions. To realign portfolio overlaps, mutual funds may adopt the following glide path for reducing excess overlap over the three-year period:
 - Year 1: Reduce at least 35% of the excess overlap;
 - Year 2: Reduce an additional 35% of the excess overlap; and
 - Year 3: Eliminate the remaining 30%.

VALUE AND CONTRA FUNDS

Earlier, mutual funds were permitted to offer either a value fund or a contra fund, but not both. The February 2026 Circular now allows mutual funds to offer both, subject to the condition that the portfolio overlap between the two schemes must not exceed 50%. This creates space for AMCs to offer two distinct styles (value and contrarian) but requires that the portfolios are genuinely differentiated rather than simply rebranded variants of each other.

DEBT SCHEMES

Debt schemes were earlier categorised based on duration, credit risk and other criteria. However, there was no category of sectoral debt funds under the MF Master Circular. There also wasn't any explicit rule to deal with how the residual portion of debt schemes could be invested, apart from general investment and exposure limits.

The February 2026 Circular introduces a new sub-category under debt schemes, namely the Sectoral Debt Fund. Key features include:

- The scheme is an open-ended debt scheme investing in a specific sector (which must be clearly mentioned in the scheme name and documents);
- Minimum 80% of total assets must be invested in debt and debt-related instruments of a particular sector across duration;
- Eligible instruments include only AA+ and above rated corporate bonds of the relevant sector;
- Sectoral debt funds may be launched only in specified sectors such as Financial Services, Energy, Infrastructure, Housing, and Real Estate (as expressly identified in the circular); and
- Sectoral exposure limits of 20% of net assets that normally apply to debt schemes under the MF Master Circular do not apply to these sectoral debt funds.
- Before launching such a scheme, the AMC must ensure that there is sufficient availability of investment-grade paper in the market for the sector in question. This practical requirement is meant to prevent illiquid or overly concentrated portfolios.

HYBRID SCHEMES

Mutual funds were permitted to offer either an aggressive hybrid fund or a balanced fund, but not both. After the February 2026 Circular, the requirement for an arbitrage fund to be an open-ended scheme investing in arbitrage opportunities and maintaining at least 65% in equity and equity-related instruments, continues. However, SEBI has now added two important restrictions:

- No investment in InvITs is permitted for arbitrage funds; and
- Exposure to debt instruments is restricted to:
 - Government securities with maturity of less than one year; and
 - Repos in government bonds only.
 - These conditions are aimed at ensuring that arbitrage funds remain true to their low-risk, market-neutral character and do not take on additional credit or duration risk through corporate bonds or InvITs.

With regards to Aggressive Hybrid and Balanced Funds, the earlier restriction that a mutual fund could offer either an aggressive hybrid fund or a balanced fund (but not both) has been removed. Now, AMCs are free to offer both scheme types, subject to their ability to differentiate portfolios and comply with other categorisation and overlap rules.

SOLUTION-ORIENTED SCHEMES

Previously, Solution Oriented Schemes were a separately recognised category, consisting mainly of:

- Retirement Fund – with a lock-in of five years or until retirement age, whichever is earlier; and
- Children’s Fund – with a lock-in of five years or until the child attains majority, whichever is earlier.

The February 2026 Circular discontinues the solution-oriented scheme category with effect from the date of the circular. As a result:

- Existing schemes in this category must stop all subscriptions immediately; and
- Such schemes must be merged with other schemes having similar asset allocation and risk profiles, subject to SEBI’s prior approval.

LIFE CYCLE FUNDS

Life Cycle Funds is a new sub-category introduced by SEBI in the February 2026 Circular with the following main features:

- They shall follow a glide path strategy that involves investing across various asset classes, such as equity, debt, InvITs, exchange-traded commodity derivatives (ETCDs), and Gold & Silver ETFs;
- They shall be Open-ended funds with attributes of a pre-determined maturity and a pre-defined glide path for goal-based investing; and
- They shall comply with detailed structural features outlined in Annexure B of the February 2026 Circular.

Life cycle funds are intended to provide investors with a more transparent, rule-based path for investing towards long-term goals (such as retirement or education) without being shoehorned into a “solution-oriented” label. The focus shifts from the label (retirement/children) to the underlying glide path and asset allocation.

FUND OF FUNDS AND PASSIVE SCHEMES

For fund-of-funds (FoFs) with multiple underlying funds, SEBI had issued a separate framework by way of a circular dated June 30, 2025. The February 2026 Circular integrates this framework into the MF Master Circular by merging it into a modified Clause 6.2.

In practice, this means that requirements relating to FoFs with multiple underlying schemes now sit within the main regulatory text on categorisation and product design; and FoFs and passive schemes (such as index funds and ETFs) are now expressly recognised under the broad heading of “Other Schemes”. For AMCs and distributors, this simplifies compliance and communication by consolidating all relevant rules into a single, harmonised framework.

NEW DISCLOSURE REQUIREMENTS

Under the earlier MF Master Circular, there was no specific requirement to disclose portfolio overlap levels between schemes in a systematic, category-wise manner. The February 2026 Circular introduces a new disclosure requirement obligating mutual funds to publish category-wise portfolio overlap levels, including:

- Equity schemes vs. other equity schemes;
- Debt schemes vs. other debt schemes; and
- Hybrid schemes vs. other hybrid schemes.

These disclosures must be made on the AMC’s website for investor communication on a monthly basis, using the detailed methodology provided in Annexure A. This is designed to help investors and distributors understand how differentiated a scheme really is within the fund house’s product suite and to discourage over-proliferation of similar products.

INVESTMENT OF “RESIDUAL PORTION”

Prior to the February 2026 Circular, the MF Master Circular did not specifically define “residual portion” of a scheme’s assets. As a result, there was some flexibility in how AMCs invested the balance of a scheme’s corpus outside the core mandated asset allocation.

The February 2026 circular explicitly defines the term. The “residual portion” refers to the part of a scheme’s corpus that is not invested in its main, core asset classes, as set out in the scheme’s defined characteristics (for example, the minimum percentage that must be invested in equity, debt, or a particular sector/theme).

SEBI now also prescribes what this residual portion can be invested in for each major category (e.g., equity and debt schemes), thereby tightening the link between the stated scheme category and its actual portfolio.

- Equity schemes: Mutual funds may now invest the residual portion (i.e., assets not covered by the minimum equity allocations) in the following:
 - Equity;
 - Money market instruments and other liquid instruments;
 - Gold and silver instruments, as permitted by SEBI; and
 - InvTs, subject to applicable ceilings under mutual fund regulations.
- Debt schemes: mutual funds may invest the residual portion of debt category ultra-short schemes in InvTs, subject to regulatory ceilings. This flexibility does not apply to the following debt categories:
 - Overnight Fund;
 - Liquid Fund;
 - Duration Fund;
 - Low Duration Fund; and
 - Money Market Fund.

This gives ultra-short duration schemes some flexibility to diversify into InvITs, while preserving the conservative nature of very short-term and high-liquidity categories such as overnight and liquid funds.

ELP Comments

- *AMCs must reassess their existing equity, debt, hybrid, solution-oriented and FoF offerings to ensure compliance with new categorisation, overlap limits and residual portion rules. Some schemes may need re-positioning, changes in mandates, or mergers. Existing sectoral, thematic, value, contra, focused, arbitrage, equity savings and debt schemes may require recalibration of asset allocation to meet new minimum equity/debt thresholds and instrument restrictions. Ongoing monitoring of portfolio overlap (especially for sectoral/thematic and value/contra schemes) and residual allocations becomes critical. Systems must be capable of computing daily overlaps and generating quarterly and monthly disclosures. AMCs must update Scheme Information Documents, Key Information Memoranda, and websites to reflect new categories, investment limits, residual allocation policies and overlap disclosures. Clear investor communication around mergers (particularly of solution-oriented schemes) is essential.*
- *Distributors will need to re-map their recommended lists to the new categories, especially with the discontinuation of solution-oriented schemes and introduction of life cycle funds and sectoral debt funds. Overlap disclosures and overlap caps make it easier to distinguish genuinely differentiated products from near-duplicates, aiding in suitable recommendations. Advisors will need to re-assess client portfolios where retired or children's funds are being merged and ensure that the resultant schemes remain suitable in terms of risk, time horizon and tax implications.*
- *Higher minimum equity thresholds and clearer definitions of residual portions will make it easier for investors to understand the risk–return characteristics of specialised equity and hybrid schemes. Portfolio overlap limits and mandatory disclosures will help investors see whether multiple schemes in their portfolio are genuinely diversified or significantly overlapping. Investors in retirement or children's funds should carefully review communications from fund houses about mergers, understand the new scheme characteristics, and, where necessary, consult advisors regarding continued suitability. Life cycle funds offer a more structured, glide-path based option for long-term goals, potentially simplifying asset allocation decisions.*
- *SEBI's February 26, 2026 circular marks an important evolution in mutual fund categorisation in India. Moving beyond broad labels, the regulator is insisting on tighter alignment between scheme names, categories, asset allocation and portfolio construction. By defining residual portions, tightening minimum exposures, introducing sectoral debt funds and life cycle funds, and mandating portfolio overlap disclosures, SEBI aims to make the mutual fund landscape more transparent, comparable and investor-friendly.*
- *For AMCs, distributors and investors alike, the key takeaway is that scheme categorisation is no longer a mere formality. It now carries concrete requirements on where and how funds can invest, how distinct similar-sounding products must be, and how clearly these features must be communicated. Understanding these changes is essential to navigating the mutual fund space effectively in the post-2026 regulatory environment.*

SEBI's circular on "Categorization and rationalization of mutual fund schemes" dated February 26, 2026 can be found here: https://www.sebi.gov.in/legal/circulars/feb-2026/categorization-and-rationalization-of-mutual-fund-schemes_99983.html

We hope you have found this information useful. For any queries/clarifications, please write to us at insights@elp-in.com or write to our author:

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