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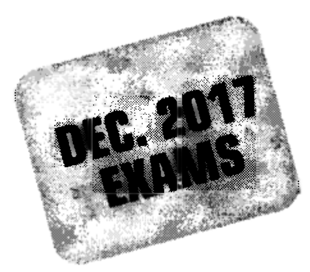

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PREFACE TO SECOND EDITION

I am indeed gratified by the students, teachers and institutions response to my First Edition. It is a pride and pleasure that I place second Edition of my book "Capital Markets & Securities Laws".

The Capital Market & Securities Laws is one of the most important subject for the CS Executive Students. Securities Laws is inherently complicated and is subject to constant refinement through new primary Legislations, Rules and Regulations made thereunder. Security law reforms are an ongoing and continuous process and the Government has been introducing new laws and amending the existing ones in response to the emerging needs of the investors in a constantly dynamic economic environment.

Keeping all the above aspects in mind and difficulty faced by students for preparation of this subject I am presenting this book specifically in Question & Answer format for easy preparation of subject. The book is a comprehensive work, with lucid and systematic presentation for theory questions and practical case laws. All the questions and practical case laws are arranged topic-wise covering all the ***past 45 exams*** *from* ***June 1994*** *to* ***June 2017*** *so that student can get 360 degree view of CS Examination pattern. Further all the theory questions, practical case laws and objectives are answered as per the latest applicable provisions and amendments up to date.*

I assure you all that CS Executive student studying for "Capital Market & Security Law" paper from this book will come out with flying colours.

I shall be grateful for any of your suggestion to improve the book further. We are also thankful to Taxmann Publications and their staff for their co-operation in presenting the book to students all over India.

I thank you, one and all.

N S Zad

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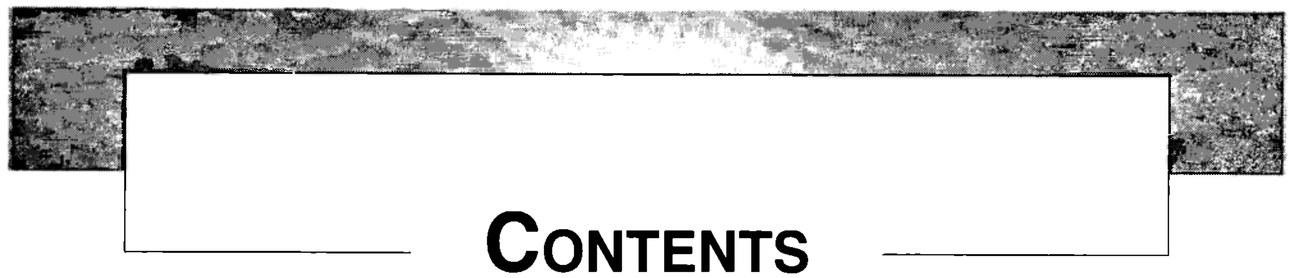

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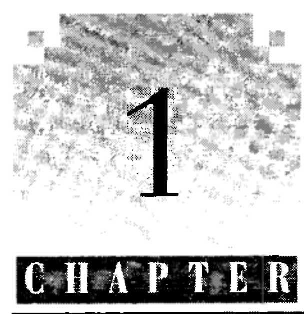
SECTION A
CAPITAL MARKET



OVERVIEW OF CAPITAL MARKET

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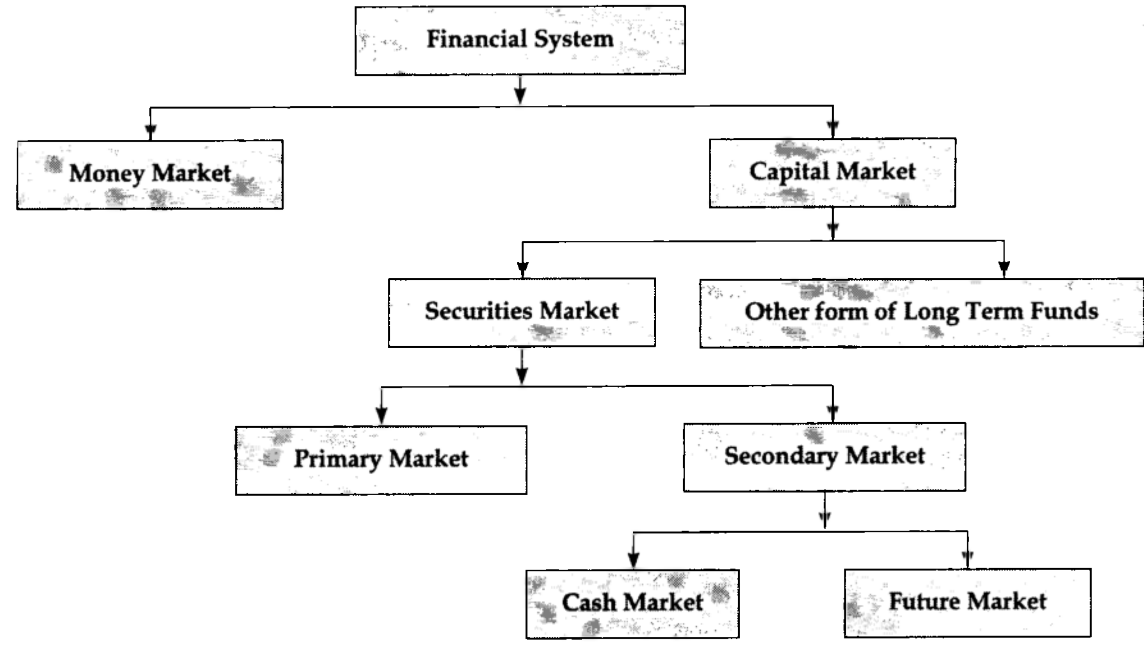

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Question 1] Write a note on: Organizational structure of financial system. What are the two segments of capital markets? **CS (Inter) - Dec 2003 (4 Marks), June 2007 (5 Marks)**
The securities market has two interdependent and inseparable segments. Comment.
CS (Executive) - Dec 2011 (4 Marks)

Ans.: The Indian financial system has two major components:

(1) Money Market : Money market refers to the market where borrowers and lenders exchange short-term funds to solve their liquidity needs. It is the market for dealing in monetary assets of short-term nature. Funds are available in this market for periods ranging from a *single day up to a year.*

Instruments used in money market are generally had:

- Low default risk,
- Maturities below 1 year,
- High marketability *[Money Market is discussed in detail in Chapter No. 7]*

(2) Capital Market : Capital market is a market for financial investments that are direct or indirect claims to capital. It is wider than the securities market and embraces all forms of lending and borrowing. It is a market, where business enterprises and governments can raise long-term funds.

Securities Market : Securities market is a place where buyers and sellers of securities can enter into transactions to purchase and sell shares, bonds, debentures etc. The main instruments used in the securities market are stocks, shares, debentures, bonds, securities of the government. Securities market has following two interdependent and inseparable segments:

(a) **Primary Market :** Primary market is that part of the capital market that deals with the issuance of new securities. Companies, governments or public sector institutions can obtain funding through the sale of new shares or bond issue. The primary market is the market where the securities are sold for the first time. Therefore it is also called the New Issue Market (NIM).

The issue of securities by companies can take place in any of the following methods:

- Initial public offer
- Further issue of capital
- Rights issue
- Firm allotment
- Offer to public
- Bonus issue

(b) **Secondary Market :** The secondary market, also known as the aftermarket, is the financial market where previously issued securities and financial instruments such as stock, bonds, options, and futures are bought and sold.

The stock market or secondary market ensures free marketability, negotiability and price discharge. Secondary market has further two components:

- **Spot Market :** Where securities are traded for immediate delivery and payment.
- **Futures Market :** Where the securities are traded for future delivery and payment.

Question 2] Distinguish between: Money Market & Securities Market
CS (Inter) - Dec 2005 (5 Marks), June 2006 (2 Marks)
CS (Inter) - Dec 2006 (2 Marks)

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Ans.: Following are the main points of distinction between money market & securities market:

Points	Money Market	Securities Market
Meaning	The money market refers to the market where borrowers and lenders exchange short-term funds to solve their liquidity needs. It is the market for dealing in monetary assets of short-term nature. Funds are available in this market for periods ranging from a **single day up to a year**.	A securities market is a place where buyers and sellers of securities can enter into transactions to purchase and sell shares, bonds, debentures etc. The main instruments used in the securities market are stocks, shares, debentures, bonds, securities of the government.
Maturity period	It deals in the lending and borrowing of **short-term finance** (i.e., for 1 year or less)	It deals in the lending and borrowing of **medium and long-term finance**.
Credit instruments	The main credit instruments of the money market are call money, collateral loans, acceptances, bills of exchange.	The main instruments used in the securities market are stocks, shares, debentures, bonds, securities of the government.
Major constituents	Banking industry, Mutual funds, Foreign institutional investors, large corporate and the RBI are the major constituents of Indian money market.	Major constituents are Stock Exchanges, Domestic Institutional Investors (DII), Foreign Institutional Investors (FII) and small investors.
Risk	The degree of risk is **small** in the money market.	The risk is much **greater** in securities capital market.
Basic role	The basic role is that of **liquidity adjustment**.	The basic role is that of **putting capital to work**, preferably to long-term, secure and productive employment.
Market Regulation	Money market is closely **regulated by RBI**.	Securities market is closely **regulated by SEBI**.

Question 3] Distinguish between: Primary Market & Secondary Market
CS (Executive) - Dec 2008 (3 Marks), Dec 2011 (3 Marks)

Ans.: Following are the main points of distinction between primary & secondary market:

Points	Primary Market	Secondary Market
Meaning	The primary market is that part of the capital markets that deals with the issuance of new securities. Companies, governments or public sector institutions can obtain funding through the sale of a new shares or bond issue. The primary market is the market where the securities are sold for the first time.	The secondary market, also known as the after-market, is the financial market where previously issued securities and financial instruments such as stock, bonds, options, and futures are bought and sold.
Contract	As primary market deals with new issue and there is contract between issuer and investor.	As secondary market deals with previously issued securities and financial instruments there is contract between two investors.
Issue/ Transfer	In a primary issue, the securities are issued by the company directly to investors.	In a secondary market the securities are exchanged between two investors.
Intermediary	In primary market important intermediaries are Lead Merchant Banker, Merchant Banker, underwriters, Issue House etc.	In a secondary market important intermediaries are Depository Participants, Brokers, Sub-Brokers and Registrar & Share Transfer Agents.
Regulation	Issue through primary market comes under Companies Act, 2013 & **SEBI (Issue of Capital & Disclosure Requirements) Regulations, 2009**	Secondary market is regulated through Companies Act, 2013, Securities Contracts (Regulation) Act, 1956 & other regulations made by SEBI.

Question 3A] The capital market and the stock exchange in particular are referred to as the barometer of the economy. **CS (Executive) - June 2016 (4 Marks)**

Ans.: The Capital Market is a market for financial investments that are direct or indirect claims to capital. It is wider than the securities market and embraces all forms of lending and borrowing, whether or not evidenced by the creation of a negotiable financial instrument. The capital market comprises the complex of institutions and mechanisms through which intermediate term funds and long term funds are pooled and made available to business, government and individuals. The capital market also encompasses the process by which securities already outstanding are transferred.

The capital market and in particular the stock exchange is referred to as the barometer of the economy. Government's policy is so moulded that creation of wealth through products and services is facilitated and surpluses and profits are channelized into productive uses through capital market operations. Reasonable opportunities and protection are afforded by the Government through special measures in the capital market to get new investments from the public and the Institutions and to ensure their liquidity.

Question 4] Explain the main functions of a good financial system
CS (Inter) - Dec 2004 (5 Marks)

Ans.: Functions performed by a financial system are:

(1) Saving Function : Public saving find their way into the hands of those in production through the financial system. Financial claims are issued in the money and capital markets which promise future income flows. The funds with the producers result in production of goods and services thereby increasing society living standards.

(2) Liquidity Function : The financial markets provide the investor with the opportunity to liquidate investments like stocks, bonds & debentures whenever they need the fund.

(3) Payment Function : The financial system offers a very convenient mode for payment of goods and services.

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(4) **Risk Function :** The financial markets provide protection against life, health and income risks. These are accomplished through the sale of life and health insurance and property insurance policies. The financial markets provide immense opportunities for the investor to hedge himself against or reduce the possible risks involved in various investments.

(5) **Policy Function :** The government intervenes in the financial system to influence macro-economic variables like interest rates or inflation so if country needs more money government would cut rate of interest through various financial instruments and if inflation is high and too much money is there in the system then government would increase rate of interest.

Question 5] Discuss briefly the regulatory framework governing the securities in India.
CS (Inter) - June 2003 (4 Marks), June 2004 (8 Marks)
Outline the main legislations governing securities market in India.
CS (Inter) - June 2007 (4 Marks), June 2009 (4 Marks)

Ans.: The following are the important statutes, which governs the Indian securities markets:

- The Securities & Exchange Board of India Act, 1992
- The Securities Contracts (Regulation) Act, 1956
- The Depositories Act, 1996
- The Companies Act, 2013
- The Foreign Exchange Management Act, 1999 (FEMA)

The agencies involved in relation of securities market are:

- Ministry of Finance
- Ministry of Corporate Affairs (MCA)
- Department of Economic Affairs (DEA)
- The Reserve Bank of India (RBI)
- The Securities Exchange Board of India (SEBI)
- Stock Exchanges

ROLE & FUNCTIONS OF SECURITY MARKET

Question 6] "Primary market is of great significance to the economy." Comment.
CS (Executive) - June 2010 (4 Marks)

Ans.: The primary market is that part of the capital markets that deals with the issuance of new securities. Companies, governments or public sector institutions can obtain funding through the sale of a new shares or bond issue. The primary market is the market where the securities are sold for the first time. Therefore, it is also called the **New Issue Market**.

Features of Primary Markets:

- This is the market for new long term equity capital.
- In a primary issue, the securities are issued by the company directly to investors.
- The company receives the money and issues new security certificates to the investors.
- Primary issues are used by companies for the purpose of setting up new business or for expanding or modernizing the existing business.
- The primary market performs the crucial function of facilitating capital formation in the economy.

The primary market is of great significance to the economy of a country. It is through the primary market that funds flow for productive purposes from investors to entrepreneurs. The latter use the funds

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for creating new products and rendering services to customers in India and abroad. The strength of the economy of a country is gauged by the activities of the stock exchanges. The primary market creates and offers the merchandise for the secondary market.

Question 7] Discuss the role of Securities Market in economic growth.

CS (Inter) - June 2006 (5 Marks), Dec 2010 (4 Marks)

Securities market enhances the peace of economic growth. Comment.

CS (Executive) - June 2012 (5 Marks)

"A well functioning securities market is conducive to sustained economic growth." Explain.

CS (Executive) - June 2016 (4 Marks)

Ans.: A securities market is a place where buyers and sellers of securities can enter into transactions to purchase and sell shares, bonds, debentures etc. The securities market has two segments *viz.* primary market and secondary market.

The various functions performed by securities markets are as follows:

(1) **Continuous & ready market for securities :** Securities market provides a ready and continuous market for purchase and sale of securities. It provides ready outlet for buying and selling of securities.

(2) **Evaluation of securities :** Securities market is useful for the evaluation of securities. This enables investors to know the true worth of their holdings at any time. Comparison of companies in the same industry is possible through securities market price list.

(3) **Encourages capital formation :** Securities market accelerates the process of capital formation. It creates the habit of saving, investing and risk taking among the investing class and converts their savings into profitable investment. It acts as an instrument of capital formation.

(4) **Safety in dealings :** Securities market provides safety in dealings as transactions are conducted as per well defined Rules and Regulations. The managing body of the exchange keeps control on the members. Fraudulent practices are also checked effectively.

(5) **Regulates company management :** Listed companies have to comply with rules and regulations of concerned securities market and work under the vigilance of various authorities.

(6) **Public borrowing :** Securities market serves as a platform for marketing Government securities. It enables government to raise public debt easily and quickly.

(7) **Clearing house facility :** Securities market provides a clearing house facility to members. It settles the transactions among the members quickly and with ease. The members have to pay or receive only the net dues because of the clearing house facility.

(8) **Healthy speculation :** Normal speculation is not dangerous but provides more business to the exchange. However, excessive speculation is undesirable as it is dangerous to investors and the growth of corporate sector.

(9) **Economic barometer :** Securities market indicates the state of health of companies and the national economy. It acts as a barometer of the economic conditions.

(10) **Bank lending :** Banks easily know the prices of quoted securities. They offer loans to customers against corporate securities.

Question 8] Financial markets, financial services and financial instruments are integral parts of the financial system. Critically examine. **CS (Inter) - Dec 2002 (16 Marks)**

Ans.: Financial system of any country consists of financial markets, financial intermediation and financial instruments or financial products. The economic development of a nation is reflected by the progress of the various economic units, broadly classified into corporate sector, government and household sector. While performing their activities these units will be placed in a surplus/deficit/balanced budgetary situations.

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There are areas or people with surplus funds and there are those with a deficit. A financial system or financial sector functions as an intermediary and facilitates the flow of funds from the areas of surplus to the areas of deficit. A financial system is a composition of various institutions, markets, regulations and laws, practices, money manager, analysts, transactions and claims and liabilities.

Financial system covers both credit and cash transactions. All financial transactions are dealt with by cash payment or issue of negotiable instruments like cheque, bills of exchanges, hundies etc. Thus a financial system is a set of institutional arrangements through which financial surpluses are mobilized from the units generating surplus income and transferring them to the others in need of them. The activities include production, distribution, exchange and holding of financial assets/instruments of different kinds by financial institutions, banks and other intermediaries of the market. In a nutshell, financial market, financial assets, financial services and financial institutions constitute the financial system.

The functions of a good financial system are manifold. They are:

- Regulation of currency
- Banking functions
- Credit control
- Administering national, fiscal and monetary policy to ensure stability of the economy
- Supply and deployment of funds for productive use
- Maintaining liquidity.

Long term growth of financial system is ensured through:

- Investor education
- Autonomy to Financial Institutions
- Entry of new institutions
- Minimizing regulatory measures

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Efficient transfer of resources from those having idle resources to others who have a pressing need for them is achieved through financial markets. Stated formally, financial markets provide channels for allocation of savings to investment. These provide a variety of assets to savers as well as various forms in which the investors can raise funds and thereby decouple the acts of saving and investment. The savers and investors are constrained not by their individual abilities, but by the economy's ability, to invest and save respectively. The financial markets, thus, contribute to economic development to the extent that the latter depends on the rates of savings and investment.

INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSION (IOSCO)

Question 9] What do you understand by IOSCO? Briefly discuss the different membership categories of IOSCO. CS (Executive) - Dec 2014 (6 Marks)

Ans.: The International Organization of Securities Commissions (IOSCO) is the worldwide association of national securities regulatory bodies, such as the Securities & Exchange Commission (SEC) in the United States, the Financial Services Authority in the United Kingdom, and about 100 other similar bodies.

The International Organization of Securities Commissions (IOSCO) was created in 1983. Eleven securities regulatory agencies from North and South America took this decision in April 1983 at a meeting in Quito, Ecuador. In 1984, securities regulators from France, Indonesia, Korea and the United Kingdom were the first agencies to join the organization from outside the Americas. Today IOSCO is recognized as the international standard setter for securities markets. Its membership regulates more than 95% of the world's securities markets and it is the primary international cooperative forum for securities market regulatory agencies.

In 2002, IOSCO adopted a multilateral memorandum of understanding (IOSCO MMoU) designed to facilitate cross-border enforcement and exchange of information among international securities regulators. The SEBI is also a signatory to IOSCO MMoU.

The MMoU represents a common understanding amongst its signatories about how they will consult, cooperate, and exchange information for securities regulatory enforcement purposes.

IOSCO's Objectives:

- Cooperate together to promote high standards of regulation in order to maintain just, efficient and sound markets
- Exchange information on their respective experiences in order to promote the development of domestic markets
- Unite their efforts to establish standards and an effective surveillance of international securities transactions
- Provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offences

IOSCO Members:

(1) **Ordinary Members :** Such members must be the primary regulators of securities and futures markets. A stock exchange or self-regulatory organization may be an ordinary member, but only if it is the jurisdiction's primary securities regulator. Each ordinary member has one vote.

(2) **Associate Members :** These members are other securities and or futures regulators in a jurisdiction, if that jurisdiction has more than one. For example, the Commodity Futures Trading Commission, the International Commission of Securities and the North American Securities Administrators Association in the United States are associate members of IOSCO with the US Securities & Exchange Commission being the ordinary members for the United States. Associate members have ***no vote*** and are not eligible for the Executive Committee; however, they are members of the Presidents Committee.

(3) **Affiliate Members :** These include stock exchanges, self-regulatory organizations, and various stock market industry associations. Affiliate members have ***no vote***, are not eligible for the Executive Committee and are not members of the Presidents' Committee. The affiliate members, which are self-regulatory organization, are however members of the SRO Consultative Committee.

Currently, IOSCO has **145 members**, 118 ordinary members, 12 associate members and 15 affiliate members.

Some important points relating to history of security market:

- The corporate securities market dates back to the 18th century when the securities of the East India Company were traded in Mumbai and Kolkata.
- The 1860's witnessed bearish dealings in securities and securities speculation.
- This brought brokers to Bombay together in July 1875 to boom the first organized stock exchange in the country, viz. The Stock Exchange, Mumbai, Ahmedabad Stock Exchange in 1894 and 22 others followed with 20th century.
- The two major Indian exchanges, the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) ranked **11th** and **12th** respectively among exchanges around the world in terms of market capitalization.
- Total listed companies on BSE in the year 1992-1993 were 2,861 which increased significantly in the year 2004-2005 to 4,731 and in the year 2011-2012 increased to 5,112. Similarly, in the year 1997-1998 listed companies on NSE were 612 which increase to 1,640 in the year 2011-2012. As the number of Companies increasing significantly, the amount raised by companies through public issue increased from ₹ 3928.56 crore in year 1998 to ₹ 29598 crore year 2011.
- A major initiative of liberalization was the repeal of the Capital Issues (Control) Act, 1947 in May 1992.

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OBJECTIVE QUESTIONS

Question A] Expand the following abbreviations:

(1)	NIM	(6)	IOSCO	(11)	FII
(2)	IPO	(7)	MMoU		
(3)	SEBI	(8)	BSE		
(4)	RBI	(9)	NSE		
(5)	FEMA	(10)	DII		

Question B] State, with reasons in brief, whether the following statements are correct or incorrect:

(1) The term 'Capital Market' is wider than 'Securities Market'.

(2) The securities market works in a vacuum.

(3) The money market refers to the market where borrowers and lenders exchange long-term funds.

(4) The primary market is the market where the already issued securities are bought and sold.

(5) Securities market is closely regulated by RBI.

Question C] Re-write the following sentences after filling-up the blank spaces with appropriate word(s)/figure(s):

(1) Financial system covers both credit and .... transactions.

(2) The market wherein companies mobilize resources through issue of securities is called ....

(3) The capital markets have two major segments namely .... and ....

(4) The primary market is also called the ....

(5) .... is a market for financial investments that are direct or indirect claims to capital.

(6) .... is a place where buyers and sellers of securities can enter into transactions to purchase and sell shares, bonds, debentures etc.

(7) .... deals in the lending and borrowing of short-term finance.

(8) Money market is closely regulated by ....

(9) The International Organization of Securities Commissions (IOSCO) was created in ....

(10) Currently, IOSCO has .... members.

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Question D] Select the correct option.

1. .... refers to the market where borrowers and lenders exchange short-term funds to solve their liquidity needs.

(*a*) Capital Market

(*b*) Securities Market

(*c*) Stock Market

(*d*) Money Market

2. .... is that part of the capital markets that deals with the issuance of new securities.

(*a*) Secondary Market

(*b*) Primary Market

(*c*) Spot Market

(*d*) Futures Market

3. The Bombay Stock Exchange ranked ......th among exchanges around the world in terms of market capitalization.

(*a*) 10

(*b*) 17

(*c*) 11

(*d*) 20

4. Currently, IOSCO has .... ordinary members.

(*a*) 145

(*b*) 118

(*c*) 181

(*d*) 15

5. Which type of member has voting right in IOSCO?

(*a*) Ordinary Members

(*b*) Associate Members

(*c*) Affiliate Members

(*d*) All of the above

6. Which of the following statute govern the Indian securities market?

(*a*) The Securities Contracts (Regulation) Act, 1956

(*b*) The Companies Act, 1956

(*c*) The Securities & Exchange Board of India Act, 1992

(*d*) All of the above

7. In primary market the issue of securities by companies can take place by way of ....

(*a*) Firm Allotment

(*b*) Initial Public Offer (IPO)

(*c*) Rights Issue

(*d*) All of the above

8. The ...., also known as the aftermarket, is the financial market where previously issued securities and financial instruments such as stock, bonds, options, and futures are bought and sold.

(*a*) Futures Market

(*b*) Secondary Market

(*c*) Commodity Market

(*d*) All of the above

9. .... is a place where buyers and sellers of securities can enter into transactions to purchase and sell shares, bonds, debentures etc.

(*a*) Commodity Market

(*b*) Securities Market

(*c*) Money Market

(*d*) All of the above

10. Instruments used in money market are generally had: ....

(*a*) High default risk

(*b*) Maturities above 1 year

(*c*) Low marketability

(*d*) None of the above

11. The National Stock Exchange (NSE) ranked .... respectively among exchanges around the world in terms of market capitalization.

(*a*) 10th

(*b*) 12th

(*c*) 15th

(*d*) 17th

12. The basic role is that of Money Market is ....

(*a*) Putting capital to work

(*b*) Liquidity adjustment

(*c*) Productive employment

(*d*) All of the above

13. Securities market is closely regulated by .... in India.

(*a*) RBI

(*b*) IOSCO

(*c*) SEBI

(*d*) IDRAI

14. Which of the following is/are the constituents of Financial System in India?

(I) Financial market

(II) Products

(III) Market participants

(*a*) (I) & (III)

(*b*) (II) only

(*c*) (II) & (III)

(*d*) (I), (II) & (III)

15. The money market refers to the market where ______ exchange ______ funds to solve their ______ needs.

(*a*) lenders and borrowers; short-term; personal

(*b*) borrowers and lenders; short-term; liquidity

(*c*) debtor and creditors; long-term; liquidity

(*d*) principle and agents; medium; day to day

16. Which of the following statement is true in relation to 'capital market'?

(*i*) The capital market is a market for financial investments that are direct or indirect claims to capital.

(*ii*) Capital market instruments are generally financial claims that have low default risk, maturities

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(*iii*) The capital market and in particular the stock exchange is referred to as the barometer of the economy.

(*iv*) The capital market refers to the market where borrowers and lenders exchange short-term funds to solve their liquidity needs.

(*a*) (ii) & (iv)

(*b*) (i) & (iv)

(*c*) (i) & (ii)

(*d*) (i) & (iii)

17. Securities Market –

(A) Is a link between investment & savings

(B) Mobilizes & channelizes savings

(C) Provides liquidity to investors

(D) Is a market place for purchase and sale of securities

(*a*) (B) and (D) only

(*b*) (A), (B), (C) and (D)

(*c*) (C) and (A) only

(*d*) (D), (A) and (B) only

18. The two major Indian exchanges, the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) ranked _____ and ________ respectively among exchanges around the world in terms of market capitalization.

(*a*) 15th, 17th

(*b*) 11th, 12th

(*c*) 5th, 7th

(*d*) 14th, 21st

19. BSDA means ....

(*a*) Basic Services Demat Account

(*b*) Basic Server Development Accountability

(*c*) Bombay Service Demat Account

(*d*) Basic Services Development Account

20. Which of the following legislation do not play any role in governing the capital market?

(*a*) The SEBI Act, 1992

(*b*) The Competition Act, 2002

(*c*) The Securities Contracts (Regulation) Act, 1956

(*d*) The Depositories Act, 1996

21. The IOSCO Annual Conference in ______, held in _______, was the first to take place outside the western hemisphere.

(*a*) June 1983; Poland

(*b*) July 1983; New York

(*c*) July 1986; Paris

(*d*) June 1986; London

22. In ______ IOSCO adopted a multilateral memorandum of understanding (IOSCO MMoU) designed to facilitate cross-border enforcement and exchange of information among international securities regulators.

(*a*) 2002

(*b*) 2006

(*c*) 2003

(*d*) 2005

23. Then in _______ IOSCO endorsed the IOSCO MMoU as the benchmark for international cooperation among securities regulators and set-out clear strategic objectives to expand the network of IOSCO MMoU signatories by 2010.

(*a*) 2005

(*b*) 2004

(*c*) 2003

(*d*) 2002

24. Which of the following agency involved in regulation of securities market?

(*a*) The Securities Exchange Board of India

(*b*) Ministry of Corporate Affairs

(*c*) Stock Exchanges

(*d*) All of the above

Answer to Question A:

Abbreviation	[illegible]
NIM	New Issue Market
IPO	Initial Public Offer
SEBI	Securities Exchange Board of India

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Abbreviation	Long Form
RBI	Reserve Bank of India
FEMA	Foreign Exchange Management Act
IOSCO	International Organization of Securities Commission
MMoU	Multilateral Memorandum of Understanding
BSE	Bombay Stock Exchange
NSE	National Stock Exchange
DII	Domestic Institutional Investors
FII	Foreign Institutional Investors

Answer to Question B:

(1) **Correct.** The Capital Market is a market for financial investments that are direct or indirect claims to capital. It is wider than the securities market and embraces all forms of lending and borrowing. It is a market, where business enterprises and governments can raise long-term funds. Securities market is a part of capital market.

(2) **Incorrect.** A securities market is a place where buyers and sellers of securities can enter into transactions to purchase and sell shares, bonds, debentures etc. It works under the defined regulatory framework.

(3) **Incorrect.** The money market refers to the market where borrowers and lenders exchange short-term funds to solve their liquidity needs. It is the market for dealing in monetary assets of short-term nature. Funds are available in this market for periods ranging from a *single day up to a year.*

(4) **Incorrect.** The primary market is that part of the capital markets that deals with the issuance of new securities. The primary market is the market where the securities are sold for the first time.

(5) **Incorrect.** Securities market is closely regulated by SEBI.

Answer to Question C:

(1) Cash **(2)** Primary Market **(3)** Primary Market and Secondary Market **(4)** New Issue Market (NIM) **(5)** Capital Market **(6)** Securities Market **(7)** Money Market **(8)** RBI **(9)** 1983 **(10)** 145

Answer to Question D:

1. (d)	**5.** (a)	**9.** (b)	**13.** (c)	**17.** (b)	**21.** (c)
2. (b)	**6.** (d)	**10.** (d)	**14.** (d)	**18.** (b)	**22.** (a)
3. (c)	**7.** (d)	**11.** (b)	**15.** (b)	**19.** (a)	**23.** (a)
4. (b)	**8.** (b)	**12.** (d)	**16.** (d)	**20.** (b)	**24.** (d)

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CAPITAL MARKET INSTRUMENTS

Question 1] What do you understand by the term 'capital market'?

Ans.: Capital Market is a market for financial investments that are direct or indirect claims to capital. It is wider than the securities market and embraces all forms of lending and borrowing. It is a market, where business enterprises and governments can raise long-term funds. Capital market is wider term and includes security market.

Security market is market where equity shares, preference shares, debentures and bonds are traded. Security market has following two segments:

(a) **Primary Market :** Primary market is that part of the capital markets that deals with the issuance of new securities. Companies, governments or public sector institutions can obtain funding through the sale of a new shares or bond issue. The primary market is the market where the securities are sold for the first time. Therefore it is also called the New Issue Market (NIM).

The issue of securities by companies can take place in any of the following methods:

- Initial public offer
- Further issue of capital
- Rights issue
- Firm allotment
- Offer to public
- Bonus issue

(b) **Secondary Market :** The secondary market, also known as the aftermarket, is the financial market where previously issued securities and financial instruments such as stock, bonds, options, and futures are bought and sold.

The stock market or secondary market ensures free marketability, negotiability and price discharge. Secondary market has further two components:

- **Spot Market :** Where securities are traded for immediate delivery and payment.
- **Futures Market :** Where the securities are traded for future delivery and payment.

Question 2] Write a short note on: Classification of instruments

Write a short note on: Hybrid Instruments

CS (Executive) - June 2009 (2 Marks), June 2011 (2 Marks)

Ans.: Instruments in capital markets can be classified into three categories: Pure, Hybrid and Derivatives.

(1) **Pure Instruments :** Equity shares, preference shares, debentures and bonds which are issued with the basic characteristics without mixing the features of other instruments are called pure instrument.

(2) **Hybrid Instruments :** Instruments which are created by combining the features of equity, preference, bond are called as hybrid instruments.

Example: Hybrid instruments are:

- Convertible preference shares

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- Non-convertible debentures with equity warrant
- Partly convertible debentures
- Secured premium notes

(3) **Derivative Instrument** : A derivative instrument is a financial instrument which derives its value from the value of some other financial instrument or variable.

Example: Futures and Options belong to the categories of derivatives.

Question 3] Distinguish between: Pure Instruments & Hybrid Instruments
CS (Executive) - Dec 2013 (3 Marks)

Ans.: Following are the main difference between pure & hybrid instruments:

Points	Pure Instruments	Hybrid Instruments
Meaning	Equity shares, preference shares, debentures and bonds which are issued with the basic characteristics without mixing the features of other instruments are called pure instrument.	Instruments which are created by combining the features of equity, preference, bonds are called as hybrid instruments.
Examples	Following are pure instruments: - Equity shares - Preference shares - Debentures	Following are hybrid instruments: - Convertible preference shares - Convertible debentures - Secured premium notes
Beneficial	These are beneficial but not like hybrid instruments.	These are more beneficial than pure instrument.

Question 4] Distinguish between: Debt Market & Equity Market
CS (Executive) - June 2015 (3 Marks)

Ans.: Following are the main difference between debt & equity market:

Points	Debt Market	Equity Market
Meaning	The debt market is the market where debt instruments are traded.	The equity market is the market where equity shares are traded.
Instruments	In debt instruments includes debentures, bonds, Notes & Mortgages.	In equity market equity and preference shares are traded.
Status of holder	Debt instrument holders are creditors of the issuing companies.	Equity holders are the owners of the issuing companies.
Risk	Investments in debt securities typically involve less risk than equity investments.	Investments in equity typically involve more risk than debt investments.
Volatility	Debt market is less volatile.	Equity market is more volatile.
Returns	In debt market there is less risk and hence returns are also low.	Equity market is more risky and may offer attract and higher return as compared to debt market.
Income	Income of debt market is fixed.	Income in equity market is variable.

PURE INSTRUMENTS

Que. No. 5] Write a short note on: Nature of a share

Ans.: Share [Section 2(84)] : A share means a share in the share capital of a company, and includes stock.

Nature of shares & debentures [Section 44] : A share or debentures or other interest of any member in a company is a movable property transferable in the manner provided by the articles of the company.

Numbering of shares [Section 45] : Each share in a company having a share capital shall be distinguished by distinctive number.

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Que. No. 6] Write a short note on: Kinds of Shares

Ans.: Kinds of share capital [Section 43(1)] : The share capital of a company limited by shares shall be of two kinds, namely:

(*a*) Equity share capital

- With voting rights
- With differential rights as to dividend, voting or otherwise

(*b*) Preference share capital

Que. No. 7] Explain the term 'equity shares' as per Companies Act, 2013.

Ans.: Equity Shares [Section 43(2)] : Equity share capital with reference to any company limited by shares means all share capital which is not preference share capital.

Question 7A] Explain briefly: Share warrants

CS (Executive) - Dec 2015 (3 Marks)

Ans.: A share warrant is a bearer document of title to shares and can be issued only by public limited companies and that to against fully paid up shares only.

A share warrant is transferable by mere delivery of the warrants without execution of any written instrument of transfer being registered by the company. The bearer of a share warrant is not a member of the company unless otherwise so provided in the articles of the company.

Question 8] An Indian company is planning to issue sweat equity shares of a class of shares already issued. Explain the meaning of sweat equity shares and advise the company regarding the conditions to be fulfilled to issue sweat equity?

CS (Executive) - Dec 2014 (6 Marks)

Write a short note on: Sweat Equity Shares

CS (Inter) - Dec 2005 (5 Marks)
CS (Executive) - June 2014 (5 Marks)

Ans.: Sweat Equity Shares [Section 2(88)] : Sweat equity shares means equity shares issued by a company to its directors or employees at a discount or for consideration, other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

Issue of sweat equity shares [Section 54] : A company can issue sweat equity shares, of a class of shares already issued, if the following conditions are satisfied:

(1) The issue has been authorized by a **special resolution** passed by the company in the general meeting.

(2) Such special resolution should clearly specify:

- Number of shares
- Current market price
- Consideration and
- Classes of directors or employees to whom such equity shares are to be issued.

(3) At least 1 year should have elapsed from the date on which the company was entitled to commence business.

(4) A company whose shares are listed on a recognized stock exchange issuing sweat equity shares should comply with the **SEBI (Issue of Sweat Equity) Regulations, 2002.**

(5) A company whose shares are not so listed should comply with the **Companies (Share Capital & Debentures) Rules, 2014.**

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The rights, limitations, restrictions and provisions as are for the time being applicable to equity shares shall be applicable to the sweat equity shares issued and the holders of sweat equity shares shall rank *pari passu (on an equal footing)* with other equity shareholders. **[Section 54(2)]**

Register of Sweat Equity Shares [Rule 8(14) of the Companies (Share Capital & Debentures) Rules, 2014]: The company shall maintain a Register of Sweat Equity Shares in **Form No. SH. 3** and shall forthwith enter therein the particulars of issue of sweat equity shares.

The Register of Sweat Equity Shares shall be maintained at the registered office of the company or such other place as the Board may decide.

The entries in the register shall be authenticated by the Company Secretary or by any other person authorized by the Board for the purpose.

Que. No. 9] Explain the provisions of the Companies (Share Capital & Debentures) Rules, 2014 relating to Sweat Equity Shares.

Ans.: Provisions of the Companies (Share Capital & Debentures) Rules, 2014 relating to sweat equity shares are as follows:

(1) **Explanatory statement to contain certain particulars [Rule 8(2)] :** The explanatory statement to be annexed to the notice of the general meeting shall contain the prescribed content like the date of the board meeting; reasons or justification for the issue; the class of shares under which sweat equity shares are intended to be issued; total number of shares; etc.

(2) **Validity of special resolution [Rule 8(3)] :** The special resolution shall be valid for making the allotment up to period of 12 months.

(3) **Limits on issue of sweat equity shares [Rule 8(4)]:** The company shall not issue sweat equity shares for more than **15% of the existing paid up equity share capital** in a year or shares of the issue value of **₹ 5 crores**, whichever is higher. The issuance of sweat equity shall not exceed **25%** of the paid up equity capital at any time.

(4) **Lock-in-period [Rule 8(5)] :** The sweat equity shares issued to directors or employees shall be locked in for a period of **3 years** from the date of allotment and this fact shall be stamped in bold on the share certificate.

(5) **Valuation Aspects [Rule 8(6), (7) & (8)] :** The sweat equity shares to be issued shall be valued at a price determined by a registered valuer as the fair price giving justification for such valuation.

The valuation of intellectual property rights or of know how or value additions shall be carried out by a registered valuer.

A copy of the valuation report shall be sent to the shareholders with the notice of the general meeting.

(6) **Issue for non-cash consideration [Rule 8(9)] :** When sweat equity shares are issued for a non-cash consideration on the basis of a valuation report obtained from the registered valuer, such non-cash consideration shall be treated in the following manner in the books of account of the company-

(*a*) Where the non-cash consideration takes the form of a depreciable or amortizable asset, it shall be carried to the balance sheet of the company in accordance with the accounting standards; or

(*b*) In other cases it shall be expensed as provided in the accounting standards.

(7) **Forms part of managerial remuneration [Rule 8(10)] :** The amount of sweat equity shares issued shall be treated as part of managerial remuneration for the purposes of Sections 197 & 198, if the following conditions are fulfilled, namely.-

(*a*) The sweat equity shares are issued to any director or manager or

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(*b*) They are issued for consideration other than cash, which does not take the form of an asset which can be carried to the balance sheet of the company in accordance with the applicable accounting standards.

(8) **Sweat equity shares and compensation aspects [Rule 8(11) & (12)]:**

(i) **If the sweat equity shares issued pursuant to no acquisition of an asset:** The accounting value *(fair value)* of sweat equity shares shall be treated as a form of compensation to the employee or the director in the financial statements.

(ii) **If the shares are issued pursuant to acquisition of an asset:** The value up to valuation report shall be carried in the balance sheet as per the Accounting Standards and excess value over the value as per valuation report shall be treated as a form of compensation to the employee or the director in the financial statements of the company.

(9) **Disclosure in Board's Report [Rule 8(13)] :** The details of issue of sweat equity shares shall be disclosed in the Directors Report for the year.

Maintenance of Register [Rule 8(14)] : The company shall maintain a Register of Sweat Equity Shares in **Form No. SH. 3**. The Register shall be maintained at the registered office of the company or such other place as the Board may decide. The entries in the register shall be authenticated by the Company Secretary or by any other person authorized by the Board.

Question 10] What is meant by differential voting rights (DVR)? Discuss the conditions subject to which a company may issue shares with DVR?

CS (Executive) - Dec 2012 (4 Marks), June 2013 (6 Marks)

Explain: Shares with differential voting rights **CS (Inter) - Dec 2007 (2 Marks)**

Ans.: 'Shares with differential voting rights' means a share issued with differential right as to dividend, voting or otherwise in accordance with section 43(*a*)(*ii*).

Rule 4 of the **Companies (Share Capital & Debentures) Rules, 2014** makes the following provisions relating to issue of shares with differential voting rights.

(1) **Conditions for issuing shares with differential rights [Rule 4(1)] :** Company limited by shares shall not issue equity shares with differential rights as to dividend, voting or otherwise, unless it complies with the following conditions:

- The AOA authorizes the issue of shares with differential rights.
- The issue of shares is authorized by an **ordinary resolution** passed at a general meeting.
- In case of listed company, the issue shall be approved by the shareholders through postal ballot.
- The shares with differential rights shall not exceed **26% of the total post-issue paid-up equity share capital** including equity shares with differential rights issued at any point of time.
- Company should have consistent track record of distributable profits for the last 3 years.
- Company has not defaulted in filing financial statements and annual returns for last 3 financial years.
- Company has no subsisting default in the payment of a declared dividend to its shareholders or repayment of its matured deposits or redemption of its preference shares or debentures that have become due for redemption or payment of interest on such deposits or debentures or payment of dividend.
- Company has not defaulted
    - ◆ In payment of the dividend on preference shares or

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- In repayment of principle or interest on any term loan from a PFI or State Level Financial Institution or Scheduled Bank
- In dues with respect to statutory payments relating to its employees to any authority
- In crediting the amount in Investor Education & Protection Fund to the Central Government.

- Company has not been penalized by Court or Tribunal during the last 3 years of any offence under the RBI Act, 1934, the SEBI Act, 1992, the Securities Contracts (Regulation) Act, 1956, the FEMA Act, 1999 or any other special Act.

(2) **Disclosures in the explanatory statement [Rule 4(2)] :** The explanatory statement to be annexed to the notice of the general meeting shall contain the prescribed particulars like - number of shares; percentage of the shares; reasons or justification for the issue; etc.

(3) **Conversion [Rule 4(3)] :** The company shall not convert its existing equity share capital with voting rights into equity share capital carrying differential voting rights and *vice versa*.

(4) **Disclosures in the Board's Report [Rule 4(4)] :** The board of directors shall disclose in the Board's Report, the following details, namely:

(*i*) Number of shares allotted with differential rights.

(*ii*) Details of the differential rights relating to voting rights and dividends.

(*iii*) Percentage of the shares with differential rights to the total post issue equity share capital with differential rights issued at any point of time and percentage of voting rights which the equity share capital with differential voting right shall carry to the total voting right of the aggregate equity share capital.

(*iv*) Price at which such shares have been issued.

(*v*) Particulars of promoters, directors or key managerial personnel to whom such shares are issued.

(*vi*) Change in control, if any, in the company consequent to the issue of equity shares with differential voting rights.

(*vii*) Diluted EPS calculated in accordance with the applicable accounting standards.

(*viii*) The pre and post issue shareholding pattern along with voting rights.

(5) **Rights of holders of equity shares with differential voting rights [Rule 4(5)] :** The holders of the equity shares with differential rights shall enjoy all other rights such as bonus shares, rights shares etc., which the holders of equity shares are entitled to, subject to the differential rights with which such shares have been issued.

(6) **Register of Members [Rule 4(6)] :** When company issues equity shares with differential rights, the Register of Members maintained u/s 88 shall contain all the relevant particulars of the shares so issued along with details of the shareholders.

Que. No. 11] Explain the term 'preference shares' as per Companies Act, 2013.

Ans.: Preference Shares [Section 43(2)] : Preference share capital, with reference to any company limited by shares, means that part of the issued share capital of the company which carries or would carry a preferential right with respect to-

(*a*) Payment of dividend, either as a fixed amount or at a fixed rate and

(*b*) Repayment in the case of a winding up or repayment of capital specified in the memorandum or articles of the company.

The following kinds of preference shares are dealt with by the companies:

- Cumulative preference shares

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- Non-cumulative preference shares
- Convertible preference shares
- Redeemable preference shares
- Participating preference shares
- Non-participating preference shares

Question 12] Write a short note on: Cumulative Preference Shares

Ans.: A preference share is said to be cumulative when the arrears of dividend are cumulative and such arrears are paid before paying any dividend to equity shareholders. Suppose a company has 10,000 8% Preference Shares of ₹ 100 each. The dividends for 2013 and 2014 have not been paid so far. The directors, before they can pay the dividend to equity shareholders for the year 2015, must pay the preference dividends of ₹ 2,40,000 (80,000 × 3) for the years 2013, 2014 & 2015 before making any payment of dividend to equity shareholders for the year 2015.

However, if a company goes into the liquidation no arrears of preference dividend will be payable unless the Articles of Association of the issuing company contains a specific provision to make such payment even in winding-up.

Question 13] Write a short note on: Non-cumulative Preference Shares

Ans.: In the case of non-cumulative preference shares, dividend does not accumulate. The dividend is only payable out of the net profits of each year. If there are no profits in any year, the arrears of dividend cannot be claimed in the subsequent years. If the dividend on the preference shares is not paid by the company during a particular year, it lapses.

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Que. No. 14] Preference shares are cumulative unless expressly stated to be non-cumulative. Comment. **CS (Executive) - June 2011 (5 Marks)**

Ans.: With regard to the payment of dividends, preference shares may be cumulative or non-cumulative. A cumulative preference share confers a right on its holder to claim fixed dividend of the past and the current year and out of future profits. The dividend keeps on accumulating until it is fully paid.

The non-cumulative preference share gives right to its holder to a fixed amount or a fixed percentage of dividends out of the profits of each year. If no profits are available in any year, the shareholders get nothing, nor can they claim, unpaid dividend in any subsequent year. *Preference shares are cumulative unless expressly stated to be non-cumulative.* Dividends on preference shares, like equity shares, can be paid only out of profits.

Question 15] Write a short note on: Convertible Preference Shares

Ans.: Convertible preference shares are those shares which can be converted into equity shares within a certain period.

If the terms of issue of preference shares includes a right for converting them into equity shares at the end of a specified period they are called convertible preference shares. In the absence of such condition or right, the preference shares are not converted into equity shares to become eligible for various rights such as voting, higher dividend, bonus issue etc. as in the case of equity shares.

Que. No. 16] Whether equity shares already issued can be converted into redeemable preference shares? **CS (Executive) - Dec 2012 (4 Marks)**

Ans.: It was held that where the equity shares are to be converted into redeemable preference shares it was necessary to adopt the process of reduction of capital u/s 66 of the Companies Act, 2013. [*Chowgule & Co. (P) Ltd.* 1972 Tax LR 2163, *St. James Court Estates Ltd.* [1944] Ch. 6]

Question 17] Write a short note on: Redeemable Preference Shares

Ans.: A company limited by shares, may if so authorized by its articles issue preference shares which are redeemable as per the provisions laid down in section 55. Shares may be redeemed either after a fixed period or earlier at the option of the company.

Issue and redemption of preference shares [Section 55]:

(1) A company limited by shares shall not issue preference shares which are irredeemable.

(2) A company limited by shares may issue preference shares which are liable to be redeemed within a period of **20 years** from the date of issue.

(3) A company may issue preference shares for a period **exceeding 20 years** for **infrastructure projects,** subject to the redemption of such percentage of shares as may be prescribed on an annual basis at the option of such preferential shareholders.

(4) Preference shares can be redeemed:

- Out of the profits available for dividend *or*
- Out of the proceeds of a fresh issue of shares.

(5) Preference shares shall be redeemed unless they are **fully paid-up**.

(6) Where preference shares are proposed to be redeemed out of the profits a sum equal to the nominal amount of the shares should be transferred to the **Capital Redemption Reserve Account**.

(7) **Premium payable on redemption** of any preference shares shall be provided for:

- Out of the profits *or*
- Out of the securities premium account before such shares are redeemed.

Question 18] Write a short note on: Participating Preference Share

Ans.: Normally preference shareholders are not entitled to dividend more than what has been indicated as part of the terms of issue, even in a year in which the company has made huge profits. However, in case of participating preference shares, holders are entitled to participate in the surplus profits left, after payment of dividend to the preference and the equity shareholders to the extent provided therein.

Subject to provisions in the terms of issue such preference shares can be entitled even to bonus shares.

Question 19] Write a short note on : Non-participating Preference Shares

Ans.: Non-participating preference shares are entitled only to a fixed rate of dividend and do not share in the surplus profits. The preference shares are presumed to be non-participating, unless expressly provided in the memorandum or the articles or the terms of issue.

Que. No. 20] Distinguish between: Preference Share Capital & Equity Share Capital
CS (Inter) - June 2002 (6 Marks), Dec 2004 (4 Marks)

Ans.: Following are the main points of distinction between preference share capital & equity share capital:

Points	Preference Share Capital	Equity Share Capital
Dividend	Preference shares are entitled to a fixed rate of dividend.	The rate of dividend on equity shares depends upon the amount of profit available and the funds requirements of the company for future expansion etc.
Preference in dividend	Dividend on the preference shares is paid in preference to the equity shares.	The dividend on equity shares is paid only after the preference dividend has been paid.
Preference in winding up	In case of winding up, preference share holder get preference over equity share holders with regard to the payment of capital.	In case of winding up, equity share holder get payment of capital after the payment of capital to preference shareholders.

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Points	Preference Share Capital	Equity Share Capital
Cumulativeness	Dividend on preference share may be cumulative.	The dividend on equity is not cumulative.
Voting rights	The voting rights of preference shareholders are restricted. A preference shareholder can vote only when his special rights as a preference shareholder are being varied, or on any resolution for the winding up of the company or for the repayment or reduction of its equity or preference share capital or if their dividend has not been paid for a period of 2 years or more. **[Section 47(2)]**	An equity shareholder can vote on all matters affecting the company.
Bonus & right shares	No bonus shares/rights shares are issued to preference shareholders	A company may issue rights shares or bonus shares to the company's existing equity shareholders.
Redemption	Preference shares are liable to be redeemed within a period of 20 years from the date of issue.	Equity shares cannot be redeemed except under a scheme involving reduction of capital or buy back of its own shares.

Question 21] Define the term 'debenture'. Also state the important features of debentures.

Ans.: Debenture [Section 2(30)] : Debenture includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not.

Important features of debentures:

1. It is issued by a company as a certificate of indebtedness.
2. It usually indicates the date of redemption and also provides for the repayment of principal and payment of interest at specified date or dates.
3. It usually creates a charge on the undertaking or the assets of the company.
4. Debenture holders do not have any voting rights.
5. Interest on debenture is compulsorily required to pay even if there is no profit to the company.
6. Debentures cannot be forfeited for non-payment of call.

Types of debentures: Debentures are issued in the following forms:

- Naked or unsecured debentures
- Secured debentures
- Redeemable debentures
- Perpetual debentures
- Bearer debentures
- Registered debentures

Question 22] Write a short note on: Types of Debentures

Explain the term 'Naked Debentures'. **CS (Executive) - June 2012 (2 Marks)**

Distinguish between: Naked Debentures & Secured Debentures
CS (Executive) - Dec 2009 (3 Marks)

Distinguish between: Perpetual Debentures & Bearer Debentures
CS (Executive) - Dec 2009 (3 Marks)

Ans.: Naked or Unsecured Debentures: Debentures of this kind do not carry any charge on the assets of the company. The holders of such debentures do not therefore have the right to attach particular property by way of security as to repayment of principal or interest and thus called as naked or unsecured debentures.

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Secured Debentures: Debentures that are secured by a charge of the whole or part of the assets of the company are called mortgage debentures or secured debentures. After creating charge on debentures, a charge is required to be registered with ROC within 30 days of creation.

Redeemable Debentures: Debentures that are redeemable on expiry of certain period are called redeemable debentures.

Perpetual Debentures: If the debentures are issued subject to redemption on the happening of specified events which may not happen for an indefinite period, e.g. winding-up, they are called perpetual debentures.

Bearer Debentures: Such debentures are payable to bearer and are transferable by mere delivery. The name of the debenture holder is not registered in the books of the company, but the holder is entitled to claim interest and principal as and when due. A *bona fide* transferee for value is not affected by the defect in the title of the transferor.

Registered Debentures: Such debentures are payable to the registered holders whose name appears on the debenture certificate and is registered on the companies register of debenture holders maintained as per section 88 of the Companies Act, 2013.

Question 23] Write a short note on: Convertible Debentures.

Aqua Portfolio Ltd. is contemplating to issue debenture to part finance their capital requirements. You are to prepare a note explaining the category of debenture based on convertibility which may be issued. **CS (Inter) - June 2004 (4 Marks)**

Ans.: Based on convertibility, debentures can be classified under three categories:

(1) **Fully Convertible Debentures (FCDs) :** These are converted into equity shares of the company with or without premium as per the terms of the issue, on the expiry of specified period. If the conversion is to take place at or after 18 months from the date of allotment but before 36 months, the conversion is optional on the part of the debenture holders in terms of SEBI (ICDR) Regulations, 2009. Interest will be payable on these debentures up to the date of conversion as per transfer issue.

(2) **Non-Convertible Debentures (NCDs) :** These debentures do not carry the option of conversion into equity shares and are therefore redeemed on the expiry of the specified period or periods.

(3) **Partly Convertible Debentures (PCDs) :** These may consist of two kinds namely, convertible and non-convertible. The convertible portion is to be converted into equity shares at the expiry of specified period. However, the non-convertible portion is redeemed at the expiry of the stipulated period. If the conversion takes place at or after 18 months, the conversion is optional at the discretion of the debenture holder.

Basic features of convertible debentures:

- Debentures are issued for cash at **par**.
- They are converted into specified or unspecified number of equity shares at the end of the specified period.
- The ratio at which the convertible debentures are exchanged for equity shares is known as conversion price or conversion ratio.

$$\text{Convertible debentures} = \frac{\text{Face value of a convertible debenture}}{\text{Conversion price}}$$

Example: If the face value of a convertible debenture is ₹ 100 and it is convertible into two equity shares, the conversion price is ₹ 50 then conversion ratio will be 2.

- The difference between the conversion price and the face value of the equity share is called conversion premium.
- If one or more parts of the debentures are convertible **after 18 months**, a company should get a **credit rating** done by a credit rating agency.

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- Fresh rating is required if debentures are **rolled over**. *(Roll over means to renew debentures)*
- Companies can pay interest at the rates they considered reasonable.

Question 24] Distinguish between: Fully Convertible & Partly Convertible Debentures
CS (Executive) - June 2015 (3 Marks)

Ans.: Following are the main points of distinctions between fully and partly convertible debentures:

Points	Partly Convertible Debentures	Fully Convertible Debentures
Meaning	When only part of debenture is converted into equity shares they are known as partly convertible debentures.	When full value of debenture is converted into equity shares they are known as fully convertible debentures.
Suitability	Better suited for companies with established track record.	Better suited for companies without established track record
Capital base	Relatively lower equity capital on conversion of debentures.	Higher equity capital on conversion of debentures.
Flexibility in financing	**Favourable** debt equity ratio.	**Highly favourable** debt equity ratio.
Classification for debt-equity ratio	Convertible portion classified as 'equity' and non-convertible portion as 'debt'.	Classified as equity for debt-equity computation.
Popularity	**Not so popular** with investors.	**Highly popular** with investors.
Servicing of equity	Relatively **lesser burden** of equity servicing.	**Higher burden** of servicing of equity.

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Question 25] Richie invest ₹ 5,00,000 in a 9% Debenture having a maturity period of 8 years with an option of 50% conversion at 24 months from the date of allotment. Interest is payable yearly. If the debenture holder goes for conversion, what amount he will receive up to time of redemption?
CS (Inter) - June 2004 (3 Marks)

Ans.:

Year	Benefits	Calculations	₹
Year 1	Interest	5,00,000 × 9%	45,000
Year 2	Interest	5,00,000 × 9%	45,000
	Shares for conversion	5,00,000 × 50%	2,50,000
Year 3	Interest	2,50,000 × 9%	22,500
Year 4	Interest	2,50,000 × 9%	22,500
Year 5	Interest	2,50,000 × 9%	22,500
Year 6	Interest	2,50,000 × 9%	22,500
Year 7	Interest	2,50,000 × 9%	22,500
Year 8	Interest	2,50,000 × 9%	22,500
	Principal amount	5,00,000 × 50%	2,50,000
			7,25,000

■■■ HYBRID INSTRUMENTS

Some basic for the students:

Common Stock = Equity Shares

Coupon = Interest

Face Value = Par Value or Principal

Yield = The figure that shows the return you get on a bond

Par Value : Also known as face value or coupon value, this is the value written on the face the certificate.

Redemption Price : It means a price at which redeemed. Bonds can be redeemed at par, premium or discount.

Coupon Rate : Coupon rate is the interest rate written on the face of the bond certificate.

Maturity date : The date on which the face value along with premium, if any, on the bond is repaid.

Callable Bond : This is the bond where the issuer has the right to redeem the bonds before the maturity date. This helps the issuer to redeem the bond when interest rates are drop down. *Example:* Suppose X Ltd. issue bonds of ₹ 500 crore at 12%. Two years later, market rate of interest is 10%, X Ltd. can now raise bonds at 10% if it had built a call option and settle the old bond of 12%. This will reduce the interest cost of X Ltd. considerably.

Call Date : The date on which a callable bond can be called back.

Cash Market : Cash market is also known as spot market, is one where the price is agreed on one day and delivery and settlement is made on the same date.

Derivative Market : Derivative market is also known as credit market, is one where the price is agreed on one day and delivery and settlement is made on a specified future date.

Long : The term 'Long' means bought position.

Short : The term 'Short' means sell position.

What do you mean by 'bond'?

A debt instrument issued for a period of more than one year with the purpose of raising capital by borrowing. The government, states, corporations and corporate sell bonds. Generally, a bond is a promise to repay the principal along with interest (coupons) on a specified date (maturity). Some bonds do not pay interest, but all bonds require a repayment of principal. When an investor buys a bond, he becomes a creditor of the issuer. However, the buyer does not gain any kind of ownership rights to the issuer, unlike in the case of equities.

How fixed income securities are classified?

In general, fixed-income securities are classified according to the length of time before maturity. There are three main categories:

Bills - Debt securities maturing in less than 1 year.

Notes - Debt securities maturing in 1 to 10 years.

Bonds - Debt securities maturing in more than 10 years.

What are the methods of interest payment in bonds?

(1) **Fixed Rate :** Most bonds still pay a traditional fixed interest rate, where a bond's interest rate is fixed to maturity.

(2) **Floating Rate :** Some bonds pay an interest rate that varies and is typically adjusted periodically according to an index tied to short-term T-bills or money markets. Such bonds offer protection against future increases in interest rates, and in exchange their yields are typically lower than those of comparable fixed-rate bonds. **[CS (Executive) – June 2010 (2 Marks)]**

(3) **Zero-coupon Rate :** These bonds that have no periodic interest payments. Instead, they are sold at a deep discount to face value, and redeemed for the full face value at maturity, with the difference between that discount and the full face value representing the interest amount.

What is the meaning of bond rating?

The bond rating system helps investors determine a company's credit risk.

Question 26] Distinguish between: Fixed Coupon Rate & Floating Coupon Rate

CS (Executive) – Dec 2009 (3 Marks)

Ans.: Following are the main points of distinction between fixed coupon rate & floating coupon rate:

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Points	Fixed Coupon Rate	Floating Coupon Rate
Meaning	When a rate is fixed for interest payment of debenture or bond it is known as fixed coupon rate.	When rate of interest on debenture or bond is linked with index or benchmark rate it is known as floating coupon rate.
Security known as	A bond which has fixed coupon rate is known as fixed rate bond.	A bond which has floating coupon rate is known as floating rate bond or variable rate bond or floater.
Benefit	The benefit of owning a fixed rate bond is that investors know with certainty how much interest they will earn and for how long.	Though such bonds offer protection against future increases in interest rates but investor is not sure about return they will get on their investments.
Investor	Investor who is willing to take less risk and desire to have constant fixed income on his investment generally invest in fixed rate bonds.	Investor who is willing to take more risk and desire to have his income similar to market generally invest in floating rate bonds.

Question 27] Write a short note on: Equipref

Ans.: This instrument is in two Parts A and B.

Part A: It is convertible into equity shares automatically and compulsorily on the date of allotment without any application by the allottee.

Part B:

- It is redeemed at par *or*
- Converted into equity after a lock in period at the option of the investor, at a price **30% lower than** the average market price.

The dividend is given only for Part B shares.

Upon conversion of each part, the face value stands reduced proportionately on the date of conversion.

Question 28] Write a short note on: Secured Premium Notes (SPN)

CS (Executive) - June 2012 (5 Marks), Dec 2012 (3 Marks)
CS (Executive) - June 2014 (5 Marks)

Ans.: Secured Premium Note is a kind of non-convertible debenture (NCD) attached with warrant *(i.e. option)*. SPN is a hybrid security i.e. it combined both features of equity and debt products.

SPN can be only issued by the listed companies after having approval from the Central Government.

Features of a SPN:

- SPN instruments are issued with a **detachable warrant.**
- These instruments have **lock in period** for **4 to 7 years**.
- No interest is paid during the lock in period.
- The detachable warrants are convertible into equity shares provided the SPNs are fully paid. The conversion of detachable warrants into equity has to be done within the specified time.
- After the lock in period, the holder has an option to sell back the SPN to the company at par value. If the holder exercises this option, no interest/premium is paid on redemption.
- In case the holder keeps his investment further, he is repaid the principal amount along with the additional interest/premium on redemption in instalments.
- SPN were so formulated that the return on investment was treated as capital gain and not regular income. Consequently, the rate of tax applicable was lower.
- **TISCO** (Tata Iron & Steel Company) took the lead in **July, 1992** by making a mega rights issue of equity shares and secured premium notes.

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Meaning of 'Warrants' : Warrants are securities that give the holder the right, *but not the obligation,* to buy a certain number of securities (usually the issuer's common stock i.e. equity shares) at a certain price before a certain time. *(Please note that 'Warrant' is not 'Share Warrant'. Do not confuse with it.)*

Occasionally, companies offer warrants for direct sale or give them to employees as incentive, but the vast majority of warrants are "attached" to newly issued bonds or stock.

Example of SPN : The details of the TISCO's SPN issue are as follows:

The face value of SPN was ₹ 300. It involved cash payment of ₹ 150 and remaining ₹ 150 on the call which was made after 6 months of allotment. Each SPN was accompanied by a warrant for subscribing to 1 equity share of TISCO between 1 to 1.5 years from the date of allotment. This required full payment of ₹ 80 per share (Face value ₹ 10 each at a premium of ₹ 70 per share) at the time of exercising the right under the warrant. No interest or repayment of principle would be due or accrue on the SPN during first 3 years. Thereafter, the investor would receive 4 equal annual instalment of ₹ 150 each (₹ 75 towards the principle and ₹ 75 towards interest) from the end of 4th year and onward till the end of 7th year. The SPN floated by TISCO has been assigned the AAA rating by the CRISIL.

Details of Issue : During July 1992, TISCO issued 4 to 7 years Secured Premium Notes of ₹ 300 each as follows:

- 1,10,00,000 SPN of ₹ 300 each to the shareholders on the basis of a minimum number of SPNs to each shareholders;
- 5,50,000 SPN of ₹ 300 each to employees on the basis of 5 SPNs to each employee and
- 1,15,50,000 warrants for subscribing against payment in cash to one share per SPNs of ₹ 10 each at a premium of ₹ 70 per share exercisable between 1 to 1.5 years from the date of allotment of SPNs (all the offered SPNs were taken up).

The principal amount of SPNs of ₹ 300 each was to be repaid in 4 equal annual instalments of ₹ 75 each from the end of 4th year to the end of the 7th year together with an equivalent additional amount as interest/return of ₹ 75 with each instalment.

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Question 29] Write a short note on: Equity shares with detachable warrants
CS (Executive) - Dec 2012 (3 Marks)

Ans.: The holder of the warrant is eligible to apply for the specified number of shares on the appointed date at the pre-determined price. These warrants are separately registered with the stock exchanges and traded separately. The practice of issuing non-convertible debentures with detachable warrants also exists in the Indian market. **Essar Gujarat, Ranbaxy & Reliance** issued this type of instruments in past.

Example : If XYZ Ltd. issued ₹ 100 million of bonds with warrants attached; each bondholder might get a ₹ 1,000 face-value bond and the right to purchase 100 equity shares of XYZ Ltd. stock at ₹ 20 per share over the next 5 years. Warrants usually permit the holder to purchase equity shares of the issuer, but sometimes they allow the purchaser to buy the shares or bonds of another entity (such as a subsidiary or even a third party).

Question 30] Write a short note on: Dual Option Warrants
CS (Executive) - June 2009 (2 Marks), Dec 2012 (3 Marks)

Ans.: Equity shares or debentures may be issued with two warrants -

- one warrant giving right to the purchaser to be allotted one equity share at the end of a certain period, and
- another warrant gives right to purchase debt or preference share option.

Dual option warrants provides the buyer good capital appreciation.

Dual option warrants have limited downside risk.

Dual option warrants may be used to sell equity shares in different markets.

Issue of Equity Shares/Debentures

Warrant 1	Warrant 2
Option to purchase equity shares	Option to purchase debt/preference shares

Question 31] Write a short note on: Debt for Equity Swap

CS (Executive) – June 2010 (2 Marks)

Ans.: *Swap means to exchange.*

A "Debt for Equity Swap" instrument gives an offer to the debt holders to exchange the debt for equity shares of the company. Converting debt to equity occurs when the debt-holder converts a debt amount into equity shares. No cash exchange occurs in the debt-to-equity swap.

Advantages to the issuer company:

- When debt is converted in equity it improves the debt-equity ratio.
- After conversion of debt into equity shares, interest burden is replaced with dividend burden.
- In case of debt, interest is compulsorily payable but when debt is converted into equity it is at the option of the company to declare and pay dividend.

Disadvantages to the issuer company:

- When debt is converted in equity it increase equity shares and EPS will be reduced.
- Dividends are not deductible against taxable profit hence it increases tax burden of the company.

Advantages to the investors : There is potential gain from rise in the value of the equity shares.

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Question 32] Write a short note on: Indexed Rate Notes

Ans.: 'Notes' means debt securities maturing in one to 10 years.

'Indexed rate' means an interest rate linked to an index, usually the Consumer Price Index (CPI).

In Indexed Rate Notes, the interest rate fixation is postponed till the actual date of placement, and not on the date of the commitment. *(This means interest is paid at the rate of index rate on the date of payment of interest and interest rate is not fixed at the date of issue)*

The interest rate is computed at then prevailing rates based on the index such as the 182 days T-bill yield rates.

These instruments are beneficial to a company in a high interest rate environment, if the interest rates are expected to decline between the date of commitment and the date of take down. *(The company may issue such security at high interest rate market environment and when subsequently interest rate comes down, the company will pay interest at low rate, as interest payment is liked to some index. Similarly, if company issues such security when market or index rate is low, then at the time of actual payment of interest, if interest rate go up, they have to pay higher interest. But normally they will not do so. If we look from the investors angle, in traditional debt security he gets only fixed interest and he will not able to cope up with market. Thus, investor by subscribing such securities can keep their return at par with market or index rate).*

Question 33] Write a short note on: Extendable Notes

Ans.: Extendable Notes or Bonds comes with maturity that can be extended by mutual agreement between the issuer and investors. Extendable Notes are bonds in which the date of maturity may be extended. Both issuer and bondholder have the authority to extend the maturity which depends upon the specific terms of the bond agreement. If a maturity is extended, the issuer continues to pay interest. Thus, extendable notes usually sell at a higher price than other bonds because there is the possibility for a higher return.

Extendable Notes are generally issued for **10 years** with flexibility to the issuer to **review the interest rate** every **2 to 3 years**. The interest rate is adjusted every 2 to 3 years to reflect the then prevailing market conditions. However, investors have a put option *(sell back or redeem)* at par value every 2 or 3 years i.e. they have the right to sell the bond to the issuer at a fixed rate on the expiry of every 2 or 3 years.

Examples of Issue of Extendable Notes:

A $200 million issue of Bank of America Corporation's 3 years Extendable Notes with a final maturity in 1995 was offered at a price of 99.9 with an 11.5% coupon to yield 11.537% to 1986 through underwriters led by Salomon Brothers Inc.

A $100 million issue of J. C. Penney & Company extendable notes was offered at a price of 99.8 with an initial coupon of 13.625% to yield 13.695 to 1988 through underwriters led by the First Boston Corporation. The notes, with a final maturity of 1999, are rated A-1 by Moody's and Ax by Standard & Poor's.

After the first maturity, in June 1988, investors have the option to redeem their Notes or to accept a new interest rate set by the company and a new maturity, which may range from 1 to 11 years.

Question 34] Distinguish between: Indexed Rate Notes & Extendable Notes
CS (Executive) - Dec 2009 (3 Marks)

Ans.: Following are the main differences between Indexed Rate Notes & Extendable Notes:

Points	Indexed Rate Notes	Extendable Notes
Meaning	In indexed rate notes, the interest rate fixation is postponed till the **actual date of placement**, and not on the **date of the commitment**.	Extendable notes are issued for **10 years** with flexibility to the issuer to **review the interest rate** every **two to three years**.
Interest rate	Interest rate fixation is postponed till the **actual date of placement.**	Interest rate is fixed but reviewed after two years.
Base of interest rate	Interest rate is based on some other benchmark rate like 182 days treasury bill yield rates.	Interest rate reflects market rate of interest.
Put option	No such option available in indexed rate notes.	Investors have a put option at par value every two years i.e. they have the right to sell the bond to the issuer at a fixed rate on the expiry of every two years.

Question 35] Write a short note on: Level Pay Floating Rate Notes

Ans.: Level pay floating rate notes are issued for a long period of time say **20 years**, with adjustment in interest rate every **5 years**. These notes provide for level payments for time intervals during the term of the note, with periodic interest adjustments tied to an index, and adjustments to the principal balance to reflect the difference between the portion of the payment allocable to interest and the amount of floating rate interest actually incurred.

Maximum limits on upward adjustments to principal are specified at the outset to protect the lender from runaway floating exposure. The level pay note has the advantage to the issuer of having a predictable level of debt service for a period of years, thereby avoiding the uncertainties of floating debt on cash flows during that time.

Question 36] Compute the coupon payment for a quarterly pay $1,000,000, LIBOR + 150 basis points floating-rate note whose interest is calculated using the act/360 days count convention. At the beginning of the quarter LIBOR was fixed at 7.0% and the quarter has 92 days.

Ans.: LIBOR + 150 bp = 7 + 1.5 = 8.5%

1,000,000 × 8.5% × 92/360 = $21,722.22

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Question 37] Write a short note on: Zero Coupon Convertible Notes

Ans.: Zero Coupon Convertible Notes is an instrument that is a combination of a zero-coupon bond and a convertible bond. Due to the zero-coupon feature, the bond pays no interest and is issued at a **discount to par value**, while the convertible feature means that the bond is convertible into common stock of the issuer at a certain conversion price.

These are debt convertible into equity shares of the issuer. If investors choose to convert, they forgo all the accrued and unpaid interest. These convertibles are generally issued with put option (sell back or redeem) to the investors. The advantage to the issuer is the raising of convertible debt without heavy dilution of equity. Since the investors give up acquired interest by exercise of conversion option, the conversion option may not be exercised by many investors.

"Discount to par value" Explained: If debt security is issued at the discount price say ₹ 90 and on maturity investor gets its Face Value say ₹ 100. Such issue of debt security is known as issue at discount to par value. No interest is paid during the tenor of the instrument. Investors return is difference between "issue price" and "face value" i.e. ₹ 10 as per example.

Question 38] Write a short note on: Deep Discount Bond

Ans.: A bond that sells at a significant discount from *par value* is known as Deep Discount Bond.

Examples:

- **IDBI & SIDBI** had issued this instrument. For a deep discount price of ₹ 5,300 in IDBI the investor got a bond with the face value of ₹ 2,00,000.
- Sardar Sarovar Nigam Ltd. issued a bond at ₹ 3,600 redeemable on face value of ₹ 1,11,000 after 21 years.

Deep discount bonds appreciate to its face value over the maturity period. Alternatively, the investor can withdraw from the investment periodically after **5 years**. The capital appreciation is charged to tax at capital gains rate which is lower than normal income tax rate.

Example of deep discount bond issued by ICICI Bank:

Deep Discount Bond of the face value of ₹ 2,00,000 was issued at a discounted price of ₹ 5,200 and will be redeemed at its face value of ₹ 2,00,000 at the end of 25th year from the Deemed Date of Allotment on July 15, 2021.

Early Redemption at the Option of the Bondholders/the Company Redemption of the Bonds at their deemed face value as follows:

Early Redemption period from the Deemed Date of Allotment	*Deemed Face Value (in ₹)*
5 years	11,000
10 years	24,000
15 years	50,000
20 years	1,00,000

Question 38A] A company is planning to issue deep discount bonds. As a financial advisor, you are required to suggest two important terms and conditions of issuing the said bond so as to minimize risk of the issuing company.

CS (Executive) - June 2016 (4 Marks)

Ans.: A bond that sells at a significant discount from *par value* is known as Deep Discount Bond. As a financial advisor, I will suggest following two points to minimize the risk of the issuing company.

(1) The bond should be issued with call provisions as these are long term bonds.

(2) Its coupon rate should be lower than the rates of fixed-income securities.

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Question 39] Write a short note on: Easy Exit Bonds

Ans.: Easy Exit Bonds are bonds that provide liquidity and easy exit route to the investor by way of redemption where investors can get ready encashment in case of need to withdraw before maturity. Easy exit bond enables the small investors to encash the bond at any time after 18 months of its issue and hereby paving a way for an easy exit.

It has a maturity period of 10 years with a *call option* with a face value. This instrument covers both bonds which provide liquidity and an easy exit route to the investor by way of redemption or buy back where investors can get ready encashment in case of need to withdraw before maturity.

Call option means an option to buy assets at an agreed price on or before a particular date.

Question 40] Write a short note on: Pay-in-Kind Bonds

Ans.: Pay-in-kind bonds are bonds that pays interest in additional bonds rather than in cash. The bond issuer incurs additional debt to create the new bonds for the interest payments. Original bond is called as **parent bond** and bonds issued for payment of interest are called as **baby bonds**.

Pay in kind bonds are used by the issuer to give themselves some breathing room in case the company runs into liquidity problems. By triggering the provision to issue the buyer more bonds, the company minimizes the need to make cash payments on the bond coupon to the bond buyer.

Question 41] Write a short note on: Split Coupon Bonds

Ans.: Split Coupon Bond begins as a zero-coupon bond paying no interest and converts to an interest paying bond on a future date. A split coupon bond is also known as a **zero-coupon convertible bond.**

Split Coupon Bond is usually issued by companies and corporations who don't want to pay out cash interest for the first few years of a bond's life. For example, a 10-year split coupon bond might pay no interest for the first 5 years and then transforms into a fixed-coupon bond that pays 11% interest for the remainder of its life. This hypothetical bond is designated "0/11", meaning it starts as a zero-coupon security and later becomes an 11% interest-bearing bond. Investors find such a bond attractive because it allows them to lock in a reinvestment rate for several years, where they will receive cash interest at a future date.

Question 42] Write a short note on: Floating Rate Bonds & Notes

Ans.: Floating Rate: Some bonds pay an interest rate that varies and is typically adjusted periodically according to an index tied to short-term T-bills or money markets. Such bonds offer protection against future increases in interest rates, and in exchange their yields are typically lower than those of comparable fixed rate bonds.

Floating rate bonds are bonds that have a variable coupon equal to a money market reference rate (e.g. LIBOR) plus a quoted *spread*. It is a bond where a coupon rate is indexed to a benchmark interest rate. Possible benchmark rates include US Treasury rates, LIBOR, prime rate, municipal and mortgage interest rate indexes. In floating rate bonds interest amount fluctuates in step with the market interest rates.

Unlike a plain bond, which pays a fixed rate of interest, a floating rate bond has a variable rate that resets periodically. Typically, the rates are based on the federal funds rate or LIBOR plus an added "spread."

For instance, a rate could be quoted as "LIBOR + 0.50%;" if LIBOR stood at 1.00%, the rate would be 1.50%. While the yield changes throughout the life of the security as prevailing interest rates fluctuate, the spread (the "+0.50" in the example above) typically stays the same. The frequency at which the yield of floating rate note resets can be daily, weekly, monthly, or every three, six, or 12 months. Corporations, municipalities, and some foreign governments typically offer floating rate notes - which are sometimes called "Floating Rate Notes".

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This instrument is used by the issuers **to hedge** against the **volatility in interest rates**.

Example: In March 1997, ICICI launched USD 100 Million subordinated floating rate notes (FRN) issue with a coupon of 80 basis points over 6 months LIBOR. The FRN has a 10 years final maturity, with a call option for ICICI after 5 years. The Notes were listed on Luxembourg stock exchange.

Question 43] Write a short note on: Clip & Strip Bonds

Ans.: Clip & strip bonds also referred to as coupon notes, **split the principal & coupon portions** of a bond issue and two separate coupon instruments are sold to the investors.

Principal portion sold as **'Deep discount bond'**, where **Gain = Purchase price - Par value**

Stripped coupon portion sold as **'Zero coupon bonds'**, where **Gain = Face value - discounted value**

Clip & strip bonds explained: First it should be pointed out how bonds used to work in the old days. A bond would actually have coupons attached to them that the bond-holder would clip off and present at a bank in exchange for a payment. Each coupon would have a date that they would come due, and for most bonds a coupon would come due every 6 months. If you had a 10 year bond, then there would be 20 coupons attached to the bond.

In a strip bond, the bank STRIPS off the coupons from the bond and you are left with just the bond "residue" or in other words, the bond without any coupons attached to it. **It is** issued at discounted value. Investors gain is difference between face value and discounted value.

Example: Let's take a look at a simplified stripped bond example. Suppose C Ltd. needs to raise capital to finance a new distillery. It decides the best way to do this is to issue bonds, which are sold with a face value of ₹ 1,000, a coupon payment of 5% paid annually and matures in 5 years. B Ltd. is in the business of bond stripping and buys the bond for ₹ 1,000 and then strips out the coupons. If B Ltd. sells the principal-stripped bond for ₹ 800 to an investor and the coupon payments for ₹ 200 to another investor. This ₹ 200 and the ₹ 800 received will make B Ltd. break even on the purchase of the bond. The individual with the coupon-stripped bond will get the par value of ₹ 1,000 at the end of the 5 years from C Ltd., making a profit of ₹ 200 and the purchaser of the coupons will pay ₹ 200 to receive ₹ 250, meaning they make ₹ 50 off the purchase. By providing this investment service, B Ltd. would receive a commission on the sale of these two stripped bonds.

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Question 44] Write a short note on: Disaster Bonds **CS (Inter) - June 2005 (2 Marks)**

Ans.: These are issued by companies and institutions to **share the risk** and expand the capital to link investors return with the size of insurer losses. The bigger the losses, the smaller the return and *vice versa*. The coupon rate and the principal of the bonds are decided by the occurrence of the casualty of disaster and by the possibility of borrower's defaults.

Disaster Bonds is a debt instrument in which rate of interest is not fixed. The rate of interest or return to investor will depend upon the risk or occurrence of casualty or disaster.

- **If there is disaster:** Investor will get **low return.**
- **If there is no disaster:** Investor will get **high return.**

Question 45] Write a short note on: Dual Convertible Bonds
CS (Executive) - June 2012 (2 Marks)

Ans.: A dual convertible bond is convertible into either equity shares or preference shares or debentures, at the option of the investor.

A dual convertible bond is convertible into:

- Equity shares *or*
- Fixed interest rate debentures/preference shares

at the option of the lender.

Depending on the prospects of the project during the conversion period, the lender may exercise either of the options. The fixed interest rate debenture may have certain additional features including higher rate of interest distinct from the original debt instrument.

Question 46] Distinguish between: Disaster Bonds & Dual Convertible Bonds
CS (Executive) - Dec 2008 (3 Marks), Dec 2010 (3 Marks)

Ans.: Following are the main differences between disaster bonds & dual convertible bonds:

Points	Disaster Bonds	Dual Convertible Bonds
Meaning	Disaster Bonds is a debt instrument in which rate of interest is not fixed. The rate of interest or return to investor will depend upon the risk or occurrence of casualty or disaster.	A dual convertible bond is convertible into: - Equity shares *or* - Fixed interest rate debentures/preference shares at the option of the lender.
Interest	Interest or return is not fixed.	Interest or return is fixed.
Purpose	These are issued by companies and institutions to **share the risk** and expand the capital to link investors return with the size of insurer losses.	These are issued by companies and institutions to raise debt finance.

Question 47] Write a short note on: Stepped Coupon Bonds

Ans.: Stepped Coupon Bonds is callable bond issued with a low coupon rate that gradually increases (step-up) over the life of the bond. The increase occurs at regular intervals stated in the bond indenture. Such bonds are also called **dual coupon bond, rising-coupon security, Step-up coupon security.**

Under stepped coupon bonds, the interest rate is **stepped-up** during the life of the bond. The main advantage to the investor is the attraction of higher rate of interest in case of general rise in interest rates.

Let's consider a five-year step-up bond issued by Company XYZ. The coupon rate might be 7% for the first two years, increasing to 8% for years three and four, and 9% in the fifth year.

Question 48] Write a short note on: Industrial Revenue Bonds

Ans.: An industrial revenue bond (IRB) is a unique type of revenue bond organized by a State or Local Government. The bond issue is sponsored by a government entity but the proceeds are directed to a private, for-profit business.

An IRB differs from traditional government revenue bonds as the bonds are issued on behalf of a private sector business.

IRBs are typically used to support a specific project like:

- Airports
- Docks and wharves
- Mass-commuting facilities including high speed rail
- Facilities for furnishing water
- Sewage facilities
- Solid waste disposal facilities
- Facilities for the local furnishing of electric energy or gas
- Facilities for local district heating and cooling
- Qualified hazardous waste facilities

Industrial Revenue Bonds (IRBs) are tax-exempt loans issued by state or local governments to finance a private company's expansion, construction or acquisition of manufacturing facilities and equipment. Local and State Governments support these projects because they can improve the economic well-being of a community. IRBs are issued at rates lower than conventional bonds because interest paid on the bonds may get exempted from income tax. The lower interest rate reduces the cost of financing and makes

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projects more attractive to pursue. Additionally, these bonds can mature in 20 to 30 years as compared to 5 to 10 years for typical bank loans.

Question 49] Write a short note on: Commodity Bonds **CS (Inter) - June 2005 (5 Marks)**
CS (Executive) - Dec 2011 (3 Marks)

Ans.: Many people say that investment in some commodities may yield higher return than investment in security market. But, practically investor cannot hold such assets physically. Thus, in order to take the advantages of rising price of commodities like **petrol, silver** and **gold** you can purchase the commodity bonds.

Commodity bonds are bonds issued to share the risk and profitability of future commodity prices with the investor.

Example: Petro bonds, silver bonds, gold bonds and coal bonds.

Question 50] Distinguish between: Industrial Revenue Bonds & Commodity Bonds
CS (Executive) - Dec 2009 (3 Marks)

Ans.: Following are the main points of difference between industrial revenue bonds & commodity bonds:

Points	Industrial Revenue Bonds	Commodity Bonds
Meaning	An industrial revenue bond (IRB) is a unique type of revenue bond organized by a State or Local government. The bond issue is sponsored by a government entity but the proceeds are directed to a private, for-profit business.	Commodity bonds are bonds issued to share the risk and profitability of future commodity prices with the investor.
Tax exempt	Tax exemption may be available on such bonds.	Tax exemption is not available on such bonds.
Purpose	These bonds are issued by financial institutions in connection with the development or purchase of industrial facilities.	These bonds are issued to hedge against inflation because the price of commodities usually rises over the time.

Question 51] Write a short note on: Third party convertible debentures

Ans.: Third party convertible debentures are debt instruments with warrant attached which gives an option to subscribe to the equity shares of another company at a price lower than the market price. These are similar to convertible debentures with warrant option except that these debentures give an option to the investor to subscribe for shares in another company. The coupon rates on these debentures are lower than pure debt in view of the warrant option. The debentures are secured and can be issued to all classes of investors. These instruments are suitable for high profile companies raising resources for **green field projects**.

Question 52] Write a short note on: Debt Instruments with Debt Warrants

Ans.: When debt instruments are issued with debt warrants which give the holder the **option to invest in additional debt** on the same terms within the period specified in the warrant are known as Debt Instruments with Debt Warrants. This instrument is beneficial to the investors in periods of **falling interest rates** when the holder can exercise the debt warrant option and hold additional debt at, interest rates above market rates.

Question 53] Write a short note on: Carrot and Stick Bond
CS (Inter) - June 2007 (5 Marks), Dec 2007 (2 Marks)

Ans.: Carrot and Stick Bonds have a low conversion premium to encourage early conversion and sticks allow the issuer to call (i.e. buy back or repurchase) the bond at a specified premium if the common stock is trading at a specified percentage above the strike price.

A variant of the traditional convertible bond with a low conversion premium to encourage early conversion **(the carrot)** and a provision which allows the issuer to call the bond at a specified premium if the

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common stock is trading at a relatively modest percentage above the conversion price **(the stick)**. This structure combines both rewards and punishments and it is up to the holder to go either course as its investment policy dictates.

Carrot and Stick Approach is an idiom that refers to a policy of offering a combination of rewards and punishment to induce behaviour. It is named in reference to a cart driver dangling a carrot in front of a mule and holding a stick behind it. The mule would move towards the carrot because it wants the reward of food, while also moving away from the stick behind it, since it does not want the punishment of pain, thus drawing the cart.

What is conversion premium: For example, if a company issues a convertible bond of ₹ 1,000 that can be exchanged in the future for 50 shares and the shares are currently valued at ₹ 30 per share, the conversion value is ₹ 1500 (50 shares × 30). The straight-bond value, on the other hand, is the value of the convertible if it did not have the conversion option.

Thus, in carrot and stock bonds, the issuer company issue the bond at low conversion *(what is low conversion has to be decided by the issuer company)* Suppose, the conversion is as stated is above, this is 'carrot' for investor. However, if stock starts to trade at above ₹ 1,500 then issuer company can call (repurchase) the bond at specified premium.

Question 54] Write a short note on: Capital Indexed Bonds
CS (Inter) - Dec 2005 (5 Marks), Dec 2007 (2 Marks)

What is inflation index bond? How it is differ from an ordinary bond?
CS (Executive) - June 2014 (5 Marks)

Write a short note on: Inflation Linked Bonds **CS (Executive) - Dec 2008 (2 Marks)**

Ans.: Capital indexed bonds are **inflation-protection securities**. Such bond, provide good hedge against inflation risk. The benefits do extend beyond hedging. Capital index bonds can be used as a market indicator for inflation expectation. This will help investors take a more intelligent decision on their current consumption.

Example: The instrument will initially carry a face value of ₹ 100. Instead of offering a nominal rate, the instrument will offer a **real rate of interest**.

Real interest rate is nothing but the nominal interest rate less the inflation. If inflation increases by 10%, the face value of the bond will also increase by 10% to ₹ 110.

You will receive a real interest rate on ₹ 110. The increase in the bond's principal amount protects your purchasing power. In the developed markets, these instruments are also called as inflation-protection securities.

How it works: Consider the following example, in which the initial investment (in 2004-2005) is ₹ 10,000, historic Wholesale Price Index (WPI data) is from 2004-2005 (taken as 100) and the coupon rate is assumed at 3%.

Year	*WPI*	*Adjusted principal*	*Coupon rate*	*Interest paid*
2005-2006	104.47	10,447	3%	313.41
2006-2007	111.35	11,135	3%	334.05
2007-2008	116.63	11,663	3%	349.89
2008-2009	126.02	12,602	3%	378.06
2009-2010	130.81	13,081	3%	392.43
2010-2011	143.32	14,332	3%	429.96
2011-2012	156.13	15,613	3%	468.39

Assuming a maturity period of 8 years; total interest payment = ₹ 2,666.19; adjusted principal at maturity = ₹ 15,613; Total amount received on maturity = ₹ 18,279.19.

In case of plain bonds the investor will receive only ₹ 300 as interest each year and total amount received up to maturity will be ₹ 12,100. (₹ 10,000 as principal and ₹ 2,100 as interest for 7 years.

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Out of several variants of Inflation Indexed Bonds, the Capital Indexed Bonds (CIB) is the most popular and widely issued debt instrument internationally. In India also one variant of CIB (viz., 6% Capital Indexed Bond 2002) was issued for the first time on December 29, 1997. Subsequent to that issuance, there was no further issuance of CIB mainly due to lack of an enthusiastic response of market participants for the instrument, both in primary and secondary markets.

Question 55] Write a short note on: Tracking Stocks

CS (Executive) - June 2013 (3 Marks), Dec 2016 (3 Marks)

Ans.: Tracking Stocks are shares issued by a company which *pay a dividend determined by the performance of a specific portion of the whole company.* In other words a tracking stock is stock that tracks the financial performance of a specific operating division of a company, rather than the operations of the company as a whole. As a result, if the unit or division performs well, the value of the tracking stocks may increase, even if the company's performance as a whole is not up to mark or satisfactory. The opposite may also be true.

A tracking stock is a special type of stock issued by a publicly held company to track the value of one segment of that company. By issuing a tracking stock, the different segments of the company can be valued differently by investors. When a parent company issues a tracking stock, all revenues and expenses of the applicable division are separated from the parent company's financial statements and bound to the tracking stock. Often this is done to separate a high-growth division from large losses shown by the financial statements of the parent company. The parent company and its shareholders, however, still control operations of the subsidiary.

Dr. J. J. Irani Expert Committee constituted by the Government to make recommendation on the Concept Paper on Company Law has recommended in its report for the introduction of Tracking Stocks in the Indian Capital Market.

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Example of tracking stock : The Walt Disney Company, which issued a tracking stock for **go.com**. At around the same time, as the bubble ended, Disney retired the tracking stock.

In 1999 Quantum Corporation (San Jose, California) issued tracking stock in two subsidiaries: its DLT and Storage Systems Group (DSS) and its Hard Disk Drive Group (HDD). In 2001, Quantum sold the Hard Disk Drive business to Maxtor Corporation and redeemed the HDD tracking stock

Note: Tracking stock concept is not applicable in India. The Companies Act, 2013 do not have any provisions for issuance of such stock.

Question 56] Write a short note on: Mortgage Backed Securities

CS (Inter) - Dec 2003 (5 Marks)
CS (Executive) - June 2010 (2 Marks)

Ans.: A mortgage-backed security (MBS) is a type of asset-backed security that is secured by a mortgage, or more commonly a collection ("pool") of sometimes hundreds of mortgages. The mortgages are sold to a group of individuals (a government agency or investment bank) that securitizes, or packages, the loans together into a security that can be sold to investors.

These securities **assure a fixed return** which is derived from the performance of the specific assets. They are issued with a **maturity period of 3 to 10 years** and backed by pooled assets like mortgages, credit card receivables, etc. **Housing loans** are widely used as the basis for issuing MBS. There is a commitment from the loan originator and/or intermediary institution to ensure a minimum yield on maturity.

Advantages of Asset backed Securities to Issuer:

(*a*) The issuer can generate cash from the assets immediately enabling funds to be redeployed in other projects.

(b) The issuer may be able to improve balance sheet ratios by excluding the original assets and the securities created by the assets from the balance sheet by suitable structuring of the transaction.

Advantages of Asset backed Securities to Investor:

These instruments have a relatively **low credit risk** since the securities are backed by good quality collateral and offer a higher yield than Government securities.

How it works/Example : To understand how MBS work, it's important to understand how they are created. Let's assume you want to buy a house, so you get a mortgage from XYZ Bank. XYZ Bank transfers money into your account, and you agree to repay the money according to a set schedule. XYZ Bank may then choose to hold the mortgage in its portfolio (i.e. simply collect the interest and principal payments over the next several years) or sell it.

If XYZ Bank sells the mortgage, it gets cash to make other loans. So let's assume that XYZ Bank sells your mortgage to ABC Company, which could be a governmental, quasi-governmental, or private entity. ABC Company groups your mortgage with similar mortgages it has already purchased (referred to as pooling the mortgages). The mortgages in the pool have common characteristics (i.e., similar interest rates, maturities, etc.).

ABC Company then sells securities that represent an interest in the pool of mortgages, of which your mortgage is a small part (called *securitizing* the pool). It sells these MBS to investors in the open market. With the funds from the sale of the MBS, ABC Company can purchase more mortgages and create more MBS.

When you make your monthly mortgage payment to XYZ Bank, they keep a fee or spread and send the rest of the payment to ABC Company. ABC Company in turn takes a fee and passes what's left of your principal and interest payment along to the investors who hold the MBS.

Question 56A] Distinguish between: Hybrid Funds and Hybrid Instruments

CS (Executive) - Dec 2015 (2 Marks)

Ans.: Hybrid funds: Such funds covers both needs of an investor i.e. provide regular income as well as provide capital appreciation. Therefore, investment targets of these mutual funds are judicious mix of both the fixed income securities like bonds and debentures and also sound equity scrips. In fact, these funds utilise the concept of balanced investment management. These funds are, thus, also known as "**balanced funds**".

Hybrid Instruments: Instruments which are created by combining the features of equity, preference, bond are called as hybrid instruments.

Example: Hybrid instruments are:

- Convertible preference shares
- Non-convertible debentures with equity warrant
- Partly convertible debentures
- Secured premium notes

DERIVATIVE INSTRUMENTS

Question 57] Write a short note on: Derivative Contract

CS (Executive) - June 2011 (2 Marks)

Derivative contracts are of various types. Comment.

CS (Executive) - Dec 2011 (3 Marks)

Derivatives are contracts which derive their value from the value of one or more of other assets. Comment. **CS (Executive) - June 2014 (5 Marks)**

Ans.: A derivative is a financial contract which derives its value from the performance of another entity such as an asset, index, or interest rate, called the "underlying".

Derivatives include a variety of financial contracts, including futures, forwards, swaps, options.

As per **Section 2(ac)** of the **Securities Contracts (Regulation) Act, 1956**, "derivative" includes –

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(*a*) A security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security;

(*b*) A contract which derives its value from the prices, or index of prices, of underlying securities.

In derivatives contracts the gain of one person results into loss of another person, so it is also called zero sum game.

Poker and gambling are popular examples of zero-sum games since the sum of the amounts won by some players equals the combined losses of the others. In the financial markets, options and futures are examples of zero-sum games, excluding transaction costs. For every person who gains on a contract, there is a counter-party who loses.

Question 58] What do you understand by 'Forward Contract'?

Ans.: *A forward contract or simply a forward is a non-standardized contract between two parties to buy or to sell an asset at a specified future time at a price agreed upon today.* This is in contrast to a spot contract, which is an agreement to buy or sell an asset today.

The main features of this definition are:

- There is an agreement.
- Agreement is to buy or sell the underlying asset
- The transaction takes place on a predetermined future date
- The price at which the transaction will take place is also predetermined

The party agreeing to buy the underlying asset in the future assumes a *long position*, and the party agreeing to sell the asset in the future assumes a *short position*.

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The price agreed upon is called the delivery price, which is equal to the forward price at the time the contract is entered into.

Features of forward contract:

(1) Unique : Each forward contract is unique i.e. to say each contact differs from one another in terms of parties, quantities and price.

(2) Performance obligation : Both parties are under obligation to perform the contract otherwise aggrieved party can take legal action against defaulting

(3) Elimination of price risk : Both parties agree the price in advance; hence price risk is eliminated.

(4) No margin : Generally, no deposit or premium is required to be paid. However, parties can agree on some deposit or premium as margin money.

(5) No premium : No premium is payable by either party because both parties have equal right and equal obligations.

(6) Default risk : Although both parties are agreed to perform, if a party to the contract does not honor its commitments, the other party has no other means except to go Court of law. Hence, each party faces risk that the other party might default on the contract.

(7) Lacks liquidity : In forward contract you cannot react except with the consent of other party. Such contract is not exchange traded. Hence, it lacks liquidity.

How forward contract works?

A forward contract is generally made for currencies & commodities. ***(generally**, not for securities)*

Consider following example of forward contract on commodity:

On January 1, 2016 Company X agrees to buy from Company Y 100 kg of coffee on April 1, 2016 at a price of ₹ 300 per kg. If on April 1, 2016 the spot price (market price) of coffee is greater than ₹ 300, at say ₹ 350 per kg., the buyer has gained. Rather than having to pay ₹ 350 per kg for coffee, he only needs to pay ₹ 300. However, the buyer's gain is the seller's loss. The seller must now sell 100 kg of coffee at only ₹ 300 per kg, when it could sell it

in the open market for ₹ 350 per kg. Rather than the buyer giving the seller ₹ 30,000 for 100 pounds of coffee as he would for physical delivery, the seller simply pays the buyer ₹ 5,000. The ₹ 5,000 is the cash difference between the agreed upon price and the current spot price, or [(350 – 300) × 100].

Question 59] What do you understand by 'Future Contract'?

Ans.: A future contract is a contract between two parties to buy or to sell an asset at a specified future time at a price agreed upon today. Thus, an instrument which is similar to forward contract but traded and under which no risk of default is called future contract.

A future contract is a standardized contract between two parties where one of the parties commits to sell, a specified quantity of a specified assets at an agreed price on a given date in the future.

Features of future contract:

(1) **Standardization :** The contract is standardized as to quantity, date and month of delivery and minimum amount by which price would move. Each deal has a market lot.

Thus, if you want to enter into future contract in Tata Ltd. stock, you have to buy 100 Tata stock or in multiples thereof.

The date and month of delivery is determined by the exchange. As of now the exchange has fixed the last Thursday of the month for settlement and delivery.

(2) **Deal with clearing house :** The clearing house plays important role in the trading of future contract. It does all back office operations. More importantly it guarantees performance. Thus, there is no risk of default.

(3) **Mark to market margin :** The clearing house requires the parties to maintain a deposit (margin) with it. The margin amount changes with the change in daily prices. If the price goes up, the buyer's margin is reduced and seller's margin is increased by an equal amount. If the price goes down, the buyer's margin is increased and seller's margin is reduced by an equal amount. This is because an increase in price is good for the buyer and bad for the seller while a decrease in price is bad for the buyer and good for the seller. This process is called marking to market. In effect marking to market ensures that the profits and losses are settled on day to day basis.

Buying and selling futures contract is essentially the same as buying or selling a number of units of a stock from the cash market, but without taking immediate delivery.

How to buy futures contracts?

One of the prerequisites of stock market trading is a trading account.

Money is the obvious other requirement. However, this requirement is slightly different for the derivatives market.

When you buy in the cash segment, you have to pay the entire value of the shares purchased. You have to pay this amount upfront to the exchange or the clearing house.

How to buy and sell futures contracts

Buying and selling futures contract is essentially the same as buying or selling a number of units of a stock from the cash market, but without taking immediate delivery.

How to settle futures contracts

When you trade in futures contracts, you do not give or take immediate delivery of the assets concerned. This is called settling of the contract. This usually happens on the date of the contract's expiry. However, many traders also choose to settle before the expiry of the contract.

On Expiry

In this case, the futures contract (purchase or sale) is settled at the closing price of the underlying asset as on the expiry date of the contract.

Example: You have purchased a single futures contract of ABC Ltd., consisting of 200 shares and expiring in the month of July. At that time, the ABC share's price was ₹ 1,000. If on the last Thursday of July, ABC Ltd. closes at

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a price of ₹ 1,050 in the cash market, your futures position will be settled at that price. You will receive a profit of ₹ 50 per share (the settlement price of ₹ 1,050 less your cost price of ₹ 1,000), which adds up to a neat little sum of ₹ 10,000 (₹ 50 × 200 shares). This amount is adjusted with the margins you have maintained in your account. If you receive profits, they will be added to the margins that you have deposited. If you made a loss, the amount will be deducted from the margins.

Before Expiry

It is not necessary to hold on to a futures contract till its expiry date. In practice, most traders exit their contracts before their expiry dates. Any gains or losses you've made are settled by adjusting them against the margins you have deposited till the date you decide to exit your contract. You can do so by either selling your contract, or purchasing an opposing contract that nullifies the agreement. Here again, your profits will be returned to you or losses will be collected from you, after adjusting them for the margins that you have deposited once you square off your position.

This upfront payment is called 'Margin Money'. It helps reduce the risk that the exchange undertakes and helps in maintaining the integrity of the market.

Once you have these requisites, you can buy a futures contract. Simply place an order with your broker, specifying the details of the contract like the Scrip, expiry month, contract size, and so on. Once you do this, hand over the margin money to the broker, who will then get in touch with the exchange.

The exchange will find you a seller (if you are a buyer) or a buyer (if you are seller).

Question 60] Distinguish between: Forward Contract & Futures Contract

CS (Executive) - Dec 2011 (3 Marks)

Ans.: Following are the main points of distinction between forward & futures contract:

Points	Forward Contract	Futures Contract
Meaning	A forward contract or simply a forward is a non-standardized contract between two parties to buy or to sell an asset at a specified future time at a price agreed upon today.	A future contract is a standardized contract between two parties where one of the parties commits to sell, a specified quantity of a specified assets at an agreed price on a given date in the future.
Structure	Forward contracts are customized to customer needs. Usually, no initial payment required and is used for hedging.	A future contract is Standardized. Initial margin payment required and used for speculation.
Initial payment	Usually, no initial payment is required.	Initial margin payment required.
Purpose	Forward contracts are used for hedging.	Future contracts are used for speculation.
Transaction method	Forward contracts are negotiated directly by the buyer and seller.	Future contracts are Quoted and traded on the Exchange.
Market regulation	Forward contracts are not regulated	SEBI and Commodity Futures Trading Commission regulated market.
Institutional guarantee	The contracting parties	Clearing House
Risk	High counterparty risk.	Low counterparty risk.
Guarantees	No guarantee of settlement.	There is guarantee of settlement.
Contract Maturity	Forward contracts generally mature by delivering the commodity.	The date and month of delivery is determined by the exchange. As of now the exchange has fixed the last Thursday of the month for settlement and delivery.
Expiry date	Depending on the transaction	Standardized
Method of pre-termination	Opposite contract with same or different counterparty. Counterparty risk remains while terminating with different counterparty.	Opposite contract on the exchange.

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Points	Forward Contract	Futures Contract
Contract size	Depending on the transaction and the requirements of the contracting parties.	The contract is standardized as to quantity, date and month of delivery and minimum amount by which price would move. Each deal has a market lot.

Question 61] Write a short note on: Index Future **CS (Inter) - Dec 2006 (5 Marks)**

Ans.: An index futures contract binds the parties to an agreed value for the underlying index at a specified future date.

Buying and selling futures contract is essentially the same as buying or selling a number of units of a stock from the cash market, but without taking immediate delivery.

In the case of index futures too, the index's level moves up or down, replicating the movement of a stock price. So, you can actually trade in index and stock contracts in just the same way as you would trade in shares.

Example: Nifty future, BSE future.

What is Nifty Future? How to trade in Nifty Future?

We know there is National Stock Exchange, one of the main stock exchanges of India. Most of the companies registered in this stock exchange and through this stock exchange we are able to do transaction in these companies stock. We are able to buy and sell the company's stock through our broker and broker registered in stock exchange.

So Index of National Stock Exchange known as Nifty. And the derivative contract of Nifty known as Nifty Future. Nifty is a portfolio of main 50 stocks and according to movement of these stock, we see the up and down movement in Nifty.

Exchanges allowing trading in stocks as well as in Index also, Example - suppose someone want to buy all the main 50 stocks of Nifty. So to make it easy exchange started trading in Nifty Future. Nifty Future lot size is 50. So one can buy Nifty Future despite to buy each Nifty stock one by one. It is also tough to watch all the 50 stocks daily. So one can buy Nifty Future and it is easy to track it.

As we said its lot size 50, suppose for example Nifty Future Oct currently running on 5700 and you want to buy this, so your trade value will be

50 (lot size) × 5700 (index future current value) = 2,85,000 (total trade value)

So does it means you require ₹ 2,85,000 to buy or sell Nifty Future? Answer is NO. To trade in Nifty Future, some margin required only. Generally it comes around ₹ 25,000 to ₹ 30,000, If stock market becomes very volatile then exchange can increase the margin also.

So if you have Minimum ₹ 30,000, you can buy or sell Nifty Future. It is not compulsory that you should have Nifty Future in your portfolio to sell it. You can sell it first and later you can buy it. But we suggest you, if you are new to stock market and do not have the capital of ₹ 100000, then do not trade in Nifty Future.

Exchange giving you some option to trade in Nifty Future. Like you think that Nifty will jump next month and you do not want to buy current month Nifty Future, then there is next month contract also available. You can buy that contract. All contracts expire on Last Thursday of the Month. Suppose you bought Nifty Future 25th Oct 2012, it means you will have to square off your position on or before 25th Oct 2012. If you will not it then exchange will settle it in last.

Let us take one example:

Suppose, you bought today Nifty Future at 5700 on 15th Oct 2012 and sold out next day at 5730, it means you gained 30 points and your profit will be

30 (Gained points) × 50 (lot size) = ₹ 1500 (Profit)

Suppose you bought today Nifty Future at 5700 on 15th Oct 2012 and sold out same day at 5680, it means you lost 20 points and your loss will be

20 (lost points) × 50 (lot size) = ₹ 1000 (Loss)

Suppose you Sold today (Shorted) Nifty Future at 5700 on 15th Oct 2012 and bought (covered) same day at 5670, it means you gained 30 points and your profit will be

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30 (Gained points) × 50 (lot size) = ₹ 1500 (Profit)

Suppose you Sold today (Shorted) Nifty Future at 5700 on 15th Oct 2012 and bought (covered) after 5 days at 5750, it means you lost 50 points and your loss will be

50 (lost points) × 50 (lot size) = ₹ 2500 (Loss)

Now, I hope that Nifty Future trading concept is clear to you.

Question 61A] Write a short note on: 'Future' and 'Options'

CS (Executive) - June 2012 (3 Marks), Dec 2015 (3 Marks)

Ans.: A future contract is a contract between two parties to buy or to sell an asset at a specified future time at a price agreed upon today. Thus, an instrument which is similar to forward contract but traded and under which no risk of default is called future contract.

A future contract is a standardized contract between two parties where one of the parties commits to sell, a specified quantity of a specified assets at an agreed price on a given date in the future.

Option is a contract which gives the holder the right to purchase or sell the underlying security at specified price within specified period of time. Option may be Put Option or Call Option.

Question 62] What do you understand by 'hedging'?

Ans.: A hedge is an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Hedging is a risk management strategy used in limiting or offsetting probability of loss from fluctuations in the prices of commodities, currencies, or securities. In effect, hedging is a transfer of risk without buying insurance policies.

Hedging involves taking equal and opposite positions in two different markets (such as cash and futures markets). Hedging is used also in protecting one's capital against effects of inflation through investing in high-yield financial instruments (bonds, notes, shares), real estate, or precious metals.

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Hedging explained: Hedging is any act which reduces the price of risk of a position taken in cash market. Future contract facilitate the hedging. One can hedge with a future contract by taking a position this is the opposite of the position taken in cash market. Position can be 'Long' or 'Short'. The term 'Long' means bought position. The term 'Short' means sell position.

Thus,

- You should sell Futures if you have long position (bought position) in assets in the cash market.
- You should buy Futures if you have short position (sell position) in assets in the cash market

Numerical Example:

(1) Selling Futures, if one has long position in cash market:

Suppose, Mr. Ram has 1,000 shares of Reliance Stock which is currently quoting at ₹ 800 in spot market. Further suppose, Reliance Futures are traded at ₹ 820. If Mr. Ram fears that the price in the spot market might fall, he should sell 1,000 Reliance Futures.

If stock price falls to ₹ 740, Mr. Ram loses ₹ 60,000 [(740 - 800) × 1,000]. However, he gain ₹ 80,000 on the futures position [(820 - 740) × 1,000].

If Mr. Ram estimates goes wrong and the price of Reliance Stock rises to ₹ 880, he gain ₹ 80,000 [(880 - 800) × 1,000] in spot market and lose ₹ 60,000 [(740 - 800) × 1,000] on Future position. Either case he ends with ₹ 20,000. In short, whichever way the price moves he makes ₹ 20,000.

(2) Buying Futures, if one has short position in cash market:

Suppose, Mr. Suresh short (sold) 1,000 shares of Tata Stock which is currently quoting at ₹ 250 in spot market. Further suppose, Tata Futures are traded at ₹ 260. If Mr. Suresh fears that the price in the spot market might rise, he should buy 1,000 Tata Futures. If stock price rises to ₹ 275, Mr. Suresh loses ₹ 25,000 [(250 - 275) × 1,000]. However, he gain ₹ 15,000 on the futures position [(275 - 260) × 1,000].

If Mr. Suresh estimates goes wrong and the price of Tata Stock falls to ₹ 240, he gain ₹ 10,000 [(250 - 240) × 1,000] in spot market and lose ₹ 15,000 [(275 - 260) × 1,000] on Future position. Either case he ends with ₹ 10,000. In short, whichever way the price moves he makes ₹ 10,000.

Question 63] What do you understand by 'Hedge Funds'? Also state the characteristics of Hedge Funds.

Ans.: A hedge fund is an alternative investment that is designed *to protect investment portfolios from market uncertainty*, while generating *positive returns* in both up and down markets.

Hedge fund serves as an important risk management tool for investors by providing valuable portfolio diversification. Hedge fund strategies are typically designed to protect investment principal. Hedge funds frequently use investment instruments (e.g. derivatives) and techniques (e.g. short selling) to hedge against market risk and construct a conservative investment portfolio - one designed to preserve wealth.

Characteristics of Hedge Funds:

- Hedge funds are organized as private investment partnerships or offshore investment corporations.
- Hedge funds use a wide variety of trading strategies involving position-taking in a range of markets.
- Hedge funds employ as assortment of trading techniques and instruments, often including short selling, derivatives and leverage.
- Hedge funds pay performance fees to their managers.
- Hedge funds have an investor base comprising wealthy individuals and institutions and relatively high minimum investment limit.

Question 64] Hedge Funds are similar to mutual funds. CS (Executive) - Dec 2012 (2 Marks)

Ans.: Hedge funds are similar to mutual funds as both entities issue units or securities to investors and holds pool of securities to diversify investment, have professional asset manager and same invest strategies. In this way hedge funds are similar to mutual funds.

Question 65] Write a short note on: Domestic Hedge Funds

Ans.: Domestic hedge funds are those hedge funds that are organized within the boundaries of the United States of America and valued as account balances. Hedge funds organized within the United States of America are subject to U.S. regulatory trading reporting and are typically designed for taxable U.S. investors. Domestic hedge funds are typically organized as limited partnerships, business trust or limited liability companies in Delaware.

Question 66] Write a short note on: Offshore Hedge Funds CS (Executive) - June 2011 (2 Marks)

Ans.: Hedge funds structured under foreign law, or located outside the U.S. are designated as "offshore hedge funds." Managers who desire to start a hedge fund offshore can enjoy several advantages over their domestic contemporaries.

One advantage is that the fund and its investors are not subject to United States taxation.

Another advantage is that since the number of accounts in a U.S. hedge fund is limited, offshore funds are a way to raise additional capital from non-U.S. investors.

Offshore hedge funds are not registered in the United States or with the U.S. Securities & Exchange Commission, and therefore offer privacy benefits as well as tax advantages.

Who can invest in an offshore hedge fund : Generally, non-U.S. citizens and non-U.S. residents who are present in the United States fewer than 180 days a year. However, many tax-exempt investors, such as not-for-profit institutes, retirement funds, and endowments may invest in offshore hedge funds. Both foreign investors and U. S. exempt investors will invest in either a parallel fund of an existing U. S. fund, or they will invest in a foreign-feeder fund which is set up as a corporation.

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Question 67] What do you understand by Leverage Funds?

Ans.: Leverage is an investment strategy of using borrowed money to generate outsized investment returns.

Leveraged funds are mutual funds using aggressive investment techniques of financial leverage, such as buying on margin, short selling and option trading, to obtain maximum capital appreciation for investors in the fund.

How it works:

Suppose, the cost of a vehicle is ₹ 20,000 and a buyer hands over ₹ 2,000 in cash and ₹ 18,000 in borrowed money in exchange for the vehicle, the buyer's cash outlay was only 10% of the vehicle's purchase price. Using borrowed money to pay 90% of the cost enabled the buyer to obtain a significantly more expensive vehicle than what could have been purchased using only available personal cash. Instead of driving around in a battered ₹ 2,000 jalopy, the buyer is cruising around town in a shiny new car, having used leverage to acquire a better vehicle than he/she could have purchased using only available cash on hand.

From an investment perspective, this buyer was levered 10 to one (10:1). That is to say, the ratio of personal cash to borrowed cash is ₹ 1 in personal cash for every ₹ 10 spent. Now, let's take the example a step further.

If the buyer in our automobile example was able to drive away from the dealership and immediately sell that car for ₹ 22,000, the buyer would pocket ₹ 2,000 in profit from a ₹ 2,000 investment, ignoring the interest expense. Mathematically speaking, that would be a 100% return on the buyer's investment. By contrast, consider the case if the buyer has paid cash for the car, without taking out a loan, and then immediately sold the car for ₹ 22,000. With a ₹ 20,000 initial investment resulting in ₹ 2,000 profit, the buyer would have generated a 10% return on the investment. While a 10% return is certainly nice, it pales in comparison to the 100% return that could have been generated using leverage.

Question 68] Distinguish between: Leverage Funds & Hedge Funds

CS (Inter) - June 2007 (4 Marks)
CS (Executive) - Dec 2013 (3 Marks)

Ans.: Following are the main points of distinction between leverage funds and hedge funds :

Points	Leverage Funds	Hedge Funds
Meaning	Leveraged funds are mutual funds using aggressive investment techniques of financial leverage, such as buying on margin, short selling and option trading, to obtain maximum capital appreciation for investors in the fund.	A hedge fund is an alternative investment that is designed *to protect investment portfolios from market uncertainty*, while generating *positive returns* in both up and down markets.
Risky	Leverage funds are more risky.	Hedge funds are less risky.
Strategy	Leverage is an investment strategy of using borrowed money to generate outsized investment returns.	Hedging is a risk management strategy used in limiting or offsetting probability of loss from fluctuations in the prices of commodities, currencies, or securities.

Question 69] Private equity funds are just like hedge funds.

CS (Executive) - Dec 2010 (2 Marks)

Write a short note on: Private Equity Funds **CS (Inter) - Dec 2006 (5 Marks)**
CS (Executive) - Dec 2012 (3 Marks)

Ans.: A private equity fund, like a hedge fund, is an unregistered investment vehicle in which investors pool money to invest. Private equity funds concentrate their investments in unregistered (and typically illiquid) securities. Like hedge funds, private equity funds also rely on the exemption from registration of the offer and sale of their securities. The investors in private equity funds and hedge funds typically include high net worth individuals and families, pension funds, endowments, banks and insurance companies. Private equity funds, however, differ from hedge funds in terms of the manner in which contribution to the investment pool is made by the investors.

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Private equity investors typically commit to invest a certain amount of money with the fund over the life of the fund, and make their contributions in response to "capital calls" from the fund's general partner. Private equity funds are long term investments, provide for liquidation at the end of the term specified in the fund's governing documents and offer little, if any, opportunities for investors to redeem their investments. A private equity fund may distribute cash to its investors when it sells its portfolio investment, or it may distribute the securities of a portfolio company.

Question 70] Write a short note on: Exchange Traded Funds

CS (Inter) - June 2007 (5 Marks)
CS (Executive) - Dec 2009 (2 Marks)

Exchange traded funds are a new variety of mutual funds.

CS (Inter) - June 2008 (2 Marks)
CS (Executive) - Dec 2012 (2 Marks)

Ans.: Exchange Traded Funds (ETFs) are funds that track indexes like the SENSEX, NIFTY or Commodity Index etc. When you buy shares of an ETF, you are buying shares of a portfolio that tracks the yield and return of its native index. The main difference between ETFs and other types of index funds is that ETFs don't try to outperform their corresponding index, but simply replicate its performance. They don't try to beat the market, they try to be the market.

In short, they are similar to index mutual funds but are traded more like a stock.

It was **State Street Global Advisors** of America that launched the first exchange-traded fund (ETF) in **1993** with the introduction of the **Standard & Poor's Depositary Receipt** (SPDR). Since then, ETFs have continued to grow in popularity and gather assets at a rapid pace. In India also there are lot of Exchange Traded Funds.

The easiest way to understand ETFs is to think of them as mutual funds that trade like stocks. Of course, trading like a stock is just one of the many features that make ETFs so popular, particularly with professional investors and individual investors who are active traders.

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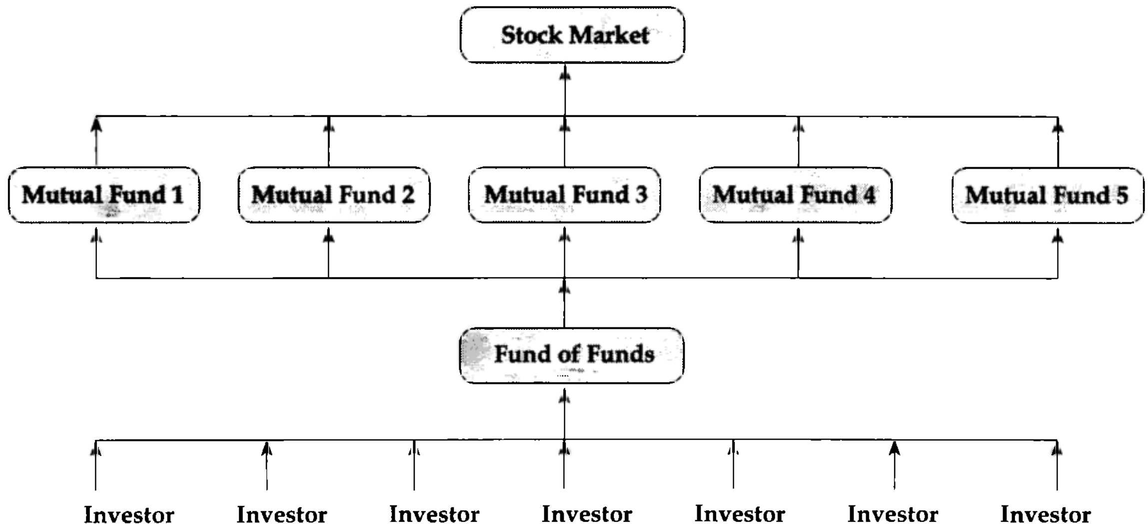
Question 71] Write a short note on: Fund of Funds (FoFs)

Explain the rationality of 'fund of funds' in the Indian financial market.

CS (Inter) - June 2008 (4 Marks)

Ans.: A Fund of Funds is a mutual fund scheme that invests in other mutual funds, and is designed to suit the varying needs of different investor categories based on their risk profiles, return expectations and investment goals. It provides investors an opportunity to take advantage of the benefits of diversification by investing in a variety of fund categories.



Benefits of fund of fund:

(1) **Diversification:** As a fund of funds invests in the schemes of other funds, it provides a greater degree of diversification.

(2) **Uncomplicated:** Instead of investing in different stocks/units of mutual funds and keeping a track record of all of them, it will be much easier to invest in and track only one fund, which in turn invests in other mutual funds.

(3) **Cheap:** While entering into the capital markets it is difficult to diversify because of limited funds. Fund of funds provide an opportunity to go for diversification with comparatively limited amounts.

(4) **Risk:** Investors can trim down the risk by choosing this route. Because of diversification, even if one stock/scheme is not performing well risk level comes down.

(5) **Expertise of Various Managers:** As in the case of schemes of mutual funds, fund of funds scheme also work under the due diligence of a fund manager. This gives the scheme additional expertise as compared to other mutual funds schemes. These schemes also provide access to information which may be difficult to obtain for an investor on a case by case basis.

Disadvantages of fund of funds scheme:

However, just like any other investment, fund of funds is not free from shortcomings. Few of the disadvantages are specified below:

(*i*) **Additional Fees:** The more diversified the fund is, the greater the likelihood that the investor will incur an incentive fee on one or more of the constituent managers, regardless of overall FoF performance.

(*ii*) **Associated Risks:** Risks associated with all the underlying funds get added at this level. Following are the type of risks associated with fund of funds scheme.

(*iii*) **Management Risks:** Every fund manager has a particular style of diversification. This diversification style will be in perfect correlation with the number of managers involved. The views of a manager may be altogether different from the market.

(*iv*) **Operational Risks:** Due diligence of a scheme in itself gives rise to operational risks. Continuous monitoring is required for knowing about performance of the funds, any possibility of a fraud and to know about the investment style of the funds and any desirable or undesirable changes in it.

(*v*) **Qualitative Risks:** These include risks associated with the management environment of the fund such as organizational structure, infrastructure, investment process, operational issues etc.

(*vi*) **Regulations in India:** The fund of funds scheme was introduced in the Indian market by making suitable amendments in **SEBI (Mutual Funds) (Amendment) Regulations, 2003**.

PROBLEMS & SOLUTIONS ON CAPITAL MARKET INSTRUMENTS

Question 72] Jai Ltd. announced issue of bonus shares in the ratio of 1:3 (i.e. one share for every three shares held). At present the face value share is ₹ 10, current market price is ₹ 621. In addition, it announced split of shares by reducing the face value from ₹ 10 to 2. Calculate the share price if all other things remain constant. What would have been the situation if split would have been done before the issue of bonus shares?

CS (Executive) - Dec 2015 (4 Marks)

Ans.: *Calculation of share price after issue of bonus shares (without split):*

$$\frac{\text{Existing shares} \times \text{Market value}}{\text{Existing shares} + \text{Bonus Shares}} = \frac{3 \times 621}{3 + 1} = 465.75$$

The company desires to split the shares form ₹ 10 to ₹ 2 per share i.e. one share will be converted into 5 shares.

Calculation of share price after issue of bonus & split:

No. of shares after split = (Existing shares + bonus shares) × Split ratio

= (3 + 1) × 5

= 20

$\frac{465.75}{5} = 93.15$

If split would have been done before the issue of bonus shares:

No. of shares after split = Existing shares × Split ratio

= 3 × 5

= 15

Market price after split = $\frac{621 \times 3}{15} = 124.2$

Calculation of share price after split & issue of bonus shares:

$$\frac{\text{Existing shares} \times \text{Market value}}{\text{Existing shares} + \text{Bonus Shares}} = \frac{15 \times 124.2}{15+5} = 93.15$$

Question 73] Prime Ltd. issued some warrants which allowed the holders to purchase, with one warrant, one equity share at ₹ 18.275 per share. The equity share was quoted at ₹ 25 per share and the warrant was selling at ₹ 9.50. In this case, you are required to compute -

(i) The minimum price of warrant and

(ii) The warrant premium **CS (Executive) - June 2016 (4 Marks)**

Ans.: Value of warrant is calculated as follows:

Condition	Minimum value of warrant
$P_s > P_c$	$(P_s - P_c) \times N$
$P_s \leq P_c$	0

P_s = Current market price for the equity shares

P_c = Exercise price of warrant

N = No. of equity shares per warrant (Generally N = 1)

Thus,

Value of warrant = 25 - 18.275 = 6.725

Warrant premium = 9.50 - 6.725 = 2.775

Question 74] Manish owns 250 preference shares of Amaze Ltd. which currently sells for ₹ 77 per share and pays annual dividend of ₹ 13 per share -

(i) What is Manish's expected return?

(ii) If Manish requires 13% return, should he sell or buy more preference shares at the current price? **CS (Executive) - June 2016 (4 Marks)**

Ans.: Expected return on preference shares = $\frac{\text{Dividend}}{\text{Market price}} \times 100 = \frac{13}{77} \times 100 = 16.88\%$

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Required return of Manish is 13%.

Analysis: Since, expected return is more than required return, Manish should buy more shares.

OBJECTIVE QUESTIONS

Question A] Expand the following abbreviations:

(1) FCD
(2) PCD
(3) NCD
(4) IDBI
(5) SIDBI
(6) GDR
(7) ADR
(8) ODB
(9) FCCR
(10) IDR
(11) MBS
(12) ETF
(13) FOF

Question B] State, with reasons in brief, whether the following statements are correct or incorrect:

(1) Every company can issue shares with differential right as to dividend, voting or otherwise.

(2) Forward contract is a contract to buy or sell an underlying financial instrument at a specified future date at a price when the contract is entered.

(3) Forward contracts are used for speculation

(4) A private equity fund is like a hedge fund.

(5) The company cannot issue sweat equity shares more than 25% of the average turnover of last three years or ₹ 100 crore whichever is less.

(6) The sweat equity shares are subject to lock in period.

(7) Partly paid-up preference shares can be redeemed.

(8) Tracking stocks are shares issued by a company which pay a dividend determined by the performance of the whole company.

(9) Hedging involves taking equal and same positions in two different markets.

(10) ADR is negotiable instrument all over the world.

Question C] Re-write the following sentences after filling-up the blank spaces with appropriate word(s)/figure(s):

(1) Instruments which were issued with their basic characteristics in-tact without mixing features of other classes of instruments are called ________

(2) Derivatives are contracts which derive their values from the value of one or more of other assets known as ________

(3) Equity shares, commonly referred to as ordinary share also represents the form of fractional ________ in which a shareholder undertakes the maximum entrepreneurial risk associated with a business venture.

(4) Equity capital and further issues of equity capital by a company are generally based on the condition that they will rank ________ along with the earlier issued share capital in all respects.

(5) A ________ is a quasi debt instrument which is issued by any corporate entity, international agency or sovereign state to the investors all over the world.

(6) Section 43 of the Companies Act, 2013 enables companies limited by shares to issue ________ as to dividend, voting or otherwise, subject to fulfilment of certain conditions.

(7) In the case of ________ the dividend payable every year becomes a first claim while declaring dividend by the company. In case the company does not have adequate profit or for some reason the company does not want to pay preference dividend, it gets accumulated for being paid subsequently.

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(8) Company limited by shares shall issue any preference shares which is irredeemable or is redeemable after the expiry of a period of ________ from the date of its issue.

(9) In case of ________, if the conversion is to take place at or after 18 months from the date of allotment but before 36 months, the conversion is optional on the part of the debenture holders in terms of SEBI ICDR Regulations.

(10) From the point of view of the ________ratio the convertible part of the debentures is treated as equity by financial institutions.

(11) __________ are issued for 10 years with flexibility to the issuer to review the interest rate every two years.

(12) __________ are issued by financial institutions in connection with the development or purchase of industrial facilities.

(13) Petro bonds, silver bonds, gold bonds and coal bonds are examples of _________

(14) _________ are inflation protection securities.

(15) The company shall maintain a Register of Sweat Equity Shares in __________

Question D] Select the correct option

1. _________ are those which are created by combining the features of equity with bond, preference and equity.

(*a*) Mixed instruments

(*b*) Baby bonds

(*c*) Hybrid instruments

(*d*) Hypothetical instruments

2. Which of the following right is/are not available to equity shareholders?

(*a*) Right of pre-emption in the matter of fresh issue of capital.

(*b*) Right to receive annual accounts along with the auditor's report, director's report and other information

(*c*) Right to inspect books of account of the company.

(*d*) All of the above

3. _____ of the Companies Act, 2013 enables companies limited by shares to issue shares with differential rights as to dividend, voting or otherwise, subject to fulfilment of certain conditions.

(*a*) Section 42

(*b*) Section 43

(*c*) Section 45

(*d*) Section 52

4. Debentures are issued by a company as a certificate of __________

(*a*) ownership

(*b*) capital

(*c*) quasi-ownership

(*d*) indebtedness

5. _______ do not carry any charge on the assets of the company.

(*a*) Naked debentures

(*b*) Bearer debentures

(*c*) Perpetual debentures

(*d*) All of the above

6. In case of Fully Convertible Debentures (FCD), if the conversion is to take place at or after _______ from the date of allotment but before _______, the conversion is optional on the part of the debenture holders in terms of SEBI ICDR Regulations.

(*a*) 18 months; 36 months

(*b*) 12 months; 24 months

(*c*) 15 months; 30 months

(*d*) 24 months; 36 months

7. In the case of partly convertible debentures, debenture redemption reserve has to be created for _____ of the face value of the __________

(*a*) 50%; convertible portion

(*b*) 50%; non-convertible portion

(*c*) 25%; non-convertible portion

(*d*) 40%; convertible portion

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8. Sweat equity shares can be issued _____

(A) at a discount

(B) for consideration other than cash

(*a*) (B) only

(*b*) (A) only

(*c*) Both (A) and (B)

(*d*) Neither (A) nor (B)

9. Sweat equity shares can be issued to ____

(I) Employees

(II) Public

(III) Directors

(IV) Creditors

(V) Government

(*a*) (II), (IV) & (V)

(*b*) (I), (III) & (IV)

(*c*) (III) & (I)

(*d*) (I), (II), (III), (IV) & (V)

10. Zero coupon bonds are bonds issued at ________ and redeemed at par.

(*a*) face value to discount

(*b*) discount to face value plus premium

(*c*) par to discounted value

(*d*) discount to face value

11. A ________ lowers the interest rate risk by neutralizing the inflation risk.

(*a*) carrot and stick bond

(*b*) capital indexed bonds

(*c*) commodity bonds

(*d*) dual convertible bond

12. Sweat equity share is an instrument permitted to be issued by specified Indian companies, under ______ of Companies Act, 2013.

(*a*) Section 54

(*b*) Section 51

(*c*) Section 55

(*d*) Section 50

13. For a deep discount price of _____ in IDBI the investor got a bond with the face value of ₹ 1,00,000.

(*a*) ₹ 2,200

(*b*) ₹ 2,500

(*c*) ₹ 2,700

(*d*) ₹ 2,750

14. The issue of sweat equity share is to be authorized by a _________ passed by the company in the _________

(*a*) special resolution; general meeting

(*b*) ordinary resolution; general meeting

(*c*) board resolution; board meeting

(*d*) special resolution; board meeting

15. In which of the following bond advantage to the investor is the attraction of higher rate of interest in case of general rise in interest rates?

(*a*) stepped coupon bonds

(*b*) pay in kind bonds

(*c*) easy exit bonds

(*d*) split coupon bonds

16. A _______ is a type of common stock that "tracks" or depends on the financial performance of a specific business unit or operating division of a company, rather than the operations of the company as a whole.

(*a*) Deferred stock

(*b*) Preferred stock

(*c*) Third party stock

(*d*) Tracking stock

17. _______ took the lead in July, 1992 by making a mega rights issue of equity shares and secured premium notes aggregating to ₹ 1,212 crores.

(*a*) TCS

(*b*) BATA

(*c*) RELIANCE

(*d*) TISCO

18. ________, including fund of funds are unregistered private investment partnerships, funds or pools that may invest and trade in many different markets, strategies and instruments including securities, non-securities and derivatives.

(*a*) Mutual funds

(*b*) Hedge funds

(*c*) Hypothetical funds

(*d*) Exchange traded funds

19. The investors in _________ typically include high net worth individuals and families, pension funds, endowments, banks and insurance companies.

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(*a*) private equity funds

(*b*) hedge funds

(*c*) both (a) and (b)

(*d*) neither (a) nor (b)

20. The terms of the secured premium notes were so formulated that the return on investment was treated as _______.

(*a*) regular income

(*b*) deferred income

(*c*) capital gain

(*d*) exempted income

21. 'Baby Bonds' & 'Parent Bond' words are used to describe which of the following bond?

(*a*) Clip and strip bonds

(*b*) Stepped coupon bonds

(*c*) Dual option warrants

(*d*) Pay in kind bonds

22. Exchange traded funds (ETFs) are a new variety of mutual fund that was first introduced _____

(*a*) 2001

(*b*) 1993

(*c*) 1997

(*d*) 2005

23. The holder has an option to sell back the SPN to the company at ______ after the lock in period.

(*a*) Par value

(*b*) Discount

(*c*) Premium

(*d*) Any of the above

24. The shares with differential rights shall not exceed ______ of the total post-issue paid-up equity share capital including equity shares with differential rights issued at any point of time.

(*a*) 20%

(*b*) 25%

(*c*) 26%

(*d*) 10%

25. Where preference shares are proposed to be redeemed out of the profits a sum equal to the nominal amount of the shares should be transferred to the _____

(*a*) Preference Share Redemption Reserve Account

(*b*) Capital Reserve Account

(*c*) Capital Redemption Reserve Account

(*d*) Profit & Loss Account

26. In ________ equity shares or debentures may be issued with two warrants - one warrant giving right to the purchaser to be allotted one equity share at the end of a certain period and another warrant with a debt or preference share option.

(*a*) Dual option warrants

(*b*) Equity shares with detachable warrants

(*c*) Indexed Rate Notes

(*d*) Extendable Notes

27. If the face value of a convertible debenture is ₹ 100 and it is convertible into two equity shares, the conversion price is ₹ 25 then conversion ratio will be ____

(*a*) 2

(*b*) 4

(*c*) 2.5

(*d*) 6

28. Sardar Sarovar Nigam Ltd. issued a bond at ₹ ______ redeemable on face value of ₹ _______ after 21 years.

(*a*) 3,600; 1,11,000

(*b*) 2,500; 1,00,000

(*c*) 3,500; 1,10,000

(*d*) 4,250; 1,15,000

29. Which of the following instrument give an offer to the debt holders to exchange the debt for equity shares of the company?

(*a*) Level pay floating rate notes

(*b*) Option Bonds

(*c*) Easy Exit Bonds

(*d*) Debt for equity swap

30. In ______, the interest rate fixation is postponed till the actual date of placement, rather than fixing it on the date of the commitment.

(*a*) Indexed Rate Notes

(*b*) Extendable Notes

(*c*) Zero Coupon Convertible Notes

(*d*) Deep Discount Bond

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31. Level Pay Floating Rate Notes are issued for a long period of time say ______, with adjustment in interest rate every ______

(*a*) 10 years; 2 years

(*b*) 20 years; 5 years

(*c*) 10 years; 3 years

(*d*) 20 years; 4 years

32. ______ are issued by companies and institutions to share the risk and expand the capital to link investors return with the size of insurer losses. The bigger the losses, the smaller the return and *vice versa.*

(*a*) Split Coupon Debentures

(*b*) Disaster Bonds

(*c*) Clip & Strip Bonds

(*d*) Stepped Coupon Bonds

33. Derivatives include a variety of financial contracts, including ______

(1) Futures

(2) Forwards

(3) Swaps

(4) Options

(*a*) (1) & (4)

(*b*) (2) & (3)

(*c*) (2), (4) & (1)

(*d*) (3), (1), (4) & (2)

34. In which of the following type of contract there is guarantee of settlement?

(A) Forward Contract

(B) Future Contract

(*a*) (B) only

(*b*) (A) only

(*c*) Both (A) and (B)

(*d*) Neither (A) nor (B)

35. Hedge funds structured under foreign law, or located outside the U.S. are designated as "______"

(*a*) Foreign hedge funds

(*b*) Offshore hedge funds

(*c*) European hedge funds

(*d*) Global Depository Funds

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Answer to Question A:

Abbreviation	Long Form
FCD	Fully Convertible Debentures
PCD	Partly Convertible Debentures
NCD	Non-Convertible Debentures
IDBI	Industrial Development Bank of India
SIDBI	Small Industries Development Bank of India
GDR	Global Depository Receipts
ADR	American Depository Receipts
ODB	Overseas Depository Bank
FCCR	Foreign Currency Convertible Bond
IDR	Indian Depository Receipts
MBS	Mortgaged Backed Securities
ETF	Exchange Traded Funds
FOF	Fund of Funds

Answer to Question B:

(1) **Incorrect.** As per **Rule 4** of the **Companies (Share Capital & Debentures) Rules, 2014**, only company limited by shares can issue shares with differential right as to dividend, voting or otherwise

(2) **Incorrect.** *Future* is a contract to buy or sell an underlying financial instrument at a specified future date at a price when the contract is entered.

(3) **Incorrect.** Forward contracts are used for hedging. Future contracts are used for speculation.

(4) **Correct.** A private equity fund, like a hedge fund, is an unregistered investment vehicle in which investor's pool money to invest.

(5) **Incorrect.** The company shall not issue sweat equity shares for more than **15% of the existing paid up equity share capital** in a year or shares of the issue value of ₹ **5 Crores**, whichever is higher.

(6) **Correct.** The sweat equity shares issued to directors or employees shall be locked in for a period of **3 years** from the date of allotment and this fact shall be stamped in bold on the share certificate.

(7) **Incorrect.** Preference shares shall be redeemed unless they are **fully paid-up**.

(8) **Incorrect.** Tracking Stocks are shares issued by a company which pay a dividend determined by the performance of a specific portion of the whole company.

(9) **Incorrect.** Hedging involves taking equal and *opposite* positions in two different markets

(10) **Incorrect.** GDR is negotiable instrument all over the world

Answer to Question C:

(1) Pure Instruments **(2)** underlying assets **(3)** ownership **(4)** *pari passu* **(5)** Foreign Currency Convertible Bond (FCCB) **(6)** shares with differential rights **(7)** cumulative preference shares **(8)** 20 years **(9)** Fully Convertible Debentures (FCD) **(10)** debt equity **(11)** Extendable Notes **(12)** Industrial Revenue Bonds **(13)** Commodity Bonds **(14)** Capital indexed bonds **(15)** Form No. SH. 3

Answer to Question D:

1.	(c)	**7.**	(b)	**13.**	(c)	**19.**	(c)	**25.**	(c)	**31.**	(b)
2.	(c)	**8.**	(c)	**14.**	(a)	**20.**	(c)	**26.**	(a)	**32.**	(b)
3.	(b)	**9.**	(c)	**15.**	(a)	**21.**	(d)	**27.**	(b)	**33.**	(d)
4.	(d)	**10.**	(d)	**16.**	(d)	**22.**	(b)	**28.**	(a)	**34.**	(a)
5.	(a)	**11.**	(b)	**17.**	(d)	**23.**	(a)	**29.**	(d)	**35.**	(b)
6.	(a)	**12.**	(a)	**18.**	(b)	**24.**	(c)	**30.**	(a)		

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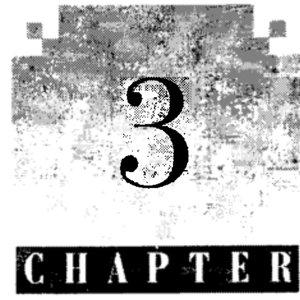

CREDIT RATING & IPO GRADING

Introduction : Credit rating is the analysis and assessment of companies issuing financial securities.

The first mercantile credit agency was established in **New York** in **1841**. Its first rating guide was published in **1859** by **Robert Dun**. Another similar agency was set up by **John Bradstreet** which published its rating guide in **1857**. These two agencies were merged to form Dun and Bradstreet in **1933** which acquired **Moody's Investor Service** in **1962**. Moody's was founded by Moody in **1900**.

The other world renowned rating agency, namely **Standard & Poor** was created in **1941** by merging the Standard Statistics Company and Poor's Publishing Company which had their origin earlier.

In India **Credit Rating & Information Services (India) Ltd. (CRISIL)** was set up as the first credit rating agency in **1987**. This was followed by **Investment Information & Credit Rating Agency of India Ltd. (ICRA)** in **1991** and **Credit Analyses and Research Ltd. (CARE)** in **1994** and then in **1999 Fitch Rating India (P) Ltd.** now known as **India Ratings & Research Pvt. Ltd., Brickwork Rating Pvt. Ltd.** in **2008** and **SME Rating Agency of India Ltd. (SMERA)** in **2011**. All these six credit rating agencies are registered with the SEBI.

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CONCEPT OF CREDIT RATING

Question 1] Define credit rating. State the benefits of credit rating to the companies and investors. Name any two credit rating agencies of India.

CS (Inter) - Dec 2002 (5 Marks)

Explain the ICRA. **CS (Inter) - June 2003 (2 Marks)**

Credit ratings establish a link between risk and return.

CS (Executive) - Dec 2011 (4 Marks), June 2015 (3 Marks)

Ans.: Credit rating is the analysis and assessment of companies issuing financial securities.

Credit ratings establish a **link between risk and return**. An investor or any other interested person uses the rating to assess the risk-level and compares the offered rate of return with his expected rate of return.

Credit Rating is a **symbolic indication** of the **current opinion** regarding the relative capability of a corporate entity to service its debt obligations in time with reference to the instrument being rated. It enables the investor to differentiate between debt instruments on the basis of their underlying credit quality. To facilitate simple and easy understanding, credit rating is expressed in **alphabetical** or **alphanumerical symbols**.

Importance of credit rating :

- It plays a role in **investor protection.**
- It benefits industry in terms of direct **mobilization of savings** from individuals.
- It provides a **marketing tool** to the company.
- Ratings also encourage **discipline amongst corporate borrowers** to improve their financial structure and operating risks to obtain a better rating for their debt obligations and thereby **lower the cost of borrowing.**

- Companies those get a lower rating are **forewarned** and thereby improve their standing in the market.
- Credit rating agencies also occupy a leading position as information providers along with rating of financial instruments.

Credit rating agencies in India :

Nick name	Full Name	Set up in
CRISIL	Credit Rating & Information Services of India Ltd.	1987
ICRA	Investment Credit Rating Agency of India Ltd. *(formerly Investment Information and Credit Rating Agency of India Limited)*	1991
CARE	Credit Analyses & Research Ltd.	1994
IRR	India Ratings & Research Pvt. Ltd. *(formerly Fitch Rating India Pvt. Ltd.)*	1999
BR	Brickwork Rating Pvt. Ltd.	2008
SMERA	SME Rating Agency of India Ltd.	2011

Question 2] State the various purposes for which credit rating is applied.

Ans.: The various purposes for which credit rating is applied are:

(1) Long-term/Medium-term debt obligations : Debentures, bonds, preference shares or project finance debts are considered long-term and debts ranging from 1 to 3 years like fixed deposits are considered medium-term.

(2) Short-term debt obligations : The period involved is 1 year or less and cover money market instruments such as commercial paper, credit notes, cash certificates etc.

(3) Equity grading and assessment, structured obligations, municipal bonds, mutual fund schemes, plantation schemes, real estate projects, infrastructure related debts, ADR, GDR issues, bank securities etc.

Credit rating does not bound the investor to decide whether to hold or sell an instrument as it does not take into consideration factors such as market prices, personal risk preferences and other consideration which may influence an investment decision. It **does not create any fiduciary relationship** between the rating agency and the user of the rating. A credit rating agency does not perform an audit but relies on information provided by the issuer and collected by the analysts from different sources hence it does not guarantee the completeness or accuracy of the information on which the rating is based.

Question 3] Credit rating is useful to investors and issuers. Comment.

CS (Executive) - Dec 2012 (2 Marks), Dec 2015 (3 Marks)

"Credit rating not only plays a significant role in investor protection but also benefits industry as a whole." Discuss. **CS (Executive) - June 2016 (5 Marks)**

Ans.: Credit rating is useful to investors, issuers, intermediaries and regulators.

(A) Benefits of credit rating to investors :

(1) Helps in investment decision : Credit rating gives an idea to the investors about the credibility of the issuer company, and the risk factor attached to a particular instrument. So, the investors can decide whether to invest in such companies or not. Higher the rating, the more will be the willingness to invest in these instruments and *vise-versa.*

(2) Benefits of rating reviews : The rating agency regularly reviews the rating given to a particular instrument. So, the present investors can decide whether to keep the instrument or to sell it. e.g. if the instrument is downgraded, then the investor may decide to sell it and if the rating is maintained or upgraded, he may decide to keep the instrument until the next rating or maturity.

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(3) **Assurance of safety** : High credit rating gives assurance to the investors about the safety of the instrument and minimum risk of bankruptcy. The companies which get a high rating for their instruments, will try to maintain healthy financial discipline. This will protect them from bankruptcy. So the investors will be safe.

(4) **Easy understandability of investment proposal** : The rating agency gives rating symbols to the instrument, which can be easily understood by investors. This helps them to understand the investment proposal of an issuer company. E.g. **AAA**, given by CRISIL for debentures ensures highest safety, whereas debentures rated **D** are in default or expect to default on maturity.

(5) **Choice of instruments** : Credit rating enables an investor to select a particular instrument from many alternatives available. This choice depends upon the safety or risk of the instrument.

(6) **Saves investor's time and effort** : Credit ratings enable an investor to his save time and effort in analyzing the financial strength of an issuer company. This is because the investor can depend on the rating done by professional rating agency, in order to take an investment decision. He need not waste his time and effort to collect and analyze the financial information about the credit standing of the issuer company.

(B) **Benefits of credit rating to issuer** : The market places immense faith in opinion of credit rating agencies, hence the issuers also depend on their critical analysis. This enables the issuers of highly rated instruments to access the market even during adverse market conditions.

(C) **Benefits of credit rating to intermediaries** : Rating is useful to Intermediaries such as merchant bankers for planning, pricing, underwriting and placement of the issues. Intermediaries like brokers and dealers in securities use rating as an input for monitoring risk exposures.

(D) **Benefits of credit rating to Regulators** : Regulatory authorities in different countries such as India, US, Australia and Japan have specified rules that restrict entry to the market of new issues rated below a particular grade, that stipulate different margin requirements for rated and unrated instruments, that prohibit institutional investors for purchasing or holding instruments rated below a particular level and so on.

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Question 4] Credit Rating is a marketing tool for the companies.

CS (Executive) - Dec 2010 (3 Marks), June 2014 (5 Marks)

Ans.: Credit rating is a powerful marketing tool for the issuer company because when the issuer get good credit rating it becomes easier for it to raise money from the market. The market places immense faith in opinion of credit rating agencies, hence the issuers also depend on their critical analysis. This enables the issuers of highly rated instruments to access the market even during adverse market conditions.

High credit rating gives assurance to the investors about the safety of the instrument and minimum risk of bankruptcy. The companies which get a high rating for their instruments, will try to maintain healthy financial discipline. So, the investors will be safe.

In nutshell, the investor make investment decision based on credit rating, so it works as a marketing tool for the company.

Question 5] Discuss briefly the rating process followed by the credit rating agencies.

Ans.: Rating process is practices and procedures which a rating agency follows to gather information for evaluating the credit risk of specific issuers and issues, to analyze and conclude on the appropriate rating, to monitor the credit quality of the rated issuer or security over time, deciding on timely changes in ratings, as and when companies' fundamentals change and to keep investors and the market players informed. All these are interrelated and ongoing processes. The general principals followed all over the world are the same. The rating agencies in India have adopted the methodology of the major international credit agencies.

ICRA's rating process involves:

- **Assigning a rating team :** The team usually comprises two members. The composition of the team is based on the expertise and skills required for evaluating the issuer's business.
- **Collecting information :** Issuers are provided a list of information requirements and the broad framework for discussions. These information requirements encompass the rating factors specific to the issuer's business. ICRA maintains internal records to support its credit ratings in accordance with our internal policies and applicable norms from SEBI. ICRA follows strict processes to maintain confidentiality. All information collected as part of the rating process is used only for rating activities and is not disclosed in ICRA's publications unless approved by the issuer.
- **Meeting key officials and the management team :** In addition to the quantitative analysis, rating involves assessment of several qualitative factors that are likely to have a bearing on credit profile of the issuer. This requires extensive interactions with issuer's senior officials and top management specifically relating to business and financial risk, management's approach to mitigating risk factors, outlook for the business, management strategy & future plans, and funding policies. Visit to the 'Works' facilitates understanding of the production process and also helps in assessing the progress of projects under implementation. Rating team also has discussions with the auditors and key lenders.
- **Preview meeting :** After the completion of analysis, the findings are discussed at length internally to validate the identification of all key factors, which have a bearing on the rating. These key rating factors are also discussed with the top management of the debt issuing entity to elicit their views.
- **Rating committee meeting :** ICRA's rating committee is the designated authority for assigning ratings. The rating team comprising the analysts presents the key rating factors and its analysis, which are discussed in this committee. The rating committee assigns a rating and all the factors, which influence the rating, are clearly spelt out.
- **Rating communication :** The assigned rating along with key rating factors are communicated to the issuer's top management for acceptance. The ratings, which are not accepted, are either rejected or reviewed. The rejected ratings are not disclosed and complete confidentiality is maintained subject to compliance with statutory guidelines.
- **Rating review :** If the rating is not acceptable to the issuer, there is a provision for a review of the rating assigned. These reviews are usually taken up only if the issuer provides fresh inputs on the key factors that were considered for assigning the rating. Issuer's response is presented to the rating committee for arriving at the final rating decision.
- **Surveillance :** Separately discussed.

Monitoring of ratings : Separately discussed.

CRISIL's Rating Process in the form of a flow chart is given below.

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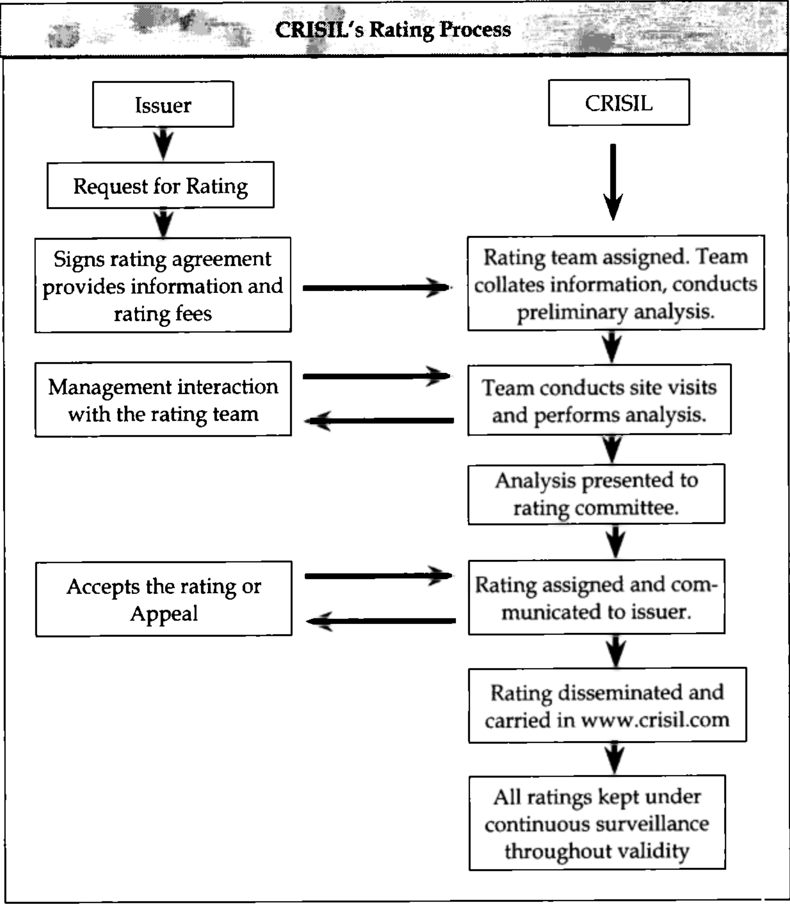

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Question 6] Discuss the factors generally considered by credit rating agencies for the rating of manufacturing companies. **CS (Executive) - June 2010 (4 Marks)**

Ans.: The factors generally considered for rating of manufacturing companies are as under:

(1) **Industry risk :** It is defined as the strength of the industry within the economy and relativity to the economic trends. It is evaluated on the basis of factors like business cyclically, earnings volatility, growth prospects, demand - supply projections, entry barriers and extent of competition and nature and extent of regulation.

(2) **Company's industry and market position :** The company's sales position in its major fields and its historical background of its market position is analyzed along with ability to sustain/increase market shares; brand strengths and position; price leadership and distribution and marketing strengths/ weaknesses.

(3) **Operating efficiencies :** Ability to control costs, productivity efficiencies relative to others, labour relationship, extent of forward and backward integration, access to raw materials/markets, and technology.

(4) **Accounting quality :** Financial statements are adjusted for non-standard accounting treatments. Overall evaluation of the accounting policies employed and the extent to which they understate or overstate financial performance and position. These include analysis of auditor's qualifications, revenue recognition, depreciation policy, inventory evaluation, funding for pension liabilities, undervalued assets etc.

(5) **Financial flexibility :** Evaluation of the company's financing needs, plans and alternatives, its flexibility to accomplish its financing programmes under stress without damaging creditworthiness.

(6) **Earnings protection :** The key measurements which indicate the basic long term earnings power of the company including return on capital, profit margins, earnings from various business segments, sources of future earnings growth, coverage ratios etc.

(7) **Financial leverage :** Relative usage of debt and levels of debt appropriate to different types of businesses, utilization of long and short term sources of funds, management of working capital.

(8) **Cash flow adequacy :** It is the relationship of cash flows to leverage and the ability to internally meet all cash needs of the business, it measures the magnitude and variability of future cash flows relative to debt servicing obligations and other commitments such as group company funding, BIFR packages and contingent liabilities. This analysis goes into the inherent protective factors for expected cash flows of the company and the sensitivity of these cash flows to changes in variables like raw material costs and selling prices.

(9) **Management evaluation :** The record of achievement in operations and financial results, strategic and financial planning, commitment, consistency and credibility, overall quality of management, line of succession, strength of middle management and organization structure and its linkage with the operating environment and management strategies.

Question 7] Discuss the factors considered by credit rating agencies for rating of an instrument.
CS (Executive) - June 2013 (6 Marks)

Ans.: Every credit rating agency develop its own rating system for rating respective instruments. Some of the common factors considered by the credit rating agencies for the rating of an instrument are as follows:

- Issuer company's operational efficiency
- Level of technology development
- Financial position
- Competency and effectiveness of management
- Past records of debt servicing
- Capital structure
- Working capital etc.

Question 8] What factors are generally considered for rating of Financial Services Companies?

Ans.: The rating methodology for non-banking financial services companies is based on **CAMEL** model encompassing, Capital adequacy, Asset quality, Management, Earnings and Liquidity. The nature and accessibility of funding sources is also considered.

SEBI (CREDIT RATING AGENCIES) REGULATIONS, 1999

Question 9] State the provisions relating to "application for grant of certificate" for carrying activity of a credit rating.

Ans.: Application for grant of certificate [Regulation 3]: Any company proposing to commence any activity as a credit rating agency shall make an application to the SEBI for the grant of a certificate of registration.

An application for the grant of a certificate shall be made in **Form A** of the **First Schedule** and shall be accompanied by a non-refundable application fee specified in **Second Schedule.** Currently application fee is ₹ 50,000.

Question 10] Who can promote or take steps to incorporate credit rating agency under the SEBI (Credit Rating Agencies) Regulations, 1999?

Ans.: Promoter of credit rating agency [Regulation 4] : The SEBI shall consider an application of any credit rating agency only it is made by following categories of persons:

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(*a*) A public financial institution

(*b*) A scheduled commercial bank

(*c*) A foreign bank operating in India with the approval of the RBI

(*d*) A foreign credit rating agency having at least 5 years experience

(*e*) Any company or a body corporate, having continuous net worth of minimum ₹ **100 Crores** as per its audited annual accounts for the 5 previous years.

Net-worth [Regulation 2(p)] : Net-worth means the aggregate value of the paid up equity capital and free reserves (excluding revaluation reserves), reduced by the aggregate value of accumulated losses and deferred expenditure not written off, including miscellaneous expenses not written off.

Eligibility Criteria [Regulation 5] : The applicant must satisfy the following conditions:

(*a*) The applicant is a company under the Companies Act, 2013.

(*b*) The applicant has specified rating activity as one of its main objects in its MOA.

(*c*) The applicant has a minimum net worth of ₹ **5 Crores**.

(*d*) The applicant should have adequate infrastructure.

(*e*) The applicant and its promoters shall have professional competence, financial soundness and general reputation of fairness and integrity in business transactions.

(*f*) The applicant or its promoter or any director shall not be is involved in past in any legal proceeding connected with the securities market, which may have an adverse impact on the interests of the investors.

(*g*) The applicant or its promoters or any director has not at any time in the past been convicted of any offence involving moral turpitude or any economic offence.

(*h*) The applicant has employed persons having adequate professional and other relevant experience.

(*i*) The applicant or any person directly or indirectly connected with the applicant has not in the past been -

(*a*) refused by the SEBI a certificate or

(*b*) subjected to any proceedings for a contravention of the SEBI Act, 1992 or of any Rules or Regulations made under the Act.

"Directly or indirectly connected person" means any person who is an associate, subsidiary, inter-connected or group company of the applicant or a company under the same management as the applicant.

(*j*) The SEBI forms opinion that the applicant is a fit and proper person for the grant of a certificate.

The provisions of the **SEBI (Criteria for Fit & Proper Person) Regulations, 2004** shall apply to all applicants or the credit rating agencies under these regulations. **[Regulation 5A]**

(*k*) Grant of certificate to the applicant is in the interest of investors and the securities market.

Application to conform to the requirements [Regulation 6] : If application for a certificate is not complete or do not conform specified instructions in Form A, it will be rejected by the SEBI.

However, before rejecting application an opportunity to remove the defect can be given within 30 days of the date of communication by the SEBI. Such time can be further extended by another 30 days if applicant shows the sufficient reason.

Furnishing of information, clarification and personal representation [Regulation 7] : The SEBI may require further information or clarification as it may consider necessary for the purpose of processing of the application.

The SEBI may ask the applicant or its authorized representative to appear before it, for personal representation in connection with the grant of a certificate.

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Grant of Certificate of registration [Regulation 8] : SEBI on being satisfied that the applicant is eligible for the grant of a certificate of registration, shall grant a certificate in **Form B**. It is valid for 5 years from the date of issue. On registration fee of ₹ 26,66,700 is payable.

Question 11] Tanushri and Richa are the partners of the firm which carries various financial advisory services. The firm has net worth of ₹ 12 crores. The firm desires to engage in providing credit rating services. Advise the firm, whether it can apply to the SEBI for grant of certificate of registration under the SEBI (Credit Rating Agencies) Regulations, 1999?

Ans.: As per **Regulation 4**, the SEBI shall consider an application of any credit rating agency only if is made by following categories of persons:

(*a*) A public financial institution

(*b*) A scheduled commercial bank

(*c*) A foreign bank

(*d*) A foreign credit rating agency having at least 5 years experience

(*e*) Any company or a body corporate, having continuous net worth of minimum ₹ **100 Crores** as per its audited annual accounts for the 5 previous years.

Partnership firm is not covered in Regulation 4 and hence it cannot apply for certificate of registration under the SEBI (Credit Rating Agencies) Regulations, 1999 irrespective of its net worth.

Question 12] The certificate of registration granted to the credit rating agencies under the SEBI (Credit Rating Agencies) Regulations, 1999 is subject to certain conditions. Comment.

Ans.: Conditions of certificate and validity period [Regulation 9] : The certificate of registration granted to credit rating agency shall be subject to the following conditions:

(*a*) The credit rating agency shall comply with the provisions of the SEBI Act, 1992 the Regulations made there under and the guidelines, directives, circulars and instructions issued by the SEBI from time to time.

(*b*) The credit rating agency shall forthwith inform the SEBI in writing where any information or particulars furnished to the SEBI by a credit rating agency

- is found to be false or misleading in any material particular or
- has undergone change subsequently to its furnishing at the time of the application for a certificate

Validity of certificate of registration : The certificate of registration granted to credit rating agency shall be valid for **3 years**. Renewal fee of ₹ 15,00,000 is payable at the expiry of every 3 years.

Question 13] India Ratings & Research Pvt. Ltd. sought you advice on renewal of the certificate of registration. Advice them suitable.

Ans.: Renewal of certificate [Regulation 10] : Since Regulation 8 has been inserted by making amendment which makes provisions for permanent registration; provisions relating to renewal of certificate contained in Regulation 10 are deleted. There is no need to apply for renewal of certificate of registration.

Question 13A] Can SEBI reject the application for grant of certificate of registration made by credit rating agency? What is the procedure? Is opportunity of being heard is required to be given in such case? Also state whether applicant has any right apply to SEBI to reconsider its decision rejecting application? What is the effect of refusal to grant certificate?

Ans.: Procedure where certificate is not granted [Regulation 11] : If, after considering an application for grant of certificate of registration, the SEBI is of the opinion that a certificate should not be granted, it may reject the application after giving the applicant a reasonable opportunity of being heard.

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The decision of the SEBI, not to grant or not to renew the certificate shall be communicated to the applicant within a period of 30 days of decision.

Any applicant aggrieved by the decision of the SEBI rejecting his application may, within a period of 30 days from the date of receipt of the communication apply to the SEBI in writing for reconsideration of such decision.

Where an application for re-consideration is made the SEBI shall consider the application and communicate to the applicant its decision in writing, as soon as may be.

Question 14] "Every credit rating agency is required to abide by the code of conduct as per the SEBI Regulations." Comment and discuss briefly the code of conduct for credit rating agencies.
CS (Inter) - Dec 2007 (4 Marks)

Ans.: Code of Conduct [Regulation 13] : Every credit rating agency shall abide by the Code of Conduct contained in the **Third Schedule**.

(1) It shall observe high standards of **integrity and fairness** in dealings with its clients while conducting of its business.

(2) It shall fulfil its obligations in an **ethical** manner.

(3) It shall render at all times **high standards of service**, exercise **due diligence**, ensure **proper care** and exercise **independent professional judgment**. It shall wherever necessary, disclose to the clients, possible sources of conflict of duties and interests, while providing unbiased services.

(4) It shall **avoid** any **conflict of interest** of any member of its rating committee participating in the rating analysis. Any potential conflict of interest shall be disclosed to the client.

(5) It shall **not indulge in unfair competition** nor shall they wean away client of any other rating agency on assurance of higher rating.

(6) It shall **not make any exaggerated statement**, whether oral or written, to the client either about its qualification or its capability to render certain services or its achievements in regard to services rendered to other clients.

(7) It shall always endeavour to ensure that all **professional dealings** are effected in a **prompt** and **efficient** manner.

(8) It shall **not divulge** to other clients, press or any other party any **confidential information** about its client, which has come to its knowledge, without making disclosure to the concerned person of the rated company/client.

(9) It shall **not make untrue statement** or **suppress** any **material fact** in any documents, reports, papers or information furnished to the SEBI or to public or to stock exchange.

   (a) It **shall not create false market** or **pass price sensitive information** to brokers, members of the stock exchanges, other players in the capital market or to any other person or take any other action which is unethical or unfair to the investors.

(10) It shall maintain an **arm's length relationship** between its credit rating activity and any other activity.

(11) It shall **abide** by the provisions of the **SEBI Act, 1992, Regulations** and **Circulars** which may be applicable and relevant to the activities carried on by the credit rating agency.

(12) A credit rating agency or any of his employees shall not render directly or indirectly any investment advice about any security in the publicly accessible media, whether real time or non-real time, unless a disclosure of his interest including long or short position in the said security has been made, while rendering such advice.

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Question 15] Is credit rating agency is required to enter into agreement with the client whose securities it proposes to rate? If yes, what are the contents of such agreement?

Ans.: Agreement with the client [Regulation 14]: Every credit rating agency shall enter into a written agreement with each client whose securities it proposes to rate. Such agreement shall include the following provisions:

(*i*) The rights and liabilities of each party shall be defined in respect of the rating of securities.

(*ii*) The fee to be charged by the credit rating agency shall be specified.

(*iii*) The client shall agree to a periodic review of the rating by the credit rating agency during the tenure of the rated instrument.

(*iv*) The client shall agree to co-operate with the credit rating agency in order to enable the latter to arrive at, and maintain, a true and accurate rating of the clients securities and shall in particular provide to the latter, true, adequate and timely information for the purpose.

(*v*) The credit rating agency shall disclose to the client the rating assigned to the securities of the latter through regular methods of dissemination, irrespective of whether the rating is or is not accepted by the client.

(*vi*) The client shall agree to disclose, in the offer document:

   (*i*) the rating assigned to the client's listed securities by any credit rating agency during the last 3 years

   (*ii*) any rating given in respect of the client's securities by any other credit rating agency, which has not been accepted by the client and

   (*iii*) The client shall agree to obtain a rating for any issue of debt securities in accordance with relevant regulations.

Question 16] "Credit rating is a one-time job on the part of credit rating agencies." Comment in the light of the SEBI regulations. **CS (Inter) - Dec 2005 (6 Marks)**

State the requirements for monitoring of ratings by a credit rating agency.

CS (Inter) - June 2007 (4 Marks)

Ans.: Credit rating is not a one-time job on the part of credit rating agencies.

Monitoring of ratings [Regulation 15] : Every credit rating agency shall continuously monitor the rating of securities rated by it during the lifetime of such securities.

It shall disseminate information regarding newly assigned ratings and changes in earlier rating promptly through press releases and websites. In the case of listed securities, such information shall also be provided simultaneously to the concerned regional stock exchange and to all the stock exchanges where the said securities are listed.

Procedure for review of rating [Regulation 16] : Every credit rating agency shall carry out periodic reviews of all published ratings during the lifetime of the securities.

If the client does not co-operate, the credit rating agency shall carry out the review on the basis of the best available information and it shall disclose to the investors the fact that the rating is so based.

A credit rating agency shall not withdraw a rating so long as the obligations under the security rated by it are outstanding, except where the company whose security is rated is wound-up or merged or amalgamated with another company.

Internal procedures to be framed [Regulation 17] : Every credit rating agency shall frame appropriate procedures and systems for monitoring the trading of securities by its employees in the securities of its clients to prevent contravention of -

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(*a*) The SEBI (Insider Trading) Regulations, 1992;

(*b*) The SEBI (Prohibition of Fraudulent & UTP relating to the Securities Market) Regulations, 1995 and

(*c*) Other laws relevant to trading of securities.

Question 17] Discuss briefly the general obligations of the credit rating agencies under the SEBI (Credit Rating Agencies) Regulations, 1999.

Ans.: General obligations of the credit rating agencies are as follows:

(1) To make disclosure of rating definitions and rationale [Regulation 18] : Every credit rating agency -

(*a*) shall make public the definitions of the concerned rating, along with the symbol and

(*b*) shall also state the ratings that do not constitute recommendations to buy, hold or sell any securities

Every credit rating agency shall make available to the general public information relating to the rationale of the ratings, which shall cover an analysis of the various factors justifying a favourable assessment, as well as factors constituting a risk.

(2) To submit information to the SEBI [Regulation 19] : Where any information is called for by the SEBI from a credit rating agency, including any report relating to its activities, the credit rating agency shall furnish such information to the SEBI -

(a) within a period specified by the SEBI or

(b) if no such period is specified, then within a reasonable time.

Every credit rating agency shall, at the close of each accounting period, furnish to the SEBI copies of its balance sheet and profit and loss account.

(3) To comply circulars issued by the SEBI [Regulation 20] : Every credit rating agency shall comply with such guidelines, directives, circulars and instructions as may be issued by the SEBI from time to time, on the subject of credit rating.

(4) To appointment of Compliance Officer [Regulation 20A] : Every credit rating agency shall appoint a compliance officer who shall be responsible for monitoring the compliance of the Act, Rules and Regulations, notifications, guidelines, instructions issued by the SEBI or Central Government.

The Compliance Officer shall immediately and independently report to the SEBI any non-compliance observed by him.

(5) To keep confidentiality of information given by client [Regulation 23] : Every credit rating agency shall treat, as confidential, information supplied to it by the client and no credit rating agency shall disclose the same to any other person, except where such disclosure is required or permitted by under or any law for the time being in force.

(6) To maintenance of books of account & records [Regulation 21] : Every credit rating agency shall keep and maintain, for a minimum period of **5 years**, the following books of account, records and documents:

(*i*) Copy of its Balance Sheet, Profit & Loss A/c and Auditor's Report on its accounts as on the end of each accounting period

(*ii*) A copy of the agreement entered into with each client

(*iii*) Information supplied by each of the clients

(*iv*) Correspondence with each client

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(*v*) Ratings assigned to various securities including upgradation and down gradation of the ratings so assigned

(*vi*) Rating notes considered by the rating committee

(*vii*) Record of decisions of the rating committee

(*viii*) Letter assigning rating

(*ix*) Particulars of fees charged for rating and such other records as the Board may specify from time to time.

Every credit rating agency shall intimate to the SEBI the place where the books of account, records and documents are being maintained.

(7) **To take steps on Auditor's Report [Regulation 22] :** Every credit rating agency shall take steps to rectify the deficiencies made out in the auditor's report within 2 months from the date of the auditor's report, insofar as they relate to the activity of rating of securities.

Question 18] Write a short note on: Internal Audit of Credit Rating Agency

Ans.: SEBI has decided in consultation with the credit rating agencies to be undertaken an internal audit on a half yearly basis which is envisaged under **Regulation 22** of the **SEBI (Credit Rating Regulations), 1999**. Such audit will be carried out by **CS**, CA or CMA who are in practice and who do not have any conflict of interest with the CRA.

Coverage of Audit : Internal Audit shall cover following aspects:

- Operations and procedures of credit rating agencies
- Investor grievance redressal mechanism
- Compliance with the requirements stipulated in the SEBI Act, Rules and Regulations made thereunder, and guidelines issued by SEBI from time to time.

Audit Report : The report shall cover the following matters:

- ◆ Methodology adopted
- ◆ Deficiencies observed
- ◆ Response of the management on the deficiencies
- ◆ Size of operations, number of transactions audited
- ◆ Number of instances where violations/deviations were observed

The report shall also comment on the adequacy of systems adopted by the credit rating agencies for compliance with the requirements of regulations and guidelines issued by SEBI and investor grievance redressal.

Time Schedule for Audit : The time schedule for the internal audit shall be as under:

- ◆ The CRA shall receive the report of the internal audit within 2 months from the end of the half-year.
- ◆ The Board of Directors of the credit rating agencies shall consider the report and take steps to rectify the deficiencies, if any, and the credit rating agencies shall send an **Action Taken Report** to SEBI within next 2 months.

Question 19] Every credit rating agency shall follow a proper rating process. Discuss in the light of provisions made under the SEBI (Credit Rating Agencies) Regulations, 1999.

Ans.: Rating Process [Regulation 24] :

(1) Every credit rating agency (CRA) shall -

(*a*) specify the rating process;

(*b*) file a copy of the same with the SEBI for record.

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Copy of any modifications or additions made in rating process from time to time is required to be filed with SEBI.

(2) Every CRA shall follow a proper rating process.

(3) Every CRA shall have professional rating committees, comprising members who are adequately qualified and knowledgable to assign a rating.

(4) Rating committee shall take all rating decisions including the decisions regarding changes in rating.

(5) Every CRA shall be staffed by analysts qualified to carry out a rating assignment.

(6) Every CRA shall inform the SEBI about new rating instruments or symbols introduced by it.

(7) While rating a security CRA shall exercise due diligence in order to ensure that the rating given by the credit rating agency is fair and appropriate.

(8) A CRA shall not rate securities issued by it.

(9) Rating definition or the structure for a particular rating product, shall not be changed by CRA, without prior information to the SEBI.

(10) A CRA shall disclose the rating assigned to the securities of a client to the concerned stock exchange through press release and websites for general investors it shall also disclose periodic review, including changes in rating.

Question 20] Discuss briefly the restrictions on credit rating agency regarding rating of securities issued by its promoter and entities connected with promoter.

Ans.: Securities issued by promoter [Regulation 26] : Credit rating agency shall not rate a security issued by its promoter.

In case promoter is a lending institution, it's Chairman, director or employee shall not be a Chairman, director or employee of credit rating agency or its rating committee.

Securities issued by certain entities, connected with a promoter, or rating agency not to be rated [Regulation 27] :

Credit rating agency shall not rate a security issued by following entities, if there are common Chairman, Directors or employees:

(*a*) A borrower of its promoter or

(*b*) A subsidiary of its promoter or

(*c*) An associate of its promoter

Credit rating agency shall not rate a security issued by its associate or subsidiary, if there are common Chairman, director or employee.

However, the credit rating agency may rate a security issued by its associate having a common independent director with it or rating committee if,-

(*i*) Such an independent director does not participate in the discussion on rating decisions, and

(*ii*) The credit rating agency makes a disclosure in the rating announcement about the existence of common independent director on its Board or of its rating committee, and that the common independent director did not participate in the rating process or in the meeting of its board of directors or in the meeting of the rating committee, when the securities rating of such associate was discussed.

Question 21] Discuss the procedure relating to inspection and investigation of the Credit rating agencies. Also state what action can be taken by the SEBI in case of defaults.

Ans.: SEBI's right to inspect [Regulation 29] : The SEBI may appoint inspecting officers, to undertake inspection or investigation of the books of account, records and documents of the credit rating agencies for any of the following purposes:

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(*a*) To ascertain whether the books of account, records and documents are being maintained properly.

(*b*) To ascertain whether the provisions of the Act and Regulations are being complied with.

(*c*) To investigate into complaints received from investors, clients or any other person on any matter having a bearing on activities of the credit rating agency.

(*d*) To investigate in the interest of the securities market or in the interest of investors.

The inspections ordered by the SEBI shall not ordinarily go into an examination of the appropriateness of the assigned ratings on the merits.

Inspections to judge the appropriateness of the ratings may be ordered by the SEBI, only in case of complaints which are serious in nature.

Inspections shall be carried out either by the officers of the SEBI or independent experts, with relevant experience or combination of both.

Notice before inspection or investigation [Regulation 30] : The SEBI shall give 10 days notice to the credit rating agency before ordering an inspection or investigation. However, such inspection and investigation can be carried out without notice if it is in the interest of investor.

Obligations of credit rating agency on inspection or investigation by the SEBI [Regulation 31] : It shall be the duty of every credit rating agency and its director, officer or employee, to produce to the officer, the books, accounts and other documents in their custody and to furnish him statements and information relating to its rating activities, as the inspecting officer may require within reasonable period as may be specified by the said officer.

The credit rating agency shall -

(*a*) Allow the inspecting officer to have reasonable access to the premises occupied by credit rating agency or by any other person on its behalf

(*b*) Extend to the inspecting officer reasonable facility for examining any books, records, documents and computer data in the possession of the credit rating agency and

(*c*) Provide copies of documents or other materials which are relevant for the purposes of the inspection or investigation in the opinion of the inspecting officer.

The inspecting officer shall be entitled to examine, or record the statements, of any officer, director or employee of the credit rating agency in the course of inspection or investigation

Every director, officer or employee of the credit rating agency shall be bound to render to the inspecting officer all assistance in connection with the inspection or investigation which the inspecting officer may reasonably require.

Submission of Report to the SEBI [Regulation 32] : The inspecting officer shall, as soon as possible, on completion of the inspection or investigation, submit a report to the SEBI. However, if directed to do so by the SEBI, he may submit an interim report.

Action on inspection or investigation report [Regulation 33] : The SEBI or the Chairman shall after consideration of inspection or investigation report take such action as the Board or Chairman may deem fit and appropriate including action under the **SEBI (Intermediaries) Regulations, 2008**.

Action in case of default [Regulation 34] : Credit rating agency which contravenes any of the provisions of the Act, Rules, or Regulations framed there under shall be liable for one or more actions specified therein including the action under Chapter V of the SEBI (Intermediaries) Regulations, 2008.

RATING SYMBOLS

Long Term Debt Instruments : These instruments are with original maturity exceeding one year.

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AAA	Instruments with this rating are considered to have the **highest degree of safety** regarding timely servicing of financial obligations. Such instruments carry **lowest credit risk.**
AA	Instruments with this rating are considered to have **high degree of safety** regarding timely servicing of financial obligations. Such instruments carry very **low credit risk.**
A	Instruments with this rating are considered to have **adequate degree of safety** regarding timely servicing of financial obligations. Such instruments **carry low credit risk.**
BBB	Instruments with this rating are considered to have **moderate degree of safety** regarding timely servicing of financial obligations. Such instruments carry **moderate credit risk.**
BB	Instruments with this rating are considered to have **moderate risk of default** regarding timely servicing of financial obligations.
B	Instruments with this rating are considered to have **high risk of default** regarding timely servicing of financial obligations.
C	Instruments with this rating are considered to have very **high risk of default** regarding timely servicing of financial obligations.
D	Instruments with this rating are in default or are **expected to be in default soon.**

Modifiers {"+" (plus) / "-"(minus)} can be used with the rating symbols for the categories AA to C. The modifiers reflect the comparative standing within the category.

Short Term Debt Instruments : These instruments are with original maturity of up to one year.

A1	Instruments with this rating are considered to have **very strong degree of safety** regarding timely payment of financial obligations. Such instruments carry **lowest credit risk.**
A2	Instruments with this rating are considered to have **strong degree of safety** regarding timely payment of financial obligations. Such instruments carry **low credit risk.**
A3	Instruments with this rating are considered to have **moderate degree of safety** regarding timely payment of financial obligations. Such instruments carry **higher credit risk** as compared to instruments rated in the two higher categories.
A4	Instruments with this rating are considered to have **minimal degree of safety** regarding timely payment of financial obligations. Such instruments carry **very high credit risk and are susceptible to default.**
D	Instruments with this rating are **in default or expected to be in default on maturity.**

Long Term Structured Finance Instruments : These instruments are with original maturity exceeding one year. Rating symbols should have CRA's first name as prefix.

AAA (SO)	Instruments with this rating are considered to have the **highest degree of safety** regarding timely servicing of financial obligations. Such instruments carry **lowest credit risk.**
AA (SO)	Instruments with this rating are considered to have **high degree of safety** regarding timely servicing of financial obligations. Such instruments carry **very low credit risk.**
A (SO)	Instruments with this rating are considered to have **adequate degree of safety** regarding timely servicing of financial obligations. Such instruments carry **low credit risk.**
BBB (SO)	Instruments with this rating are considered to have **moderate degree of safety** regarding timely servicing of financial obligations. Such instruments carry **moderate credit risk.**
BB (SO)	Instruments with this rating are considered to have **moderate risk of default** regarding timely servicing of financial obligations.
B (SO)	Instruments with this rating are considered to have **high risk of default** regarding timely servicing of financial obligations.
C (SO)	Instruments with this rating are considered to have **very high likelihood of default** regarding timely payment of financial obligations.
D (SO)	Instruments with this rating are **in default or are expected to be in default soon.**

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Short Term Structured Finance Instruments : The instruments with original maturity of up to one year.

A1 (SO)	Instruments with this rating are considered to have **very strong degree of safety** regarding timely payment of financial obligation. Such instruments carry **lowest credit risk**.
A2 (SO)	Instruments with this rating are considered to have **strong degree of safety** regarding timely payment of financial obligation. Such instruments carry **low credit risk**.
A3 (SO)	Instruments with this rating are considered to have **moderate degree of safety** regarding timely payment of financial obligation. Such instruments carry **higher credit risk** as compared to instruments rated in the two higher categories.
A4 (SO)	Instruments with this rating are considered to have **minimal degree of safety** regarding timely payment of financial obligation. Such instruments carry **very high credit risk** and are **susceptible to default**.
D (SO)	Instruments with this rating are **in default or expected to be in default on maturity**.

Long Term Debt Mutual Fund Schemes : These debt mutual fund schemes have an original maturity exceeding one year.

AAAmfs	Schemes with this rating are considered to have the **highest degree of safety** regarding timely receipt of payments from the investments that they have made.
AAmfs	Schemes with this rating are considered to have the **highest degree of safety** regarding timely receipt of payments from the investments that they have made.
Amfs	Schemes with this rating are considered to have the **adequate degree of safety** regarding timely receipt of payments from the investments that they have made.
BBBmfs	Schemes with this rating are considered to have the **moderate degree of safety** regarding timely receipt of payments from the investments that they have made.
BBmfs	Schemes with this rating are considered to have **moderate risk of default** regarding timely receipt of payments from the investments that they have made.
Bmfs	Schemes with this rating are considered to have **high risk of default** regarding timely receipt of payments from the investments that they have made.
Cmfs	Schemes with this rating are considered to have **very high risk of default** regarding timely receipt of payments from the investments that they have made.

Short Term Debt Mutual Fund Schemes : These debt mutual fund schemes that have an original maturity of up to one year.

A1mfs	Schemes with this rating are considered to have **very strong degree of safety** regarding timely receipt of payments from the investments that they have made.
A2mfs	Schemes with this rating are considered to have **strong degree of safety** regarding timely receipt of payments from the investments that they have made.
A3mfs	Schemes with this rating are considered to have **moderate degree of safety** regarding timely receipt of payments from the investments that they have made.
A4mfs	Schemes with this rating are considered to have **minimal degree of safety** regarding timely receipt of payments from the investments that they have made.

Question 22] Explain the following credit rating symbols:

(i) AAA

(ii) AA

(iii) A

(iv) BBB **CS (Inter) - June 2008 (4 Marks)**

Ans.:

(*i*) **AAA:** This symbol is used for rating "long term debt instruments".

Instruments with this rating are considered to have the **highest degree of safety** regarding timely servicing of financial obligations. Such instruments carry **lowest credit risk**.

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(*ii*) **AA** : This symbol is used for rating "long term debt instruments".

Instruments with this rating are considered to have **high degree of safety** regarding timely servicing of financial obligations. Such instruments carry **very low credit risk.**

(*iii*) **A** : This symbol is used for rating "long term debt instruments".

Instruments with this rating are considered to have **adequate degree of safety** regarding timely servicing of financial obligations. Such instruments carry **low credit risk.**

(*iv*) **BBBB** : This symbol is used for rating "long term debt instruments".

Instruments with this rating are considered to have **moderate degree of safety** regarding timely servicing of financial obligations. Such instruments carry **moderate credit risk.**

Question 23] Explain the following credit rating symbols:

(i) A

(ii) A1

(iii) A2 **CS (Executive) - June 2009 (3 Marks)**

Ans. :

(*i*) **A:** This symbol is used for rating "long term debt instruments".

Instruments with this rating are considered to have **adequate degree of safety** regarding timely servicing of financial obligations. Such instruments carry **low credit risk.**

(*ii*) **A1:** This symbol is used for rating "short term debt instruments".

Instruments with this rating are considered to have **very strong degree of safety** regarding timely payment of financial obligations. Such instruments carry **lowest credit risk.**

(*iii*) **A2:** This symbol is used for rating "short term debt instruments".

Instruments with this rating are considered to have **strong degree of safety** regarding timely payment of financial obligations. Such instruments carry **low credit risk.**

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IPO GRADING

Question 24] What is Initial Public Offerings (IPO) Grading? Explain the procedure for IPO Grading. **CS (Executive) - Dec 2008 (5 Marks), Dec 2013 (5 Marks),**

CS (Executive) - June 2014 (5 Marks)

Write a short note on: IPO Grading

CS (Executive) - June 2011 (2 Marks), June 2013 (4 Marks)

Ans.: Meaning of IPO : When a company publicly sells shares in the open market, it is initial public offering (IPO). It is also known as "going public."

Meaning of IPO Grading : IPO grading is the grade assigned by a Credit Rating Agency to the initial public offering of equity shares or any other security which may be converted into or exchanged with equity shares at a later date.

The grade assigned to any individual issue represents a relative assessment of the 'fundamentals' of that issue. Such grading is assigned on a five-point scale with a higher score indicating stronger fundamentals.

IPO grading is different from an investment recommendation : Investment recommendations are expressed as 'buy', 'hold' or 'sell' and are based on a security specific comparison of its assessed 'fundamentals factors' to its price. On the other hand, IPO grading is expressed on a five-point scale and is a relative comparison of the assessed fundamentals of the graded issue to other listed equity securities in India.

As the IPO grading does not take cognizance of the price of the security, it is not an investment recommendation. Rather, it is one of the inputs to help the investor in the decision making process.

IPO Grading : A company cannot make an initial public offer, unless as on the date of registering prospectus or red-herring prospectus with the ROC, the issuer has obtained grading for the initial public offer from at least one credit rating agency registered with SEBI. ***IPO grading is optional for public issue w.e.f. February 4, 2014.***

IPO Grading & SEBI (ICDR) Regulations, 2009 : Every unlisted company obtaining grading for IPO shall disclose all the grades obtained, along with the rationale discretion furnished by the credit rating agencies for each of the grades obtained.

Such disclosure has to be made in the prospectus, abridged prospectus, issue advertisements and at all other places where the issuer company is advertising for the IPO.

Benefits of IPO Grading :

- It would be useful for assessing the offerings of companies accessing the equity markets for the first time where there is no track record of their market performance.
- It can be used by the investor as tool to make investment decision.
- It will help the investor better appreciate the meaning of the disclosures in the issue documents to the extent that they affect the issue's fundamentals.

Procedure for IPO Grading : Credit Rating agencies will carry out IPO grading. SEBI does not play any role in the assessment made by the grading agency. The grading is intended to be an independent and unbiased opinion of that agency.

It is intended that IPO fundamentals would be graded on a five-point scale from Grade 5 (indicating strong fundamentals) to Grade 1 (indicating poor fundamentals). The grade would read as: "Rating Agency name" IPO Grade 1 *viz.* CARE IPO Grade 1, CRISIL IPO Grade 1 etc.

The assigned grade would be a onetime assessment done at the time of the IPO and meant to aid investors who are interested in investing in the IPO. The grade will not have any ongoing validity.

The company needs to first contact one of the grading agencies and mandate it for the grading exercise. The agency would then follow the process outlined below:

- The credit rating agency will seek necessary information relating to grading from the company.
- On receipt of required information, the credit rating agency will discuss with the company's management and visit the company's operating locations, if required.
- The credit rating agency will prepare an analytical assessment report.
- The credit rating agency will present the analysis to a committee comprising senior executives of the concerned grading agency.
- This committee would discuss all relevant issues and assign a grade.
- The credit rating agency will communicate the grade to the company along with an assessment report outlining the rationale for the grade assigned.

Though this process will ideally require 2-3 weeks for completion, it may be a good idea for companies to initiate the grading process about 6-8 weeks before the targetted IPO date to provide sufficient time for any contingencies.

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Question 25] Massive Ltd. came out with its IPO in November, 2015 and offered shares of ₹ 10 each at ₹ 450 charging a premium of ₹ 440. Shyam applied for 1,000 shares which had been allotted. On the list day, the closing share price was ₹ 418 and he was very upset about it. He looked at the prospectus of the company and found that company's IPO was not graded. So, he filed a complaint with SEBI stating that the company did not obtain IPO grading which is mandatory and hence, the IPO should be cancelled and the company should be asked to refund the money to investors.

Assume that you are working with the SEBI, will you suggest that the said issue should be cancelled as there has been violation of SEBI rules and regulations. Give your answer with reasons.

CS (Executive) - June 2016 (5 Marks)

Ans.: When a company publicly sells shares in the open market, it is initial public offering (IPO). It is also known as "going public."

Meaning of IPO Grading: IPO grading is the grade assigned by a Credit Rating Agency to the initial public offering of equity shares or any other security which may be converted into or exchanged with equity shares at a later date.

IPO Grading: A company cannot make an initial public offer, unless as on the date of registering prospectus or red-herring prospectus with the ROC, the issuer has obtained grading for the initial public offer from at least one credit rating agency registered with SEBI. This means IPO grading is mandatory for making an IPO.

IPO grading is optional for public issue w.e.f. February 4, 2014

IPO Grading & SEBI (ICDR) Regulations, 2009: Every unlisted company obtaining grading for IPO shall disclose *(if applicable)* all the grades obtained, along with the rationale discretion furnished by the credit rating agencies for each of the grades obtained.

Such disclosure has to be made in the prospectus, abridged prospectus, issue advertisements and at all other places where the issuer company is advertising for the IPO.

Form the above discussion it clear that as on date IPO grading is not mandatory; it is optional and hence contention of Shyam that as Massive Ltd. not obtained IPO grading its IPO should be cancelled is not correct.

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OBJECTIVE QUESTIONS

Question A] Expand the following abbreviations :

(1) CRISIL	(6) CRA	(11) BR
(2) ICRA	(7) IPO	(12) SMERA
(3) CARE	(8) MFS	
(4) FRI	(9) SO	
(5) CAMEL	(10) IRR	

Question B] State, with reasons in brief, whether the following statements are correct or incorrect :

(1) Credit rating is nothing but the analysis of profit making capacity of the business.

(2) Credit rating creates fiduciary relationship between the rating agency and the user of the rating.

(3) Credit rating guarantees the completeness or accuracy of the information on which the rating is based.

(4) Credit rating is a powerful marketing tool for the issuer company.

(5) Credit rating is a one-time job on the part of credit rating agencies.

(6) Credit rating agency shall not rate a security issued by its promoter.

(7) There is no difference between IPO grading and investment recommendation.

(8) IPO grading is mandatory.

Question C] Re-write the following sentences after filling-up the blank spaces with appropriate word(s)/figure(s) :

(1) Credit ratings establish a link between ______ and _______

(2) Credit rating is a ______ of the current opinion regarding the relative capability of a corporate entity to service its debt obligations in time with reference to the instrument being rated.

(3) Credit rating plays an important role in ______ protection.

(4) Credit rating does not create any _______ relationship between the rating agency and the user of the rating.

(5) The rating methodology for non-banking financial services companies is based on ____

(6) Any company or body corporate, having continuous net worth of minimum ________ as per its audited annual accounts for the previous five years to register as credit rating agency.

(7) The period of validity of certificate of initial registration issued to credit rating agency shall be _______

(8) The client shall agree to obtain a rating from at least two different rating agencies for any issue of debt securities whose size is equal to or exceeds ______

(9) Credit rating agency should keep and maintain, for a minimum period of _____, the prescribed books of account, records and documents.

(10) Credit rating agency should within ______ from the date of the auditor's report, take steps to rectify the deficiencies if any, made out in the auditor's report, insofar as they relate to the activity of rating of securities.

(11) As per CRISIL Debenture Rating Symbols, _______ rating indicates highest safety in timely payment of interest and principal.

(12) The first mercantile credit agency was established in _____ in 1841.

(13) In India, _______ was set up as the first credit rating agency in 1987.

Question D] Select the correct option.

1. The other world renowned rating agency namely _______ was created in 1941 by merging the Standard Statistics Company and Poor's Publishing Company which had their origin earlier.

(*a*) Moody

(*b*) Standard & Rich

(*c*) Standard & Poor

(*d*) SME Rating

2. An application for the grant of a certificate shall be made in ______ by the credit rating agency.

(*a*) Form A

(*b*) Form I

(*c*) Form B

(*d*) Form II

3. Credit rating is expressed in ______

(*I*) Alphabetical symbols

(II) Alphanumerical symbols

(*a*) (II) only

(*b*) (I) only

(*c*) Both (I) and (II)

(*d*) Neither (I) nor (II)

4. Every credit rating agency shall keep and maintain books of account, records and documents for a minimum period of ____

(*a*) 10 years

(*b*) 8 years

(*c*) 5 years

(*d*) 3 years

5. Credit rating provides a ______ to the company.

(*a*) Financial tool

(*b*) Marketing tool

(*c*) Both (a) and (b)

(*d*) Neither (a) nor (b)

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6. Every credit rating agency shall take steps to rectify the deficiencies made out in the auditor's report within _______ from the date of the auditor's report, insofar as they relate to the activity of rating of securities.

(a) 4 weeks

(b) 45 days

(c) 2 months

(d) 6 weeks

7. India Ratings & Research Pvt. Ltd. was earlier known as _______

(a) Brickwork Rating Pvt. Ltd.

(b) Fitch Rating India Pvt. Ltd.

(c) Fare Ratings & Research Pvt. Ltd.

(d) Fire Ratings India Pvt. Ltd.

8. Internal audit of credit rating agency will be carried out by _____ who are in practice.

(a) CS

(b) CA

(c) CMA

(d) Any of the above

9. Credit Analyses & Research Ltd. was set up in the year ______

(a) 1994

(b) 1991

(c) 1987

(d) 2001

10. The SEBI shall give _______ notice to the credit rating agency before ordering an inspection or investigation.

(a) 8 days

(b) 10 days

(c) 15 days

(d) 30 days

11. Which of the following factors are considered by the credit rating agencies in assigning ratings to the companies?

(i) Industry risk

(ii) Operating efficiencies

(iii) Personal achievement of directors and employees

(iv) Financial leverage

(v) Cash flow adequacy

(vi) Political conditions in country

(a) (i), (iii), (v) & (vi)

(b) (i), (ii), (iii), (v) & (vi)

(c) (i), (ii), (iv) & (v)

(d) (ii), (iv) & (vi)

12. In case of long term debt instruments, which of the following rating shows that the instrument is considered to have the highest degree of safety regarding timely servicing of financial obligations and carries lowest credit risk?

(a) A1

(b) AA

(c) A+++

(d) AAA

13. While making application for registration, the credit rating agency has to pay application fees as per _____ to the SEBI (Credit Rating Agencies) Regulations, 1999.

(a) Second Schedule

(b) Third Schedule

(c) First Schedule

(d) Fourth Schedule

14. In case of short term debt instruments, which of the following rating shows that the instrument is considered to have the moderate degree of safety regarding timely payment of financial obligations?

(a) A3

(b) AA (SO)

(c) BBB

(d) A++

15. In case of long term structured finance instruments, which of the following rating shows that the instrument is considered to have very high likelihood of default regarding timely payment of financial obligations?

(a) D (SO)

(b) B (SO)

(c) C (SO)

(d) D++

16. Which of the following applicant's application for registering as credit rating agency cannot be considered by the SEBI under the SEBI (Credit Rating Agencies) Regulations, 1999?

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(*a*) Foreign bank

(*b*) Public financial institution

(*c*) Partnership Firm

(*d*) Foreign credit rating agency

17. XYZ Mutual Fund introduced a mutual fund in the market and Credit Rating Agency assigned to it "AAmfs" rating. This rating indicates that ________

(*a*) Scheme has the highest degree of safety regarding timely receipt of payments from the investments that they have made.

(*b*) Scheme has the high degree of safety regarding timely receipt of payments from the investments that they have made.

(*c*) Scheme has the adequate degree of safety regarding timely receipt of payments from the investments that they have made.

(*d*) Scheme has the moderate degree of safety regarding timely receipt of payments from the investments that they have made.

18. Any company or a body corporate, having continuous net worth of minimum ₹ ______ as per its audited annual accounts for the _____ can make application to the SEBI for registration as credit rating agency.

(*a*) 100 crores; 5 previous years

(*b*) 500 crores; 3 previous years

(*c*) 400 lakhs; 5 previous years

(*d*) 100 lakhs; 3 previous years

19. In case of Short Term Debt Mutual Fund Schemes, which of the following rating shows that the Scheme have 'minimal degree of safety' regarding timely receipt of payments from the investments that they have made?

(*a*) C3mfs

(*b*) C4mfs

(*c*) P4mfs

(*d*) A4mfs

20. The SEBI, on being satisfied that the applicant is eligible for the grant of a certificate of registration, shall grant a certificate in ______

(*a*) Form B

(*b*) Form A

(*c*) Form D

(*d*) Form C

21. In case of Long Term Debt Mutual Fund Schemes, which of the following rating shows that the Scheme have 'highest degree of safety' regarding timely receipt of payments from the investments that they have made?

(*a*) AAAmfs

(*b*) A1mfs

(*c*) A+++mfs

(*d*) None of the above

22. PQR Mutual Fund introduced a Short Term Structured Finance Instrument in the market and Credit Rating Agency assigned to it "A4 (SO)" rating. This rating indicates that ________

(*a*) Instrument has very high likelihood of default regarding timely payment of financial obligations.

(*b*) Instrument is in default or expected to be in default on maturity.

(*c*) Instrument has minimal degree of safety regarding timely payment of financial obligation.

(*d*) Instrument has moderate degree of safety regarding timely payment of financial obligation.

23. A credit rating agency can make application for permanent registration ______ before expiry of the period of validity of the initial certificate of registration.

(*a*) 4 weeks

(*b*) 2 months

(*c*) 6 weeks

(*d*) 3 months

24. Every credit rating agency shall abide by the Code of Conduct contained in the __________ to the SEBI (Credit Rating Agencies) Regulations, 1999.

(*a*) First Schedule

(*b*) Second Schedule

(*c*) Third Schedule

(*d*) Fourth Schedule

25. As per Regulation 14 to the SEBI (Credit Rating Agencies) Regulations, 1999, the client shall agree to obtain a rating from at least 2 different rating agencies for any issue of debt securities whose size is equal to or exceeds, _______

(*a*) ₹ 400 crores

(*b*) ₹ 500 crores

(*c*) ₹ 200 crores

(*d*) ₹ 100 crores

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Answer to Question A :

Abbreviation	Long Form
CRISIL	Credit Rating & Information Services (India) Ltd.
ICRA	Investment Credit Rating Agency of India Ltd.
CARE	Credit Analyses & Research Ltd.
FRI	Fitch Rating India Pvt. Ltd.
CAMEL	Capital adequacy, Asset quality, Management, Earnings & Liquidity
CRA	Credit Rating Agencies
IPO	Initial Public Offering
MFS	Mutual Fund Schemes
SO	Structured Obligations
IRR	India Ratings & Research Pvt. Ltd.
BR	Brickwork Rating Pvt. Ltd.
SMERA	SME Rating Agency of India Ltd.

Answer to Question B :

(1) **Incorrect.** Credit rating is the evaluation of the creditworthiness of an individual or of a business concern or of an instrument of a business based on relevant factors indicating ability and willingness to pay obligations as well as net worth.

(2) **Incorrect.** Credit rating does not create any fiduciary relationship between the rating agency and the user of the rating.

(3) **Incorrect.** A credit rating agency does not perform an audit but relies on information provided by the issuer and collected by the analysts from different sources hence it does not guarantee the completeness or accuracy of the information on which the rating is based.

(4) **Correct.** Credit rating is a powerful marketing tool for the issuer company because when the issuer get good credit rating it becomes easier for it to raise money from the market.

(5) **Incorrect.** Credit rating is not a one-time job on the part of credit rating agencies. Every credit rating agency shall continuously monitor the rating of securities rated by it during the lifetime of such securities. Every credit rating agency shall carry out periodic reviews of all published ratings during the lifetime of the securities.

(6) **Correct.** As per **Regulation 26** of the **SEBI (Credit Rating Agencies) Regulations, 1999,** credit rating agency shall not rate a security issued by its promoter.

(7) **Incorrect.** Investment recommendations are expressed as 'buy', 'hold' or 'sell' and are based on a security specific comparison of its assessed 'fundamentals factors' to its price. On the other hand, IPO grading is expressed on a five-point scale and is a relative comparison of the assessed fundamentals of the graded issue to other listed equity securities in India. As the IPO grading does not take cognizance of the price of the security, it is not an investment recommendation. Rather, it is one of the inputs to help the investor in the decision making process.

(8) **Correct.** A company cannot make an initial public offer, unless as on the date of registering prospectus or red-herring prospectus with the ROC, the issuer has obtained grading for the initial public offer from at least one credit rating agency registered with SEBI. This means IPO grading is mandatory for making an IPO.

Answer to Question C :

(1) Risk; Return **(2)** Symbolic indication **(3)** Investor **(4)** Fiduciary **(5)** CAMEL **(6)** ₹ 100 crores **(7)** 3 years **(8)** ₹ 100 crores **(9)** 5 years **(10)** Two months **(11)** AAA **(12)** New York **(13)** Credit Rating & Information Services (India) Ltd. (CRISIL)

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Answer to Question D :

1.	(c)	**6.**	(c)	**11.**	(c)	**16.**	(c)	**21.**	(a)
2.	(a)	**7.**	(b)	**12.**	(d)	**17.**	(b)	**22.**	(d)
3.	(c)	**8.**	(d)	**13.**	(a)	**18.**	(a)	**23.**	(d)
4.	(c)	**9.**	(a)	**14.**	(a)	**19.**	(d)	**24.**	(c)
5.	(b)	**10.**	(b)	**15.**	(c)	**20.**	(a)	**25.**	(d)

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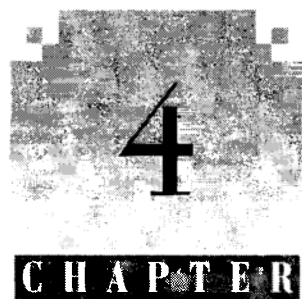

SECURITIES MARKET INTERMEDIARIES

Question 1] Capital Market Intermediaries are vital link between the SEBI and investors in a public. Comment. **CS (Executive) - Dec 2008 (5 Marks)**

Ans.: The capital market intermediaries are vital link between **Investor, Issuer & Regulator.**

The objective of these intermediaries is to -

- Smoothen the process of investment and
- Establish a link between the investors and the users of funds.

Companies do not market their securities directly to the investors. Instead, they hire the services of the market intermediaries to represent them to the investors.

Capital market intermediaries are also important from the point of view of small investors as they find it difficult to make direct investment. A small investor may not be able to diversify across borrowers to reduce risk. He may not be equipped to assess and monitor the credit risk of borrowers. Market intermediaries help investors to select investments by providing

- Investment consultancy
- Market analysis
- Credit rating of investment instruments etc.

In order to operate in secondary market, the investors have to transact through share brokers. Registrars and Transfer Agents, Custodians and Depositories are capital market intermediaries that provide important infrastructure services for both primary and secondary markets.

Role of Capital Market Intermediaries : These market intermediaries provide different types of financial services to the investors. They provide expertise to the securities issuers.

The role of intermediaries makes the market to function smoothly and continuously. Intermediaries possess professional expertise and play a promotional role in organizing a perfect match between the supply and demand for capital in the market.

Their services include:

- Issue Management
- Underwriting
- Portfolio Management
- Corporate Counselling
- Stock Broking
- Syndicated Credit
- Arranging Foreign Collaboration Services
- Mergers and Acquisitions
- Debenture Trusteeship
- Capital Restructuring

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Question 2] Name any eight capital market intermediaries.

Ans.: The following market intermediaries are involved in the securities market:

- Merchant Bankers
- Registrars & Share Transfer Agents
- Underwriters
- Bankers to issue
- Debenture Trustees
- Portfolio managers
- Syndicate members
- Foreign Institutional Investor (FII)
- Stock-brokers and Sub-brokers
- Custodians
- Investment Advisers
- Credit rating Agencies
- Depository Participant

Question 3] What do you mean by 'Merchant Bankers'? State the activities that can be undertaken by the Merchant Bankers.

Role of Merchant Bankers in capital market. **CS (Executive) - Dec 2012 (2 Marks)**

Define and state the function of Lead Managers. **CS (Executive) - June 2006 (2 Marks)**

"Merchant bankers are the key intermediary between the company and issue of capital." Comment.
CS (Executive) - June 2016 (4 Marks)

Ans.: 'Merchant Banker' means any person engaged in the business of issue management. Merchant Bankers are generally engaged in following activities:

- Making arrangements regarding selling buying or subscribing to securities or
- Acting as manager/consultant/advisor or
- Rendering corporate advisory services

Merchant bankers are the key intermediary between the company and issue of capital.

Making public issue of shares is a highly specialized job which involves tremendous and time bound work. Organizations undertaking this task are called as Merchant Bankers. Most of the leading banks and financial institutions have formed 'Merchant Banking Division' specializing in this work. They have to register with SEBI and hence called Registered Merchant Bankers. SEBI has little control over the companies making public issue as they are not registered with SEBI and SEBI does not have many legal powers to control them. Hence, SEBI casts all responsibility on Merchant Bankers in respect of public issue. Merchant Bankers are also known as Lead Managers.

Who can be a merchant banker : Only body corporate is allowed to function as merchant bankers.

Activities of Merchant Bankers : SEBI has advised that merchant bankers shall undertake only those activities which relate to securities market. These activities are:

(*a*) Managing of public issue of securities

(*b*) Underwriting connected with the aforesaid public issue management business

(*c*) Managing/Advising on international offerings of debt/equity i.e. GDR, ADR, bonds and other instruments

(*d*) Private placement of securities

(*e*) Primary or satellite dealership of government securities

(*f*) Corporate advisory services related to securities market including takeovers, acquisition and disinvestment

(*g*) Stock broking

(*h*) Advisory services for projects

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(i) Syndication of rupee term loans

(j) International financial advisory services.

Regulatory Framework : SEBI regulates the activities of 'merchant bankers' under the SEBI Act, 1992 and **SEBI (Merchant Bankers) Regulations, 1992.**

Question 4] Write a short note on: Bankers to an issue

CS (Executive) - Dec 2012 (2 Marks)

Ans.: The Bankers to an issue are engaged in activities such as acceptance of applications along with application money from investors in respect if issues of capital and refund of application money.

Only **'Scheduled Bank'** i.e. banks approved by RBI and listed in Second Schedule can act as 'Banker to an Issue'.

Bankers to the issue carry out all the activities of ensuring that the funds are collected and transferred to the Escrow Accounts.

To carry on the activities as a banker to an issue, a person must obtain a certificate of registration from the SEBI. The SEBI grants registration on the basis of all the activities relating to banker to an issue in particular with reference to the following requirements:

- The applicant has the necessary infrastructure, communication and data processing facilities and manpower to effectively discharge his activities.
- The applicant/any of the directors of the applicant is not involved in any litigation connected with the securities market/has not been convicted of any economic offence.
- The applicant is a **scheduled bank** and grant of a certificate is in the interest of the investors.

A banker to an issue can apply for renewal of his registration 3 months before the expiry of the certificate.

Regulatory Framework: SEBI regulates the activities of 'Bankers to an Issue' under the SEBI Act, 1992 and **SEBI (Bankers to an Issue) Regulations, 1994.**

Escrow Accounts: Escrow Account means a separate bank account for keeping money that is the property of others. In many SEBI Regulations we find that the company has to open Escrow Account. For example, in case of 'buy back' the company has to open Escrow Account. This means that the company has to deposit the amount required for the buy back in separate account and such account is called as Escrow Account.

Question 5] What do you mean by 'Registrar to an Issue'?

Explain briefly the role and responsibilities of 'Registrar to an Issue'

CS (Executive) - Dec 2011 (4 Marks)

Ans.: 'Registrar to an Issue' means the person appointed by a body corporate or any person or group of persons to carry on the following activities on its or his or their behalf i.e.:

(i) Collecting application for investor in respect of an issue

(ii) Keeping a proper record of applications and monies received from investors or paid to the seller of the securities

(iii) Assisting body corporate or person or group of persons in determining the basis of allotment of the securities in consultation with the stock exchange

(iv) Finalizing the list of person entitled to allotment of securities

(v) Processing and despatchment of allotment letters, refund orders or certificates and other related documents in respect of the issue

Thus, Registrar to an Issue do all processing of share application form receipt till issue of shares/sending refund orders.

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Regulatory Framework: SEBI regulates the activities of 'Registrar to an Issue' under the SEBI Act, 1992 and **SEBI (Registrar to an Issue & Share Transfer Agents) Regulations, 1993.**

Question 6] What do you mean by 'Share Transfer Agent'?

Define and state the functions of Share Transfer Agent.

CS (Executive) - June 2006 (2 Marks)

Ans.: Share Transfer Agent means:

(*i*) Any person who on behalf of any body corporate, maintains the records of holders of securities issued by such body corporate and deals with all matters connected with the transfer and redemption of its securities;

(*ii*) The department or division of a body corporate performing the activities as share transfer agents if at any time the total number of holders of its securities issued exceed **one lakh**.

Regulatory Framework: SEBI regulates the activities of 'Share Transfer Agents' under the SEBI Act, 1992 and **SEBI (Registrar to an Issue and Share Transfer Agents) Regulations, 1993.**

Question 7] The Registrars to an Issue and Share Transfer Agents constitute an important category of intermediaries in the primary market. Discuss in the light of 'pre-issue' and 'post-issue' work done by them.

State the activities that can be undertaken by the Merchant Bankers.

CS (Executive) - Dec 2013 (5 Marks)

Ans. : The Registrar to an Issue and Share Transfer Agents undertake the following activities with respect to issue:

Pre-Issue Work

1. Finalization of bankers to issue, list of branches, controlling and collecting branches.
2. Design of application form, bank schedule, pre-printed stationery.
3. Preparing and issuing detailed instructions on procedure to be followed by collecting and controlling branches.
4. Arranging, despatch of application schedule for listing of applications to collecting and controlling branches.
5. Placing of orders for and procuring pre-printed stationery.

During the issue :

1. Collection of daily figure from bankers to the issue.
2. Expediting despatch of applications, final certificate to the controlling branches.
3. Collection of application along with final certificate and schedule pages from controlling branches of bankers to the issue.

Post-Issue Work :

1. Informing Stock Exchange/SEBI and providing necessary certificates to Lead Manager on closure of issue.
2. Preparing 'Obligation of Underwriters statement' in the event of under subscription and seeking extension from stock exchange for processing.
3. Scrutiny of application received from bankers to issue.
4. Numbering of application and banks schedule and batching them for control purposes.
5. Transcribing information from documents to magnetic media for computer processing.

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6. Reconciliation of number of applications, securities applied and money received with final certificate received from bank.
7. Identify and reject applications having technical faults.
8. Prepare statement for deciding basis of allotment by the company in consultation with the Stock Exchange.
9. Finalizing basis of allotment after approval of the stock exchange.
10. Seeking extension of time from SEBI.
11. Allotment of shares on the formula derived by stock exchange (In the case of allotment to employee it shall be ensured that only full time employee actually on rolls are given the allotment on the basis of list of employees furnished under the signature of MD/Company Secretary).
12. Obtaining certificate from auditors that the allotment has been made as per the basis of allotment.
13. Preparation of reverse list, list of allottees and non-allottees as per the basis of allotment approved by stock exchange.
14. Preparation of allotment register cum return statement register of members, index register.
15. Preparation of list of brokers to whom brokerage is to be paid.
16. Printing covering letters for despatching share certificates, for refunding application money/stock invest, printing of allotment letter cum refund order.
17. Printing postal journal for despatching share certificate or allotment letters and refund orders by registered post.
18. Printing, distribution schedule for submission to stock exchange.
19. Preparing share certificate on the computer.
20. Preparing register of member and specimen signature cards.
21. Arranging share certificate in batches for signing by authorized signatories.
22. Trimming share certificate and affixing common seal of the company.
23. Attaching share certificate to covering letter.
24. Mailing of documents by registered post.
25. Binding of application forms, application schedule and computer outputs.
26. Payment of consolidated stamp duty on allotment letters/share or debenture certificates or procuring and affixing stamp of appropriate value.
27. Issuing call notices for allotment money to allottees.
28. Issue of duplicate refund order.
29. Revalidation of refund orders.
30. Segregation of stock invest from application and safe custody thereof.
31. Preparation of separate schedule/list for stock invest applications.
32. Filing of right hand portion of stock invest in respect of allottees.
33. Lodging stock invest with computerized stock invest statement to collecting banks.
34. Cancellation of stock invest in case of non-allottees.
35. Printing of covering letters and despatching of cancelled stock invest to non-allottees.
36. Particular attention should be paid to Redressal of Investor Grievances promptly and furnishing prescribed reports in time to SEBI.

** Students are expected to write at least 8 to 10 point relating to 'post issue' work.*

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Question 8] Write a short note on : Underwriter **CS (Inter) - June 2006 (2 Marks)**

Ans.: Meaning of Underwriter : Underwriter means a person who agrees to subscribe to prescribed amount of shares if issue is not fully subscribed. He gets underwriting commission for this. Financial institution, banks, merchant banker generally acts as underwriter. They must have registration with the SEBI.

Underwriting Agreement : An underwriting agreement will be entered into between the issuing companies and underwriter.

Underwriting is compulsory for a public issue : It is necessary for a public company which invites public subscription for its securities to ensure that its issue is fully subscribed. The company cannot depend on its advertisements to bring in the full subscription. In case of short fall, the underwriting arrangements will help to subscribe the issue fully. It is the underwriter who agrees to take up securities which are not fully subscribed in a public issue. The underwriter makes a commitment to get the issue subscribing either by others or by themselves.

The Lead Managers are required to satisfy themselves about the net worth of the underwriters and their outstanding commitments and disclose the same to SEBI. In this connection each underwriter should furnish an undertaking to the Lead Manager about their net worth and outstanding commitments. Both the lead managers and the directors are required to give a statement in the prospectus that in their opinion the underwriters have the necessary resources to discharge their liabilities in full.

Penal Action : Penal action will be taken against underwriters for not taking up the assured amount of security in case of development and to debar them from the underwriting public issues in future.

Regulatory Framework : SEBI regulates the activities of 'Underwriter' under the SEBI Act, 1992 and **SEBI (Underwriters) Regulations, 1993**.

Question 9] Write a short note on: Debenture Trustees

CS (Inter) - June 2006 (2 Marks), CS (Executive) - Dec 2011 (3 Marks)

Write a short note on: Obligations of a debenture trustee

CS (Executive) - Dec 2016 (4 Marks)

Ans.: Since it is not possible for each debenture holder to execute security, 'debenture trustee' has to be appointed. Often, banks or financial institution are appointed as debenture trustee.

'Debenture Trustee' means a trustee of a trust deed for securing any issue of debentures of a body corporate. Thus, debenture trustees are appointed to protect the interest of debenture holders.

As per **Section 71(2)** of the Companies Act, 2013, appointment of debenture trustees is mandatory if a company wants to issue prospectus or make an offer to public or its members exceeding 500. Such appointment must be made before issue of debentures.

The company shall appoint debenture trustees, after complying with the following conditions:

- Names of the debenture trustees shall be stated in **letter of offer** inviting subscription for debentures and also in all the subsequent notices or other communications sent to the debenture holders.
- Before appointment a **written consent** from the debenture trustee shall be taken and a statement to that effect shall appear in the letter of offer.
- The Board may fill any casual vacancy in the office of the trustee but while any such vacancy continues, the remaining trustee may act. When such vacancy is caused by the resignation of the debenture trustee, the vacancy shall only be filled with the written consent of the majority of the debenture holders.
- Any debenture trustee may be removed from office before the expiry of his term only if it is approved by the holders of not less than $3/4^{th}$ (75%) in value of the debentures outstanding, at their meeting.

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Role, functions and obligations of debenture trustees:

- Call for periodical reports from the issuer of debentures.
- Take possession of trust property in accordance with the provisions of the trust deed.
- Enforce security in the interest of the debenture holders.
- Ensure that the property charged to the debenture is available and adequate at all times to discharge the interest and principal amount payable in respect of the debentures.
- Property charged is free from any other encumbrances.
- Exercise due diligence to ensure compliance by the issuer company with the provisions of the Companies Act, 2013, the listing agreement or the trust deed.
- To take appropriate measures for protecting the interest of the debenture holders as soon as any breach of the trust deed or law comes to his notice.
- To ascertain that the debentures have been converted or redeemed as per applicable law.
- Inform the Board immediately of any breach of trust deed or provision of any law.
- Appoint a nominee director on the board of the body corporate when required.

Regulatory Framework : SEBI regulates the activities of 'debenture trustees' under the SEBI Act, 1992 and **SEBI (Debenture Trustees) Regulations, 1993.**

Question 10] Write a short note on: Portfolio Manager

CS (Executive) - Dec 2010 (3 Marks)

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Ans.: Meaning of Portfolio : The term portfolio means a basket or combination of securities. Thus, if a person invests in more than security, he is creating portfolio.

Meaning of Portfolio Manager : Portfolio manager means any person who pursuant to contract or arrangement with the client, advises or directs or undertakes on behalf of the client the management or administration of a portfolio of securities or the funds of the clients as the case may be.

There are two types of portfolio managers :

(1) Discretionary portfolio manager : Discretionary portfolio manager is one who exercises any degree of discretion as to the investment or management of the portfolio of the securities or the funds of the client.

(2) Non-discretionary portfolio manager : Non-discretionary portfolio manager manages the funds with the discretion of client.

A portfolio manager plays important role in deciding the best investment plan for an individual as per his income, age and ability to undertake risks.

A portfolio manager makes aware his client regarding various investment tools available in the market and benefits associated with each plan.

After investment, portfolio manager also advise his client whether to hold the security or sell as per the movement in stock market.

A portfolio manager is responsible for designing customized investment solutions for the clients according to their financial needs.

Regulatory Framework : SEBI regulates the activities of 'portfolio managers' under the SEBI Act, 1992 and **SEBI (Portfolio Managers) Regulations, 1993.**

Question 11] Distinguish between: Merchant Banker and Portfolio Manager

CS (Executive) - June 2010 (3 Marks)

Ans.: Following are the main points of difference between merchant banker & portfolio manager:

Points	Merchant Banker	Portfolio Manager
Meaning	'Merchant Banker' means any person engaged in the business of issue management.	Portfolio manager means any person who pursuant to contract or arrangement with the client, advises or directs or undertakes on behalf of the client the management or administration of a portfolio of securities or the funds of the clients as the case may be.
Regulation	Merchant Bankers are regulated by the SEBI (Merchant Bankers) Regulations, 1992.	Portfolio Managers are regulated by the SEBI (Portfolio Managers) Regulations, 1993.
Type of intermediary	Merchant Bankers mostly acts as primary capital market intermediary.	Portfolio Managers are secondary capital market intermediary.
Acts on behalf of	Merchant Bankers acts on behalf of issuer company.	Portfolio Managers acts on behalf of their client i.e. investors.
Nature of work	Merchant Bankers most of the work is to comply with the SEBI Act, 1992 and Rules and Regulations made thereunder.	Portfolio Managers has to handle the portfolio of his client and try to increase market value by buying, holding and selling securities.

Question 12] Write a short note on: Syndicate

Ans.: Meaning of syndicate : Syndicate is a professional financial services group formed temporarily for the purpose of handling a large transaction that would be hard for the entities involved to handle individually. Syndication allows companies to pool their resources and share risks. There are several different types of syndicates, including underwriting syndicates, banking syndicates and insurance syndicates.

Example of 'Underwriter Syndicate' : Underwriter syndicate is a temporary group of investment banks and broker-dealers who come together to sell new offerings of equity or debt securities to investors. The underwriter syndicate is formed and led by the lead underwriter for a security issue. An underwriter syndicate is usually formed when an issue is too large for a single firm to handle.

Syndicate in IPO : The Book Runner may appoint those intermediaries who are registered with the SEBI and who are permitted to carry on certain activities in relation to IPO as syndicate members. The syndicate members are mainly appointed to collect and entire the bid forms in a book built issue.

Role of 'Syndicate Members' in IPO Processing : Syndicate members are the broking houses responsible for distributing IPO applications, receiving filled applications from investors and timely update the data on the stock exchange IPO shares bidding platform (NSE/BSE).

Question 13] Write a short note on: Foreign Institutional Investor

CS (Executive) - Dec 2010 (3 Marks), Dec 2012 (2 Marks)

Ans.: Foreign Institutional Investor (FII) means an institution established or incorporated outside India which proposes to make investment in securities in India.

FII can buy, sell or otherwise deal in securities in India only if they are registered in India with SEBI. An application for the grant of certificate should be made to SEBI in the prescribed form.

SEBI may require the applicant to furnish further information or clarification as it considers necessary for grant of certificate. The applicant or his authorized representative may appear before SEBI for personal representation in connection with the grant of a certificate. An application will be rejected by the SEBI if it is not complete or does not conform to the instructions specified or is false or misleading in any material particulars. However, before rejecting any such application, the applicant should be given a reasonable opportunity to remove objection indicated by SEBI within the time specified by the SEBI.

Foreign Institutional Investors (FII's) during last one decade have become an integral part of Indian equity Markets. They have been an incredible source of money ever since. The influence of FII's is such that the market players anticipate their arrival with breathless anxiety. This reputation of FII's is a well earned status. The authority of these institutions is evident

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from the very fact that by the mere news of their arrival it is sufficient for the market to supplement itself with a double digit growth. The era of FII's investments in India originated in 1993. FII's of different countries, mainly the US, started operating in India. The number of FII's in India has grown over the years from 250 to nearly 750.

Question 14] Comment on the role of Stock-broker and Sub-broker in Indian stock market.
CS (Inter) - Dec 2007 (4 Marks)

Ans.: Stock-broker means a member of stock exchange. Sub-broker is one who acts on behalf of a stock broker as an agent or otherwise for assisting the investor in buying, selling or dealing in securities through the stock-brokers.

Stock-broker and Sub-broker has to be registered with the SEBI as per the **SEBI (Stock-broker and Sub-broker) Regulations, 1992.**

Stock-brokers buy and sell on their own behalf as well as on behalf of their clients.

A stock-broker plays a very important role in the secondary market helping both the seller and the buyer of the securities to enter into a transaction.

The buyer and seller may be either a broker or a client. The transaction entered cannot be annulled except in the case of fraud, wilful misrepresentation or upon *prima facie* evidence of a material mistake in the transaction, in the judgment of the existing authorities.

If a broker has orders to buy and to sell the same kind of securities, he may complete the transaction between his clients concerned.

When executing an order the stock-broker may on behalf of his client buy or sell securities from his own account i.e. as principal or act as an agent. For each transaction he has to issue necessary contract note indicating whether the transaction has been entered into by him as a principal or as an agent for another. While buying or selling securities as a principal, the stock-broker has to obtain the consent of his client and the prices charged should be fair and justified by the conditions of the market.

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A sub-broker is one who works along with the main broker and is not directly registered with the stock exchange as a member. He acts on behalf of the stock broker as an agent or otherwise for assisting the investors in buying, selling or dealing in securities through such stock brokers.

Question 15] Write a short note on: Custodian of securities
CS (Executive) - Dec 2008 (3 Marks)

'Custodian of securities' means any person who carries on or proposes to carry on the business of providing custodial services. **CS (Executive) - June 2016 (4 Marks)**

Ans.: *Usually, large investors (particularly Foreign Institutional Investors) do not keep the securities in their own custody and do not look after routine work in respect of securities. This work is handed over to Custodian for safe custody.*

A Custodian is a person who carries on the business of providing custodial services to the client. The custodian keeps the custody of the securities of the client.

A Custodian has to be registered with the SEBI under the **SEBI (Custodian of Securities) Regulations, 1996**.

Custodial services means safekeeping of securities or gold or gold related instruments or title deeds of real estate assets and providing incidental services and includes –

(1) Maintaining accounts of securities or gold or gold related instruments or title deeds of real estate assets of a client.

(2) Undertaking activities as a Domestic Depository in terms of the Companies (Issue of Indian Depository Receipts) Rules, 2004.

(3) Collecting the benefits or rights accruing to the client in respect of securities or gold or gold related instruments or title deeds of real estate assets.

(4) Keeping the client informed of the actions taken or to be taken by the issuer of securities, having a bearing on the benefits or rights accruing to the client.

(5) Maintaining and reconciling records of the services to in clauses (1) to (3).

Every custodian should have adequate facilities, sufficient capital and financial strength to manage the custodial services.

Question 16] Investment Advisor provides guidance about financial obligations and investment. Comment. **CS (Executive) - June 2015 (5 Marks)**

Ans.: An investment adviser is an individual or a firm that is in the business of giving advice about securities to clients. For instance, individuals or firms that receive remuneration for giving advice on investing in stocks, bonds, mutual funds, or exchange traded funds are investment advisers. Some investment advisers manage portfolios of securities.

In terms of the **SEBI (Investment Advisers) Regulations, 2013**, a person cannot act as an investment adviser unless he has obtained a certificate of registration from the SEBI or he is specifically exempt.

The Applicant for grant of registration as an Investment Adviser should make an application to SEBI in **Form A** as provided in the Regulations along with all the necessary supporting documents.

Generally on receipt of application, the applicant will receive a reply from SEBI within one month. However, the time taken for registration depends on how the applicant fulfils all the registration requirements and provides the complete information in all respects.

Question 17] Write a short note on: Depository Participants

Ans.: A depository to mean "a company formed and registered under the Companies Act and which has been granted a certificate of registration u/s 12(1A) of the SEBI Act, 1992."

At present there are two depositories - **National Securities Depository Ltd. (NSDL)** and **Central Depositories Services Ltd. (CDSL)**.

Promoters: NSDL has been promoted by UTI, IDBI & NSE while CDSL is promoted by BSE Ltd. jointly with SBI, Bank of India, Bank of Baroda, HDFC Bank, Standard Chartered Bank, Axis Bank and Union Bank of India.

Interconnection: NSDL and CDSL have been interconnected.

A Depository Participant (DP) is an agent of the depository who is authorized to offer depository services to investors.

Depository Participant must be attached to Depositaries i.e. NSDL or CDSL. The Depository Participant may be Financial institutions, banks, custodians of securities and stock brokers, NBFC, Registrar to Issue (RTI), Stock Transfer Agents (STA) etc. They must be connected with NSDL or CDSL.

Every Depository Participant has to be registered with the SEBI.

Individual investor has to open a demat account with a depository participant. The depository participant will maintain account of securities of each investor.

OBJECTIVE QUESTIONS

Question A] Expand the following abbreviations:

(1) CMI
(2) FII
(3) STA
(4) DP
(5) IA
(6) MB
(7) NSDL
(8) CDSL

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Question B] Re-write the following sentences after filling-up the blank spaces with appropriate word(s)/figure(s) :

(1) A _______ is an agent of the depository who is authorized to offer depository services to investors.

(2) ______ is one who exercises any degree of discretion as to the investment or management of the portfolio of the securities or the funds of the client.

(3) _______ is a professional financial services group formed temporarily for the purpose of handling a large transaction that would be hard for the entities involved to handle individually.

(4) ________ means an institution established or incorporated outside India which proposes to make investment in securities in India.

(5) _________ manages the funds with the discretion of client.

Question C] Select the correct option.

1. NSDL has been promoted by _______

(*a*) Axis Bank, ICICI & BSE

(*b*) SIDBI, BSE & NSC

(*c*) SBI, ADBI & BSC

(*d*) UTI, IDBI & NSE

2. The capital market intermediaries are vital link between ______

(*a*) Issuer & Investor

(*b*) SEBI, Issuer & Regulator

(*c*) Investor, Issuer & Regulator

(*d*) Investor, Issuer & SBI.

3. Market intermediaries help investors to select investments by providing _____

(*a*) Investment consultancy

(*b*) Market analysis

(*c*) Credit rating of investment instruments

(*d*) Any of the above

4. Which of the following is/are not capital market intermediary?

(*a*) STA

(*b*) RBI

(*c*) MB

(*d*) All of the above

5. _______ means any person engaged in the business of issue management.

(*a*) Merchant Banker

(*b*) Portfolio Managers

(*c*) Custodians

(*d*) Share Transfer Agents

6. In which of the following service(s) the Merchant Banker may be engaged?

(*a*) Making arrangements regarding selling buying or subscribing to securities

(*b*) Acting as manager or consultant or advisor

(*c*) Rendering corporate advisory services

(*d*) Any of the above

7. Any person appointed by a body corporate for collecting application for investor in respect of an issue is known as ________

(*a*) Registrar to an Issue

(*b*) Share Transfer Agent

(*c*) Underwriters

(*d*) Custodians

8. The ________ are engaged in activities such as acceptance of applications along with application money from investors in respect if issues of capital and refund of application money.

(*a*) Underwriters

(*b*) Bankers to an issue

(*c*) Custodians

(*d*) Investment advisors

9. _______ means a person who agrees to subscribe to prescribed amount of shares if issue is not fully subscribed.

(*a*) Investment Advisers

(*b*) Underwriter

(*c*) Both (a) & (b)

(*d*) Neither (a) nor (b)

10. Only 'Scheduled Bank' i.e. banks approved by RBI and listed in ______ Schedule can act as 'Banker to an Issue'.

(*a*) Second

(*b*) First

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(*c*) Fourth

(*d*) Third

11. Which of the following can be appointed as debenture trustees?

(*a*) Banks

(*b*) Financial Institutions

(*c*) Both (a) and (b)

(*d*) Neither (a) nor (b)

12. As per ________ of the Companies Act, 2013, appointment of debenture trustees is mandatory if a company wants to issue prospectus or make an offer to public or its members exceeding 500.

(*a*) Section 71(2)

(*b*) Section 61(4)

(*c*) Section 81(2)

(*d*) Section 101(4)

13. _____ means any person who pursuant to contract or arrangement with the client, advises or directs or undertakes on behalf of the client the management or administration of securities or the funds of the clients.

(*a*) Investment Advisors

(*b*) Custodians

(*c*) Share Transfer Agents

(*d*) Portfolio Manager

14. Portfolio Managers are ________

(*a*) Primary capital market intermediary

(*b*) Secondary capital market intermediary

(*c*) Both (a) and (b)

(*d*) None of the above

15. _________ means a member of stock exchange.

(*a*) Stock-broker

(*b*) Sub-broker

(*c*) Both (a) and (b)

(*d*) Neither (a) nor (b)

Answer to Question A:

Abbreviation	Long Form
CMI	Capital Market Intermediaries
FII	Foreign Institutional Investor
STA	Share Transfer Agents
DP	Depository Participant
IA	Investment Advisors
MB	Merchant Bankers
NSDL	National Securities Depository Ltd.
CDSL	Central Depositories Services Ltd.

Answer to Question B:

(1) Depository Participant (DP) **(2)** Discretionary portfolio manager **(3)** Syndicate **(4)** Foreign Institutional Investor (FII) **(5)** Non-discretionary portfolio manager

Answer to Question C:

1.	(*d*)	**4.**	(*b*)	**7.**	(*a*)	**10.**	(*a*)	**13.**	(*d*)
2.	(*c*)	**5.**	(*a*)	**8.**	(*b*)	**11.**	(*c*)	**14.**	(*b*)
3.	(*d*)	**6.**	(*d*)	**9.**	(*b*)	**12.**	(*a*)	**15.**	(*a*)

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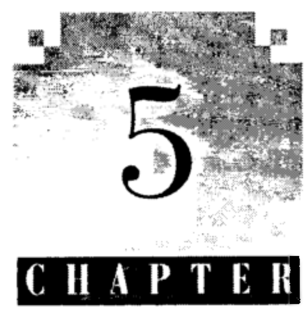

MARKET INFRASTRUCTURE INSTITUTIONS (STOCK EXCHANGE TRADING MECHANISM)

Introduction : A public company can list its shares on a stock exchange. Listing is compulsory only when shares are issued to public. A private company cannot issue shares to public and hence obviously cannot list shares in any stock exchange.

A modern stock exchange is like a **supermarket** where various securities can be bought and sold. It is well regulated and computerized. It is efficient, transparent and market oriented.

Stock exchange provides easy marketability to securities of a company. One advantage of India is that it has fairly well developed and regulated stock market.

After abolition of concept of regional stock exchanges in India, future of all stock exchanges is uncertain. Only BSE and NSE may survive after few years. BSE and NSE are big stock exchanges in India and located at Mumbai. A vibrant stock exchange is necessary for a growing economy. Health and mood of stock exchange is judged by stock exchange index. Most popular index in BSE Sensex followed by Nifty of NSE.

BSE Sensex is based on 30 scrips while Nifty is based on 50 scrips. BSE is the oldest stock exchange established in July 1875. NSE was incorporated in 1992 and started operations in July, 1994. Bombay Stock Exchange is the world's **11th** largest stock market by market capitalization at $ 1.7 Trillion as of 23 January, 2015. More than 5,000 companies are listed on BSE, while NSE has more than 1,600 companies listed on its platform.

History of BSE : The Bombay Stock Exchange is the oldest exchange in Asia. It traces its history to 1855, when four Gujarati and one Parsi stockbroker would gather under banyan trees in front of Mumbai's Town Hall. The location of these meetings changed many times as the number of brokers constantly increased. The group eventually moved to Dalal Street in 1874 and in 1875 became an official organization known as "The Native Share & Stock Brokers Association".

On 31st August 1957, the BSE became the first stock exchange to be recognized by the Indian Government under the Securities Contracts Regulation Act. In 1980, the exchange moved to the Phiroze Jeejeebhoy Towers at Dalal Street, Fort area. In 1986, it developed the BSE SENSEX index, giving the BSE a means to measure overall performance of the exchange. In 2000, the BSE used this index to open its derivatives market, trading SENSEX futures contracts. The development of SENSEX options along with equity derivatives followed in 2001 and 2002, expanding the BSE's trading platform.

Historically an open outcry floor trading exchange, the Bombay Stock Exchange switched to an electronic trading system developed by CMC Ltd. in 1995. It took the exchange only fifty days to make this transition. This automated, screen-based trading platform called BSE On-Line Trading (BOLT) had a capacity of 8 million orders per day. The BSE has also introduced a centralized exchange-based internet trading system, BSEWEBx.co.in to enable investors anywhere in the world to trade on the BSE platform.

Eligibility criteria for listing on BSE:

- The minimum post-issue paid-up capital of the applicant company shall be ₹ **10 crore** for Initial Public Offerings (IPOs) & ₹ **3 crore** for Follow-on Public Offerings (FPOs); and
- The minimum issue size shall be ₹ 10 crore; and
- The minimum market capitalization of the Company shall be ₹ **25 crore**.

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History of NSE : Based on Pherwani Committee's report submitted in June, 1991, the National Stock Exchange of India Limited was established. The NSE is the leading stock exchange of India, located in Mumbai. NSE was established in 1992 as the first demutualized electronic exchange in the country. NSE was the first exchange in the country to provide a modern, fully automated screen-based electronic trading system which offered easy trading facility to the investors spread across the length and breadth of the country.

NSE has a market capitalization of more than US$ 1.65 Trillion, making it the world's **12th** largest stock exchange as of 23 January, 2015. NSE's flagship index, the CNX Nifty is used extensively by investors in India and around the world as a barometer of the Indian capital markets.

NSE was set up by a group of leading Indian financial institutions at the behest of the Government of India to bring transparency to the Indian capital market. Based on the recommendations laid out by the government committee, NSE has been established with a diversified shareholding comprising domestic and global investors.

NSE offers trading, clearing and settlement services in equity, equity derivatives, debt and currency derivatives segments. It is the first exchange in India to introduce electronic trading facility thus connecting together the investor base of the entire country. NSE has 2,500 VSATs (Very Small Aperture Terminals) and 3,000 leased lines spread over more than 2000 cities across India.

The exchange was incorporated in 1992 as a tax-paying company and was recognized as a stock exchange in 1993 under the Securities Contracts (Regulation) Act, 1956. NSE commenced operations in the Wholesale Debt Market (WDM) segment in June 1994. The capital market (equities) segment of the NSE commenced operations in November 1994, while operations in the derivatives segment commenced in June 2000.

Eligibility criteria for listing on NSE : The paid up equity capital of the applicant shall not be less than **₹ 10 Crores** and the capitalization of the applicant's equity shall not be less than **₹ 25 Crores.**

Over-the-Counter Exchange of India (OTCEI) : OTCEI was incorporated in 1990 as a Section 25 company under the Companies Act, 1956 and is recognized as a stock exchange u/s 4 of the Securities Contracts (Regulation) Act, 1956.

OTCEI is based in Mumbai, Maharashtra. It is India's first exchange for small companies as well as the first screen-based nationwide stock exchange in India. OTCEI was set up to access high-technology enterprising promoters in raising finance for new product development in a cost-effective manner and to provide a transparent and efficient trading system to investor.

Reliance, SBI, ITC, Pentafour Software, HLL and Infosys are traded on OTCEI as Permitted Securities. The Permitted Securities are securities listed on other stock exchanges but allowed to trade on OTCEI. At present (Dec 2015), there are 60 listed securities and 389 permitted securities. Trading volume is very low or almost nil as per Directors Report for the year ended 31-3-2014. OTCEI director has also informed to the SEBI that, they are not going to renew the recognition of SEBI.

Eligibility criteria for listing on OTCEI : The company should have minimum capital of ₹ 30 Lakhs and maximum ₹ 10 crores.

SEBI vide its "Exit Order" No. WTM/RKA /MRD/25/2015 issued on March 31, 2015 by Mr. Rajeev Kumar Agarwal, Wholetime member, has allowed the exit of OTC Exchange of India (OTCEI). As per the "Exit Order", OTC Exchange of India is no longer a recognized Stock Exchange under the relevant provisions of Securities and Exchange Board of India Act, 1992 and the Securities Contracts (Regulation) Act, 1956 with effect from March 31, 2015.

Question 1] Stock exchanges are virtually the nerve centre of the capital market. Comment.
CS (Executive) - Dec 2012 (2 Marks)

Ans.: Secondary market comprises of stock exchanges which provide platform for purchase and sale of securities by investors. The trading platforms of stock exchanges are accessible only through brokers and trading of securities is confined only to stock exchanges.

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The stock exchanges are the exclusive centres for trading in securities and the trading platform of an exchange is accessible only to brokers. The regulatory framework heavily favours the recognized stock exchanges by almost banning trading activity outside the stock exchanges.

The stock market ensures free marketability, negotiability and price discharge. For these reasons the stock market is referred to as the nerve centre of the capital market, reflecting the economic trend as well as the hopes, aspirations and apprehensions of the investors.

Question 1A] Stock market indices are the barometer of stock markets. Comment.

CS (Executive) - Dec 2015 (3 Marks)

Ans.: A modern stock exchange is like a **supermarket** where various securities can be bought and sold. It is well regulated and computerized. It is efficient, transparent and market oriented.

Stock exchange provides easy marketability to securities of a company.

The capital market and in particular the stock exchange is referred to as the barometer of the economy. Government's policy is so moulded that creation of wealth through products and services is facilitated and surpluses and profits are channelised into productive uses through capital market operations. Reasonable opportunities and protection are afforded by the Government through special measures in the capital market to get new investments from the public and the Institutions and to ensure their liquidity.

Question 2] How many stock exchanges are presently operating in India? What is legal status of various stock exchanges in India? Who manages the stock exchanges?

Ans.: There are **19** stock exchanges at present in India.

Legal status of stock exchanges: All of them are regulated by **Securities Contracts (Regulation) Act, 1956** and **SEBI Act, 1992** and the Rules and Regulations made thereunder.

Some of the exchanges started as voluntary non-profit associations such as BSE and Indore Stock Exchange. The Stock Exchanges at Chennai, Jaipur, Hyderabad and Pune were incorporated as companies limited by guarantee. The other stock exchanges are companies limited by shares and incorporated under the Companies Act, 1956 or earlier acts.

Who manages the stock exchanges: The stock exchanges are managed by Board of Directors or Council of Management consisting of elected brokers and representatives of Government and Public appointed by SEBI. The Boards of stock exchanges are empowered to make and enforce Rules, Bye-laws and Regulations with jurisdiction over all its members.

Question 3] Write a short note on : Types of Securities

Distinguish between : Listed Securities & Permitted Securities

CS (Executive) - June 2015 (3 Marks)

Ans.: Securities traded in the stock exchanges can be classified as under:

(1) Listed Cleared Securities: The securities admitted for dealing on stock exchange after complying with all the listing requirements and placed by the SEBI on the list of cleared securities are known as listed cleared securities.

> The securities of companies which have signed the Listing Agreement with BSE, are traded as "Listed Securities". Almost all Securities traded in the equity segment fall in this category.

(2) Permitted Securities: The security listed on one stock exchange, when permitted to be traded by some other stock exchange where it is not listed is called permitted security. Such permission is given if suitable provisions exist in the regulations of the concerned stock exchanges.

> **Example :** Suppose, Company X is listed on BSE. If other stock exchange like OTCEI allows trading of securities of Company X, then securities of Company X is known as permitted security for other stock exchange i.e. OTCEI.

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Similarly, if any security is not listed on BSE but BSE allows the security to trade on BSE, such security is known as permitted security.

Question 4] Write a short note on : Types of Delivery

Distinguish between : Spot Delivery & Special Delivery

CS (Executive) - Dec 2011 (3 Marks)

Ans.: Types of delivery in the stock exchanges are as follows:

(1) **Spot Delivery :** If the delivery and payment for securities are to be made on the same day or the next day it is said to be spot delivery.

(2) **Hand Delivery :** If the delivery and payment are to be made on the delivery date fixed by the stock exchange authorities it is said to be hand delivery.

(3) **Special Delivery :** Where the delivery is to be made after the delivery period fixed by the stock exchange authorities it is said to be a special delivery.

In spot market, settlement happens in T+2 working days, i.e., delivery of cash and commodity must be done after two working days of the trade date.

Question 5] What do you understand by 'margin' in relation to stock trading?

Distinguish between: Initial Margin & Maintenance Margin

CS (Executive) - June 2009 (4 Marks), June 2013 (4 Marks)

CS (Executive) - June 2016 (2 Marks)

Ans.: Margin is an advance payment of a portion of the value of a stock transaction. The amount of credit a broker extends to a customer for stock purchase.

An investor has to deposit some amount for trading in stock which is called as margin. One can take 15 times exposure on the available margin on certain approved scrips (NIFTY 50 Stocks) for intra-day. Thus, if you have ₹ 1,00,000 margin you can execute trade in stocks having value of ₹ 15,00,000 without actually investing ₹ 15,00,000. If stocks are bought for long position, obliviously the investor has to deposit the remaining amount at later date.

'Margin' can be further broken down into **initial margin** and **maintenance margin.**

Initial Margin : Initial margin means the minimum amount, calculated as a percentage of the transaction value, to be placed by the client, with the broker, before the actual purchase. The broker may advance the balance amount to meet full settlement obligations.

In simple words, initial margin is the percentage of a stock price that you are required to have in your account, when purchasing that stock on margin.

Maintenance Margin : Maintenance margin means the minimum amount, calculated as a percentage of market value of the securities, calculated with respect to last trading day's closing price, to be maintained by client with the broker.

In other words, a maintenance margin is the required amount of securities an investor must hold in his account if he either purchases shares on margin, or if he sells shares short. If an investor's margin balance falls below the set maintenance margin, the investor would then need to contribute additional funds to the account or liquidate stocks in the account to bring the account back to the initial margin requirement. This request is known as a margin call.

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Example on Initial margin and maintenance margin:

Suppose, Regulations stipulates the minimum margin that an individual can trade on under normal conditions is 50% (although some brokers require more). So, if you were buying ₹ 10,000 worth of a particular stock, you would be required to have at least ₹ 5,000 in your account in order to do so. If you had more than this then this would be no problem, but if you had less than this you could not purchase the stock.

Maintenance margin on the other hand, is the amount of money you are required to have in your account once the position is opened. Basically, there are two different margin requirements for opening and then holding a position, to give the trader room for a position to move against him or her once it is opened, without having to put up additional margin funds. The minimum maintenance margin that a trader is required to have in order to hold an open position, is 25% (although some brokers require more). So, using our same example where a trader purchased ₹ 10,000 worth of stock, once the position is open, the trader will be required to have 25% of the current market value of the position in his account in order to continue holding the position. If the price did not move, then the trader would need at least ₹ 2,500 in his account in order to continue holding the position. If the position moved against the trader however and fell to a market value of ₹ 9,000, then the trader would need ₹ 2,250 (9,000 × 25%). Similarly, if the position moved in the traders favour and moved up to a market value of ₹ 11,000, then the trader would need ₹ 2,750 (11,000 × 25%) in order to continue holding the position.

Question 6] Write a short note on : Margin Trading **CS (Inter) - June 2008 (4 Marks)**
CS (Executive) - Dec 2009 (2 Marks)

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Ans.: Margin trading is buying stocks without having the entire money to do it. The exchanges have an institutionalized method of buying stocks without having the capital through the futures market.

For example, if you were to buy 2,000 shares of say Company A, which trades at ₹ 300, you will need about ₹ 6 lakh. But if you buy a future contract of that company, which comprises 2,000 shares, you only need to pay a margin of 15%. So, by putting ₹ 90,000, you can get an exposure of ₹ 6 lakh.

The same operation can also be executed through margin trading. Here, the trader will buy 2,000 shares, which are partly funded by the broker, and the rest by the trader.

The percentage of margin funding may range between 50% to 90%, depending on the broker and his relationship with the client. The broker, in turn, funds his line of credit from a bank, and keeps the shares in his account with any profit/loss going to the client.

Margin trading *v.* Futures : Most investors buy the futures, but there are times when margin trading makes more sense. If a stock is not in the futures list, the client can go for margin funding.

Since futures are generally not available beyond one or two months, if the client has a longer view, then margin trading is better. Also, some brokers offer lower interest rates on margin trading than the prevalent rates in the futures market.

The Margin Call : Once the trader buys a future or stocks in the margin account, the client gets the profit/loss since his purchase in his account.

In both futures market and margin trading, if the value of the share falls below the purchase price, the broker will make margin calls, asking the client to deposit additional margin.

In a normal market, these margin calls are not a problem as clients can deposit the additional amount easily.

When clients are not able to meet the margin requirement, the broker sells the security so that he does not have to bear the risk in case the stock falls further.

This typically become a problem when the markets fall far more than expected and traders are not liquid enough to meet the margin calls. When a lot of traders can't meet margin calls, the situation snowballs.

This is what happened in the past few days when traders, who were over-leveraged could not meet the margin calls, and their securities kept being sold.

Question 7] Distinguish between : Book Closure and Record Date

CS (Executive) - Dec 2010 (3 Marks), Dec 2011 (3 Marks),
CS (Executive) - Dec 2013 (3 Marks)

Ans.: Book closure is the periodic closure of the "Register of Members & Transfer Books", to take a record of the shareholders to determine their entitlement to dividends or bonus or right shares or other rights pertaining to shares.

Closing "Register of Members & Transfer Books" every time is not possible. In such case recorded date is fixed and informed to stock exchange in advance.

Record date is the date on which the records of a company are closed for the purpose of determining the stock holders who are entitled to dividends, bonus or right shares or other rights.

In case of a record date, the company does not close its register of security holders. Record date is the cutoff date for determining the number of registered members who are eligible for the corporate benefits.

A company may close the register of members for a maximum of **45 days** in a year and for not more than **30 days** at any one time. *[Section 91 of the Companies Act, 2013]*

Book closure become necessary for the purpose of paying dividend, making rights issue or bonus issue. The listed company is required to give notice of book closure in a news paper at least 7 days before the commencement of the book closure. The members whose names appear in the register of members on the last date of book closure are entitled to receive the benefits of dividend, right shares or bonus shares as the case may be.

The minimum time gap between the two book closures and/or record dates would be at least 30 days. *[Clause 16 of Listing Agreement of BSE]*

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Question 8] Write a short note on : Trend Line **CS (Executive) - Dec 2010 (3 Marks)**

Ans.: When the price of shares moves in a particular direction which persists for a period of time, a price line is regarded as established. When trend line is upward moving it is called as 'bullish trend'. On the other hand, if the trend line is falling it is called as 'bearish trend'.

Secondary movements that reverse the uptrend temporarily are known as **reactions**. The movements that reverse the down trend temporarily are known as **rallies**. When an uptrend breaks in the downward direction, it is called trend reversal.

Question 9] Write a short note on : Bull Market and Bearish Market

Distinguish between: Bullish Trend & Bearish Trend

CS (Executive) - June 2013 (4 Marks)

Ans.: Bull Market: A bull market is a period of generally rising prices. This is when the market is showing confidence. Indicators of confidence are prices going up, market indices like the SENSEX & NIFTY are going up.

Example : *India's Bombay Stock Exchange Index, BSE SENSEX, was in a bull market trend for about five years from April 2003 to January 2008 as it increased from 2,900 points to 21,000 points.*

Bull markets are characterized by optimism, investor confidence and expectations that strong results will continue. It's difficult to predict consistently when the trends in the market will change. Psychological effects and speculation may sometimes play a large role in the bull markets.

Bear Market: A bear market is a general decline in the stock market over a period of time. It is the opposite of a bull market.

A bear market is a market showing a lack of confidence. Prices of securities go down, indices falls and volumes are stagnant.

In India, the stock market crashes of 1992 and 1994 (lasted 16 months each) and the infamous dotcom crash of 2000 (kept markets under pressure for 19 months at a stretch) are considered as examples for bear market.

Question 10] Write a short note on: Trading Volume

CS (Executive) - Dec 2011 (2 Marks)

"Trends in the stock market get strength from the volume." Comment on the statement highlighting relation between trends and volume in a stock market.

CS (Executive) - Dec 2016 (5 Marks)

Ans.: Trading volumes in relation to cash market refers to number of shares bought and sold in a day. Companies performing well in terms of profitability or companies having some news about bonus issue, right issue or high dividend has high volume trades.

In case of some companies more than 25,00,000 shares are traded in a single day.

Trading volumes confirm whether the rise or fall in prices is in line with the trend. The high trading volume is built on rising prices, similarly the high trading volume is also linked with fall in prices. They respectively reflect a BULLISH trend and a BEARISH trend.

Question 11] Write a brief note on 'market making'.

CS (Executive) - Dec 2010 (2 Marks), June 2010 (3 Marks)

CS (Executive) - Dec 2012 (4 Marks)

What is 'market making'? Discuss in brief the obligation of a market maker.

CS (Executive) - June 2015 (5 Marks)

The market makers infuse liquidity in securities that are not frequently traded on stock exchanges.

CS (Executive) - Dec 2015 (4 Marks)

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Ans.: Not all shares are actively traded in stock market. There may be case where shares are not traded at all or shares are thinly traded and here comes the role of market maker.

A market maker may be an individual or firm that stands ready to buy or sell particular security during the trading session maintaining liquidity and a fair and orderly market in a security. Sometimes no one is interested to buy shares of particular company or no one trying to sell the security. This is where the market makers comes in by making a market or making bids and offers to accommodate orders that cannot matched in market. The bid and ask spread is maintained by market makers and is the difference between price to buy and sell the security. For example, the market bid to ask for KK Security for ₹ 50.00 - 50.50. The market maker decides to buy 1,000 shares from the seller who is ready to sell the shares for ₹ 50.00 each. Know the market maker has 1,000 shares of KK Security and he hopes to get the buyer soon. The market maker offers to sell the shares for ₹ 50.40 each thus creating or making new market. Because his best offer in the market, he attracts another buyer who is willing to purchase 1,000 shares. The bid-ask spread of Re. 0.4 per share is his profit and thus makes total profit of ₹ 400. By buying low and selling high, market makers capture profits through these relatively small spreads. The market maker mentioned in the example can lose the money if the stock price drop below ₹ 50.00 by the time another buyer emerges. In this case the market maker may have to sell at a price below at which he purchases KK Security. The market maker is compensated for taking on risk like this by charging commission and fees. Market maker serves an important role in the stock market, as they helps to reduce liquidity risk and facilitates the pace at which participants can enter or exit the market.

A process of market making was clearly needed to build up liquidity. The market maker by offering a two-way quote not only increases the supply of scrips but also triggers of a demand in the scrips. Thus, market-making is aimed at infusing liquidity in securities that are not frequently traded on stock exchanges.

To conclude, a market-maker usually is responsible for enhancing activity in a few chosen securities. In the process, the market-maker provides both a buy and a sell quote for his chosen securities. He profits from the spread between buy and sell quotes.

Question 12] Write a short note on : Securities Lending **CS (Executive) - Dec 2008 (3 Marks)**
Securities lending does not have direct contacts between the borrower and lender of securities.
CS (Executive) - June 2014 (5 Marks)

Ans.: Securities lending or stock lending refers to the lending of securities by one party (the lender) to another (the borrower). The Borrower is obliged to return them either on demand or at the end of an agreed term and also has an option to early return. Lender may recall securities at any time within normal market settlement cycle.

Securities lending is regulated by SEBI which introduced guidelines in 1997 for this purpose. Under the scheme, a person with idle shares can lend them to another who does not have the shares to fulfil his obligation under a trade finalized by him. There will be no direct contacts between the borrower and lender of securities. An intermediary who can guarantee the scheme and make good the loss in the borrower who fails to honour his obligations can alone provide substance to the scheme. The borrower has to put up collateral for his borrowings and pay cash margin levied on the securities by the authorities. Income from securities lending is exempt from Capital Gains Tax.

Some important points relating to SLB:

- SLB is a mechanism for borrowing of securities which enable settlement of securities sold short.
- SLB helps in improving market liquidity, more efficient settlement, tighter dealer prices and perhaps a reduction in the cost of capital.
- The SLB shall be operated through Clearing House having nation-wide terminals who will be registered as Approved Intermediaries (AIs) under the **Securities Lending Scheme, 1997**.

Question 13] What is short selling?

Ans.: Short selling is the sale of a security that is not owned by the seller, or that the seller has borrowed. Short selling is motivated by the belief that a security's price will decline, enabling it to be bought back at a lower price to make a profit. Thus, short selling is a trading strategy that seeks to capitalize on an anticipated decline in the price of a security. Essentially, a short seller is trying to sell high and buy low.

How short selling works:

Short selling involves a three-step process:

(1) Borrow shares of the security, typically from a broker.

(2) Sell the shares immediately at the market price.

(3) Repurchase the shares (hopefully at a lower price) and return them to whomever you borrowed them from. After all this, you will pocket the difference if the share price has fallen, but will have lost money if the price went up.

Example:

Mr. Ram believes that the stock of ABC Ltd. will fall in the future. He calls his broker and asks him to find 100 shares of ABC Ltd. that he (Mr. Ram) can borrow for a short sale. ABC's current price is ₹ 25 per share. Mr. Ram receives a cash inflow of ₹ 2,500 after he sells the shares he has borrowed.

Two weeks later, the price has indeed dropped, and shares of ABC now trade for ₹ 20 each. Mr. Ram buys back the shares (known as covering his short position) for ₹ 20 each. He spends ₹ 2,000 to repurchase the shares and returns the shares to the person he borrowed them from.

Mr. Ram's profit on the trade is ₹ 500 (₹ 2,500 received from the sale of the stock minus ₹ 2,000 paid to repurchase the stock).

Using this same calculation, we see that if the shares had risen to ₹ 27 during his holding period, then he would have lost ₹ 200 (₹ 2,500 received from the sale of the stock minus ₹ 2,700 paid to repurchase the stock).

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Why it Matters : Short selling is a way for investors to benefit from a decline in a stock's price. The market always needs people on both the long end (owners/buyers) and the short end (renters/sellers) for it to work properly.

Short selling is controversial because when a large number of investors decide to short a particular stock, their collective actions can have a dramatic impact on the company's share price.

Short selling is risky for a number of reasons. An investor is exposed to theoretically unlimited losses if the underlying stock rises instead of falls.

Short selling in cash market:

Mr. X feels today that tomorrow the market price of Tata shares would fall. Closing price of Tata shares today is ₹ 500. On next day he decides to sell 1,000 shares of Tata Company though he does not own such shares. This is known as short selling. After selling 1,000 shares of Tata Company for ₹ 500, the price fall up to ₹ 492 and he buy the shares at this price. Thus, by short selling he made a profit of ₹ 8,000. But, if on next day price rises and Mr. X has to cover up his position at ₹ 505, he will lose ₹ 5,000. Thus, short selling is risky because perfect judgment about movement of stock market and price of particular shares is unpredictable.

Question 14] What is short selling? Explain briefly the broad framework for short selling.

CS (Executive) - June 2010 (4 Marks), June 2015 (5 Marks)

Ans.: SEBI permitted all classes of investors to short sell subject to the broad framework specified there in which are enumerated as follows. *[SEBI vide Circular No. MRD/DoP/SE/Dep/Cir- 14 /2007 dated December 20, 2007]*

1. **Meaning :** Short selling shall be defined as selling a stock which the seller does not own at the time of trade.
2. **Eligible investors :** All classes of investors, viz., retail and institutional investors, shall be permitted to short sell.
3. **Prohibition on short selling :** Naked short selling shall not be permitted and all investors would be required to mandatorily honour their obligation of delivering the securities at the time of settlement.
4. **Prohibition for institutional investors :** No institutional investor shall be allowed to do day trading i.e., square-off their transactions intra-day. In other words, all transactions would be grossed for institutional investors at the custodians level and the institutions would be required to fulfil their obligations on a gross basis. The custodians, however, would continue to settle their deliveries on a net basis with the stock exchanges.
5. **Deterrent provisions :** The stock exchanges shall frame necessary uniform deterrent provisions and take appropriate action against the brokers for failure to deliver securities at the time of settlement which shall act as a sufficient deterrent against failure to deliver. *(Deterrent means a thing that discourages or is intended to discourage someone from doing something)*
6. **SLB scheme to be provided for short selling :** A scheme for Securities Lending & Borrowing (SLB) shall be put in place to provide the necessary impetus to short sell. The introduction of a full-fledged securities lending and borrowing scheme shall be simultaneous with the introduction of short selling by institutional investors.
7. **F&O segment eligible for short selling :** The securities traded in F&O segment shall be eligible for short selling. SEBI may review the list of stocks that are eligible for short selling transactions from time to time.
8. **Disclosure :** The institutional investors shall disclose upfront at the time of placement of order whether the transaction is a short sale. However, retail investors would be permitted to make a similar disclosure by the end of the trading hours on the transaction day.

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9. **Duties of brokers :** The brokers shall be mandated to collect the details on scrip-wise short sell positions, collate the data and upload it to the stock exchanges before the commencement of trading on the following trading day. The stock exchanges shall then consolidate such information and disseminate the same on their websites for the information of the public on a weekly basis. The frequency of such disclosure may be reviewed from time to time with the approval of SEBI.

Question 15] Explain briefly the broad framework for "Securities Lending & Borrowing".

CS (Executive) - June 2010 (4 Marks), June 2011 (6 Marks)

CS (Executive) - Dec 2015 (5 Marks)

Ans.: The broad framework for "Securities Lending & Borrowing" is as follows:

Operation of SLB : The SLB shall be *operated* through *Clearing House* of stock exchanges having nation-wide terminals that will be *registered as Approved Intermediaries* (AIs) under the SLS, 1997.

SLB through automated screen based platform : The SLB shall take place on an automated, screen based, order-matching platform. This platform shall be independent of the other trading platforms.

F&O segment eligible for SLB : The securities traded in F&O segment shall be eligible for lending & borrowing under the SLB scheme.

Roll-over of positions : Any lender or borrower who wishes to extend an existing lent or borrow position shall be permitted to roll-over such positions i.e. a lender who is due to receive securities in the pay out of an SLB session, may extend the period of lending. Similarly, a borrower who has to return borrowed securities in the pay-in of an SLB session, may, through the same SLB session, extend the period of borrowing. The roll-over shall be conducted as part of the SLB session.

Roll-over shall not permit netting of counter positions, i.e. netting between the 'borrowed' and 'lent' positions of a client.

Roll-over shall be available for a period of 3 months i.e. the original contract plus 2 roll-over contracts.

ETFs eligible for SLB : Liquid Index ETFs shall be eligible for trading in the SLB segment.

An Index ETF shall be deemed 'liquid' provided the Index ETF has traded on at least 80% of the days over the past 6 months and its impact cost over the past 6 months is less than or equal to 1%.

Investor eligible for SLB : All categories of investors including retail, institutional etc. will be permitted to borrow and lend securities. The borrowers and lenders shall access the platform for lending/borrowing set up by the AIs through the clearing members (CMs) (including banks and custodians) who are authorized by the AIs in this regard.

Agreement with clients : The Authorised Intermediary (AIs), CMs and the clients shall enter into an agreement specifying the rights, responsibilities and obligations of the parties to the agreement. The agreement shall include the basic conditions for lending and borrowing of securities as prescribed under the scheme. In addition to that, AIs may also include suitable conditions in the agreement to have proper execution, risk management and settlement of lending and borrowing transactions with clearing member and client. Given the nature of the client base, while the major responsibility of ensuring compliance with "Know Your Client" (KYC) norms in respect of the clients rests with CMs, the exact role of AIs/CMs *vis-à-vis* the clients in this regard needs to be elaborated in the aforesaid agreement between the AIs/CMs/ clients. In this regard, there would be one master agreement with two individual parts to the same. The first part of the agreement would be between the AIs and the CMs and the second part of the agreement would be between the CMs and the clients. There would be adequate cross referencing between the two parts of the agreement so that all the concerned parties, viz., the AIs/CMs and the clients agree completely and are aware of all the provisions governing the SLB transactions between them. However, there shall be no direct agreement between the lender and the borrower. The CM will attach a certified copy of the first part of the agreement signed with the AI in the second part of the agreement signed with each client. The model agreements in this regard would be devised by the stock exchanges.

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Allotment of unique ID to client : The AIs shall allot a unique ID to each client which shall be mapped to the Permanent Account Number (PAN) of the respective clients. The AIs shall put in place appropriate systemic safeguards to ensure that a client is not able to obtain multiple client IDs.

Standardized contracts : The tenure of lending/borrowing shall be fixed as standardized contracts. To start with, contracts with tenure of 30 trading days may be introduced.

Settlement : The settlement cycle for SLB transactions shall be on **T+1** basis.

The settlement of lending and borrowing transactions shall be independent of normal market settlement.

Settlement on gross basis : The settlement of the lending and borrowing transactions shall be done on a gross basis at the level of the clients i.e. no netting of transactions at any level will be permitted.

Authorised Intermediary to frame risk management system : AIs would frame suitable risk management systems to guarantee delivery of securities to borrower and return of securities to the lender. In the case of lender failing to deliver securities to the AI or borrower failing to return securities to the AI, the AI shall conduct an auction for obtaining securities. In the event of exceptional circumstances resulting in non-availability of securities in auction, such transactions would be financially closed-out at appropriate rates, which may be more than the rates applicable for the normal close-out of transactions, so as to act as a sufficient deterrent against failure to deliver securities.

Limit for positions : Position limits at the level of market, CM and client shall be decided from time to time by AIs in consultation with SEBI. To begin with (*a*) the market-wide position limits for SLB transactions shall be 10% of the free-float capital of the company in terms of number of shares (*b*) No clearing member shall have open position of more than 10% of the market-wide position limits or ₹ 50 crore (base value), whichever is lower (*c*) For a FII/MF, the position limits shall be the same as of a clearing member (*d*) The client level position limits shall be not more than 1% of the market-wide position limits.

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No lending/borrowing during periods of corporate action : There shall be no lending/borrowing activity during the periods of corporate action in the security and shall be disclosed by AI to the market. *(Corporate action means right issue, bonus issue, payment of dividend etc.)*

Compliance with specified requirements : Any borrowing/lending and return of securities would not amount to purchase/disposal/transfer of the same for the purpose of compliance with the extant FDI/FII limits and the norms regarding acquisition of shares/disclosure requirements specified under the various Regulations of SEBI.

There must be adequate systems to distinguish SLB transactions from normal market transactions: Adequate systems shall be put in place by the stock exchanges/Depositories to distinguish the SLB transactions from the normal market transactions in the demat system.

Arbitration mechanism for settling the disputes : AIs shall provide suitable arbitration mechanism for settling the disputes arising out of the SLB transactions executed on the platform provided by them.

Disseminating information in public domain : AIs shall disseminate in public domain, the details of SLB transactions executed on the platform provided by them and the outstanding positions on a weekly basis. The frequency of such disclosure may be reviewed from time to time with the approval of SEBI.

Question 16] Write a short note on: Settlement System

Ans.: Meaning of settlement : Settlement is the process of netting of transactions and actual delivery of securities and transfer deeds against receipts or payment of agreed amount.

Why Settlement : It is necessary to make a settlement to know the net effect of a series of transaction during a given period.

Settlement Date : Settlement date is the date specified for delivery of securities between securities firms. For administrative convenience, a stock exchange divides the year into a number of settlement periods so as to enable members to settle their trades. All transactions executed during the settlement period are settled at the end of the settlement period.

Settlement Risk : Settlement risk or principal risk is the risk that the seller of a security or funds delivers its obligation but does not receive payment or that the buyer of a security or funds make payment but does not receive delivery. In this event, the full principal value of the securities or funds transferred is at risk.

Question 17] What settlement cycle is followed in Indian stock market?

Ans.: India is one of the most advanced markets when it comes to settlement of trade. The domestic market follows a **T+2** settlement cycle w.e.f. 1.4.2003. *(Till March 2003, settlement was on T+3 basis)*

Question 18] What do you understand by rolling settlement?

CS (Executive) - Dec 2009 (3 Marks)

Write a short note on: Rolling Settlement **CS (Executive) - Dec 2016 (3 Marks)**

Ans.: In a rolling settlement, each trading day is considered as a trading period and trades executed during the day are settled based on net obligations for the day. In India, trades in rolling settlement are settled on a **T+2** basis i.e. on the 2nd working day after a trade.

> Under rolling settlement, all trades executed on a trading day are nettled X days later. This is called 'T+X' rolling settlement, where 'T' is the trade date and 'X' is the number of business days after the trade date on which settlement takes place. The rolling settlement prevailing in India is T+2, implying that the outstanding positions at the end of the day 'T' are compulsorily settled 2 days after the trade date.

Question 19] Which days are calculated for the purpose of rolling settlement?

Ans.: For arriving at the settlement day, all intervening holidays including **bank holidays, exchange holidays, Saturdays** and **Sundays**, are ***excluded.***

Example: Trades taking place on Monday are settled on Wednesday, Tuesday's trades are settled on Thursday and so on.

Question 20] When does the open positions result in payment/delivery under rolling settlement?

Ans.: Under rolling settlement, all open positions at the end of the day mandatorily result in payment/ delivery 'n' days later. Currently, trades in rolling settlement are settled on T+2 basis where T is the trade day. For example, a trade executed on Monday is mandatorily settled by Wednesday (considering two working days from the trade day).

	Activity	**Day**
Trading	Rolling settlement	T
Clearing	Custodial confirmation and delivery generation	T+1 working days
Settlement	Securities and funds pay-in and pay-out	T+2 working days
Post settlement	Auction	T+3 working days
	Bad delivery reporting	T+4 working days
	Auction settlement	T+5 working days
	Rectified bad delivery pay-in and pay-out	T+6 working days
	Re-bad delivery reporting and pick up	T+8 working days
	Close out of re-bad delivery and funds pay-in and pay-out	T+9 working days

For intra-day traders, rolling settlement changes nothing. For institutional investors, who are forbidden to square off anyway, there would be no change. It is for retail investors who take leveraged positions across one night or more that rolling settlement has an impact. The funds and securities pay-in and pay-out are carried out on T+2 days.

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Question 21] A transaction of dematerialized equity shares took place on Wednesday, the 19th March, 2014 at BSE. According to the compulsory rolling settlement, complete the following table with timeline of the settlement cycle:

Activity	Day & Date
Rolling settlement trading	?
Custodial information	?
Delivery generation	?
Securities and funds pay-in	?
Securities and funds pay-out	?
Valuation debit	?
Auction	?
Auction settlement	?

CS (Executive) - June 2014 (5 Marks)

Ans.:

Activity	**Day**	**Day & Date**
Rolling settlement trading	T	Wednesday i.e. 19th March, 2014
Custodial information	T+1	Thursday i.e. 20th March, 2014
Delivery generation	T+1	Thursday i.e. 20th March, 2014
Securities and funds pay-in	T+2	Friday i.e. 21st March, 2014
Securities and funds pay-out	T+2	Friday i.e. 21st March, 2014
Valuation debit	T+2	Friday i.e. 21st March, 2014
Auction	T+3	Monday i.e. 24th March, 2014
Auction settlement	T+5	Wednesday i.e. 26th March, 2014

Question 22] What is 'pay-in' and 'pay-out'?

Distinguish between: Pay-in & Pay-out

CS (Executive) - June 2010 (3 Marks), Dec 2011 (3 Marks)

CS (Executive) - Dec 2014 (3 Marks)

Ans.: Pay-in day is the designated day on which securities or funds are paid in by the **members to clearing house** of stock exchange.

Pay-out day is the day when securities are delivered and money is paid out by the **clearing house to members.**

The trades done on BSE On-Line Trading (BOLT) by the trading members in all securities in Compulsory Rolling System (CRS) are now settled on BSE by payment of monies and delivery of securities on T+2 basis. All deliveries of securities are required to be routed through the Clearing House.

The Pay-in/Pay-out of funds based on the money statement and that of securities based on Delivery Order/Receiver Order issued by BSE are settled on T+2 day.

Demat pay-in : The member-brokers can effect pay-in of demat securities to the Clearing House either through the NSDL or CDSL. In case of NSDL, the member brokers are required to give instructions to their respective DPs specifying settlement No., settlement type, effective pay-in date, quantity, etc.

Question 23] What is no-delivery period?

Ans.: Whenever a company announces a book closure or record date, the exchange sets up a no-delivery period for that security. During this period only trading is permitted in the security. However, these trades

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are settled only after the no-delivery period is over. This is done to ensure that investor's entitlement for the corporate benefit is clearly determined.

Question 24] What is an auction?

Ans.: On account of non-delivery of securities by the trading member on the pay-in day, securities are put up for auction by the exchange. This ensures that buying trading member receives the securities. The exchange purchases the requisite quantity in auction market and gives them to the buying trading member.

Question 25] How stocks are classified in Bombay Stock Exchange?

Ans.: The Securities traded on BSE have been classified into various groups.

BSE has, for the guidance and benefit of the investors, classified the Securities in the Equity Segment into 'A', 'B', 'T' and 'Z' groups on certain qualitative and quantitative parameters.

Group	Important points
Group A	◆ These are the most liquid counters among the whole lot of stocks listed in the BSE. ◆ These are companies which are rated excellent in all aspects. ◆ Volumes are high and trades are settled under the normal rolling settlement (i.e. to say intra-day buy-sell deals are netted out). ◆ These are best fit for a novice investor's portfolio considering that information about them is extensively available. For instance, all the 30 stocks in SENSEX are 'A' grade stocks.
Group B	◆ All companies not included in group 'A', 'S' or 'Z' are clubbed under this category. ◆ B1 and B2 groups will be merged as a single Group B effective from March 2008.
Group F	The "F" Group represents the Fixed Income Securities.
Group G	Trading in Government Securities by the retail investors is done under the "G" Group.
Group S	◆ These are shares that fall under the BSE's Indonext segment. ◆ The BSE Indonext comprises small and medium companies that are listed in the Regional Stock Exchanges (RSE). ◆ S grade companies are small and typically ones with turnover of ₹ 5 crore and tangible assets of ₹ 3 crore. Some also have low free-float capital with the promoter holding as high as 75%. ◆ Besides their smaller size, the other risk that comes with investing in them is low liquidity. Owing to lower volumes, these stocks may also see frenzied price movements.
Group T	◆ The 'T Group' represents securities which are settled on a **trade-to-trade basis** as a surveillance measure. ◆ Each trade here is seen as a separate transaction and there's no netting-out of trades as in the normal rolling system. ◆ The trader needs to pay to take delivery for his buys and deliver shares for his sells, both on the second day following the trade day (T+2). For example, assume you bought 100 shares of 'T' grade scrip and sold another 100 of it on the same day. Then, for the shares you have bought, you would have to pay the exchange in two days. As for the other bunch that you sold, you should deliver the shares by T+2 days, for the exchange to deliver it to the one who bought it. ◆ Failure to produce delivery shares against the sale made would be considered as short sales. The exchange will, in that case, on the T+3rd day, debit an amount that is 20% higher than the scrip's closing price that day. This means unless the scrip's price falls more than 20% from the price of your sale transaction, you would have to pay a penalty for the short sale so made.

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Group	Important points
	◆ Even so, there will be no credit made to you in the case of substantial fall in the share price. The exchange will, instead, credit the gain to its investor fund. ◆ Stocks are regularly moved in and out of trade-to-trade settlement depending on the speculative interest that governs them.
Group Z	◆ The 'Z' Group was introduced by BSE in July 1999 and includes companies which have failed to comply with its listing requirements or have failed to resolve investor complaints and/or have not made the required arrangements with both the depositories, viz., CDSL and NSDL for dematerialization of their securities. ◆ This grade also includes stocks of companies that have dematerialization arrangement with only one of the two depositories, CDSL and NSDL. ◆ These stocks may perhaps be the riskiest in terms of various grades accorded. For one, not much information would be available in the public domain on these companies, making it tough to track them. Second, the low media coverage that keeps them relatively hidden from public scrutiny also makes them more vulnerable to insider trading. Third, these companies already have a poor score in redressing investor complaints.

BSE also provides a facility to the market participants for on-line trading of odd-lot securities in physical form in 'A', 'B', 'T' and 'Z' groups and in rights renunciations in all groups of Securities in the Equity Segment.

With effect from December 31, 2001, trading in all securities listed in the Equity segment takes place in one market segment, viz., Compulsory Rolling Settlement Segment (CRS).

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Question 26] How closing price of scrips in the cash segment is calculated?

Ans.: The closing price of scrips is computed by the stock exchange on the basis of weighted average price of all trades executed during the last 30 minutes of the continuous trading session. However, if there is no trade recorded during the last 30 minutes, then the last traded price of scrip in the continuous trading session is taken as the official closing price.

Question 27] The following information has been collected regarding two shares, Share-A and Share-B, trading at BSE on 18th September, 2014:

Share-A

Date	Time	Price	No. of shares traded
18th September, 2014	14:45:10	385.60	550
18th September, 2014	14:55:35	382.78	1,575
18th September, 2014	15:00:20	380.99	1,514
18th September, 2014	15:01:30	381.79	1,625
18th September, 2014	15:05:40	380.38	1,025
18th September, 2014	15:10:20	381.51	1,390
18th September, 2014	15:20:25	381.42	800
18th September, 2014	15:22:20	384.07	600
18th September, 2014	15:25:55	383.74	1,200

Share-B

Date	Time	Price	No. of shares traded
18th September, 2014	14:07:30	50.60	250
18th September, 2014	14:11:40	52.10	585
18th September, 2014	14:16:20	49.85	700
18th September, 2014	14:26:25	51.25	425
18th September, 2014	14:45:10	50.75	450
18th September, 2014	14:55:35	49.95	500

You are required to determine the closing prices and last traded prices for both the shares for 18th September, 2014.
CS (Executive) - Dec 2014 (6 Marks)

Ans.: Closing price of Share A : Since, Share A is continuously traded in last 30 minutes; its closing price will be weighted average price of all trades executed during the last 30 minutes as shown below:

Price (1)	No. of shares traded (2)	Product (3) [(1) × (2)]
380.99	1,514	5,76,818.86
381.79	1,625	6,20,408.75
380.38	1,025	3,89,889.50
381.51	1,390	5,30,298.90
381.42	800	3,05,136.00
384.07	600	2,30,442.00
383.74	1,200	4,60,488.00
Total ☞	**8,154**	**31,13,482.01**

$$\text{Closing Price} = \frac{31,13,482.01}{8,154} = 381.83$$

Closing price of Share B : Since, Share is not continuously traded in last 30 minutes; its closing price will be last traded price of scrip in the continuous trading session i.e. ₹ 49.95

Question 27A] Following information has been collected regarding Share-X trading at NSE on 2nd September, 2016:

Date	*Time*	*Price (₹)*	*No. of shares traded*
2nd September, 2016	14:42:10	265.60	550
2nd September, 2016	14:53:35	262.78	1,575
2nd September, 2016	15:00:20	260.99	1,514
2nd September, 2016	15:03:30	261.79	1,625
2nd September, 2016	15:05:40	260.38	1,025
2nd September, 2016	15:12:20	261.51	1,390
2nd September, 2016	15:21:25	261.42	800
2nd September, 2016	15:22:20	264.07	600
2nd September, 2016	15:26:55	263.74	1,200

You are required to determine the closing price and last traded price for Share-X for 2nd September, 2016.
CS (Executive) - Dec 2016 (4 Marks)

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Ans.: Closing price of Share-X: Since, Share-X is continuously traded in last 30 minutes; its closing price will be weighted average price of all trades executed during the last 30 minutes as shown below:

Price (1)	No. of shares traded (2)	Product (3) [(1) × (2)]
260.99	1,514	3,95,138.86
261.79	1,625	4,25,408.75
260.38	1,025	2,66,889.50
261.51	1,390	3,63,498.90
261.42	800	2,09,136.00
264.07	600	1,58,442.00
263.74	1,200	3,16,488.00
Total ☞	**8,154**	**21,35,002.01**

$$\text{Closing Price} = \frac{21,35,002.01}{8,154} = 261.83$$

Question 28] Explain the term 'BOLT'. **CS (Executive) - Dec 2009 (2 Marks)**

Explain the term 'NEAT'. **CS (Executive) - Dec 2009 (2 Marks)**

Ans.: Both NSE & BSE offer online trading platforms for its investors. Online trading platform of BSE is called BOLT (BSE's Online Trading System) while that of NSE is called NEAT (National Exchange for Automated Trading).

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Both BOLT & NEAT use satellite communication for trading, using VSAT. Traders can book buy and sell orders from their computers by connecting to BOLT/NEAT online.

Question 29] Write a short note on: Basket Trading System

CS (Inter) - June 2007 (5 Marks)

CS (Executive) - June 2010 (2 Marks), Dec 2011 (2 Marks)

Ans.: Basket trading is the trading of a group of securities in a single order.

The BSE has a facility of the Basket Trading System (BTS), which enables the investors to create Sensex-linked portfolios and a linkage of market prices of the underlying securities of the Sensex in cash segment future segment. In BTS, investor can buy all 30 scrip of the Sensex, in one transaction in proportion of weights in the Sensex.

The investors need not calculate the quantity of Sensex scrips to be bought or sold for creating Sensex linked portfolios and this function is performed by the system. The investors can also create their own baskets by deleting certain scrips from 30 scrips in the Sensex.

Further, the investors can alter the weights of securities in such profiled baskets and enter their own weights. The investors can also select less than 100% weightage to reduce the value of the basket as per their own requirements. In order to participate in this system, the member-brokers need to indicate number of Sensex basket(s) to be bought or sold, where the value of one Sensex basket is arrived at by the system by multiplying ₹ 50 to prevailing Sensex.

The minimum value of shares to be brought or sold is ₹ 50,000 for each order.

Example:

If the Sensex is 19,000, then value of one basket of Sensex would be 19000 × 50 = i.e. ₹ 9,50,000.

Question 30] Write a short note on: Rolling Settlement **CS (Inter) - Dec 2007 (4 Marks)**

Ans.: Under rolling settlement, all trades executed on a trading day are settled X days later. This is called 'T+X' rolling settlement, where 'T' is the trade date and 'X' is the number of business days after trade date on which settlement takes place. The rolling settlement prevailing in India is T+2, implying that the outstanding positions at the end of the day 'T' are compulsorily settled 2 days after the trade date.

Rolling settlement was first introduced in India by OTCEI.

SEBI introduced T+5 rolling settlement in equity market from July 2001. Subsequently shortened the settlement cycle to T+3 from April 1, 2002. After having gained experience of T+3 rolling settlement, it was felt appropriate to further reduce the settlement cycle to T+2 thereby reducing the risk in the market and to protect the interest of investors. As a result, SEBI, as a step towards easy flow of funds and securities, introduced T+2 rolling settlement in Indian equity market from 1st April, 2003.

Question 31] Write a short note on: Surveillance at BSE

CS (Executive) - Dec 2010 (2 Marks)

Discuss the various functions of Price Monitoring **CS (Executive) - Dec 2009 (5 Marks)**

Explain the term 'Price Monitoring' in relation to security market.

CS (Inter) - June 2008 (2 Marks)

Ans.: The main objectives of the surveillance function of the Stock Exchange is to -

- To promote market integrity
- Monitor price and volume movements (volatility)
- Detecting potential market abuses
- Managing default risk by taking necessary actions timely.

All the instruments traded in the equity segment of Cash and Derivative market come under the Surveillance umbrella of BSE.

Surveillance activities at the Stock Exchange are divided broadly into two major segments:

- Price Monitoring and
- Position Monitoring.

Price Monitoring: Price monitoring is mainly related to the price movement or abnormal fluctuation in prices or volumes. The functioning of the Price Monitoring is broadly divided into following activities:

- On-Line Surveillance
- Off-Line Surveillance
- Derivative Market Surveillance
- Investigations
- Surveillance Actions
- Rumour Verification
- Pro-active Measures

Position Monitoring: Position monitoring relates mainly to abnormal position of members in order to manage default risk.

- Statement of Top 100 Purchasers/Sellers
- Concentrated Purchases/Sales
- Purchases/Sales of Scrips having Thin Trading
- Trading in B1, B2 and Z group Scrips
- Pay-in liabilities above a Threshold Limit

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- Verification of Institutional Trades
- Snap Investigation
- Market Intelligence

Question 32] Distinguish between: On line Surveillance & Off-Line Surveillance
CS (Inter) - Dec 2007 (4 Marks)

Discuss briefly the different surveillance system adopted by the stock exchanges.
CS (Executive) - June 2011 (4 Marks)

Write a short note on: On line Surveillance **CS (Inter) - June 2008 (2 Marks)**
CS (Executive) - June 2014 (5 Marks)

Ans.: On line Surveillance : One of the most important tools of the surveillance is the On-line Real Time Surveillance system which was commissioned in 1999.

The system has a facility to generate the alerts on-line, in real time, based on certain preset parameters like -

- price and volume variations in scrips,
- members taking unduly large positions not commensurate with their financial position or
- having large concentrated positions in one or few scrips, etc.

An alert is a measure of abnormal behaviour. An Alert occurs in the surveillance system when a metric behaves significantly differently from its benchmark. The alerts generated by the system are analyzed and corrective action based on preliminary investigations is taken in such cases. The system also provides facility to access trades and orders of members.

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Off-Line Surveillance : The Off-Line Surveillance system comprises of the various reports based on different parameters and scrutiny thereof.

- High/Low difference in prices
- % change in prices over a week/fortnight/month
- Top N scrips by turnover
- Trading in infrequently traded scrips
- Scrips hitting new high/low

The surveillance actions or investigations are initiated in the scrips identified from the above-stated reports.

Question 33] What kinds of surveillance actions can be taken as part of Off-Line Surveillance by the stock exchanges?

Ans.: Following surveillance actions can be taken as part of Off-Line Surveillance by the stock exchanges:

(1) **Special margins :** Special margins are imposed on scrips which have witnessed abnormal price or volume movements. Special margin is imposed @ 25% or 50% or 75% as the case may be, on the client-wise net outstanding purchase or sale position (or on both sides) by the department.

(2) **Reduction of Circuit Filters :** The circuit filters are reduced in case of illiquid scrips or as a price containment measure in low volume scrips. The circuit filters are reduced to 10% or 5% or 2% as the case may be, based on the criteria decided by the Exchange.

(3) **Circuit Breakers :** Discussed separately in next question.

(4) **Trade to Trade :** Discussed separately in next question.

(5) **Suspension of scrip :** The scrips are suspended by the surveillance department in exceptional cases pending investigation or if the same scrip is suspended by any other Stock Exchange as a Surveillance action.

(6) **Warning to Members :** The department may issue verbal/written warning to member(s) when market manipulation in the scrip is suspected.

(7) **Imposition of penalty/suspension/de-activation of terminals :** The department imposes penalty or deactivate BOLT terminals or suspend the member(s) who are involved in market manipulation, based on the input/evidence available from investigation report or as and when directed by SEBI.

Question 34] Write a short note on: Circuit breakers

CS (Executive) - June 2013 (3 Marks)

Ans.: What is a circuit : Circuits are of two types - circuit for an index and for a stock. So, if an index or the price of a stock increases or declines beyond a specified threshold it is said to have entered into a circuit. SEBI specifies this threshold as a percentage of the prior day's closing figures.

Circuit breaker for an Index : Circuit breakers are applied only on equity and equity derivative markets. Whenever the major stock indices like BSE SENSEX and Nifty cross the threshold level, SEBI rules require that the trading at the stock exchange be stopped for a certain period of time beginning from half an hour to even an entire day. The time frame for which trading is stopped depends upon the time and amount of movement in the indices. The idea is to allow the market to cool down and resume trading at normal levels. The thresholds are implemented stage wise.

SEBI *vide* its Circular No. CIR/MRD/DP/25/2013 dated 3rd September, 2013 has partially modified the earlier circular. The revised guidelines are as below.

The index-based market-wide circuit breaker system applies at 3 stages of the index movement, either way viz. at 10%, 15% and 20%. These circuit breakers when triggered bring about a coordinated trading halt in all equity and equity derivative markets nationwide. The market-wide circuit breakers are triggered by movement of either the BSE SENSEX or the Nifty 50, whichever is breached earlier.

The market shall re-open, after index based market-wide circuit filter breach, with a pre-open call auction session. The extent of duration of the market halt and pre-open session is as given below:

Trigger Limit	Trigger time	Market halt duration	Pre-open call auction session post market halt
10%	Before 1:00 pm.	45 minutes	15 minutes
	At or after 1:00 pm up to 2.30 pm	15 minutes	15 minutes
	At or after 2.30 pm	No halt	Not Applicable
15%	Before 1 pm	1 hour 45 minutes	15 minutes
	At or after 1:00 pm before 2:00 pm	45 minutes	15 minutes
	On or after 2:00 pm	Remainder of the day	Not Applicable
20%	Any time during market hours	Remainder of the day	Not Applicable

Note: *Exchange shall compute the Index circuit breaker limits for 10%, 15% and 20% levels on a daily basis based on the previous day's closing level of the index rounded off to the nearest tick size.*

Example: The BSE SENSEX moved up by 2,111 points on 18.5.2009 after the Parliament election results were announced. The trading had to be halted since the market became extremely volatile and moved beyond reasoning.

Circuit breaker for a stock : A price band specifies the span or price range for a stock to move without any interference from regulatory authorities. Only when the stock prices move beyond the range, it is considered as entering into a circuit and circuit breakers are applied. Daily price bands of 2%, 5% and 10% are applicable to different equity stocks. Price bands of 20% are applicable to all remaining scrip like preference shares or debentures. For example, for a stock with a price band of 5% that closes at ₹ 100 on the previous day, the price band will be between ₹ 105 and ₹ 95.

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Upper Circuit & Lower Circuit : Stock prices can either move up or down and hence circuit breakers are required for movements in both directions. An upward movement over the threshold will cause a stock to enter an upper circuit. Similarly, a downward movement in stock price beyond the threshold will cause a stock to enter a lower circuit.

The objective of circuit breakers is to control the stock markets at times when they move beyond reasonable limits. When a stock enters an upper circuit, it puts an investor who has already invested in the stock at an advantage. On the contrary a stock movement into a lower circuit places the investor at a disadvantage because it is now difficult to sell off these shares as they have lost a lot of money.

Question 35] Write a short note on : Trade to Trade (T2T)

CS (Executive) - Dec 2009 (2 Marks), June 2012 (2 Marks)

Ans.: Trade-to-Trade (T2T) or T segment on BSE is segment in which no intra-day trading is allowed for shares falling in that segment, as each trade results in delivery. Transactions placed in this segment have to be mandatorily settled on gross basis i.e. by taking or giving delivery even if you have bought and sold the shares during the same settlement cycle.

If you buy shares, you must pay the money and take delivery.

If you sell shares, you must give the delivery of shares and you will get money.

If you buy today and sell today and don't have delivery, then the sell position will go into auction and you will have to pay heavy penalty.

The scrips which form part of 'Z Group' are compulsorily settled on a Trade to Trade settlement basis.

As a part of Surveillance measure the Exchange transfers various securities for settlement on a Trade-to-Trade basis. The said action is reviewed on monthly basis based on market capitalization, price earnings ratio, price variation *vis-à-vis* the market movement, volatility, volume variation, client concentration and number of non-promoter shareholders etc. The criteria for shifting Securities to/from for settlement on T2T basis are decided jointly by the stock exchanges in consultation with SEBI and reviewed periodically.

Securities on which derivative products are available are not considered for transfer to Trade for Trade segment.

Question 36] Write a short note on : Market Abuse **CS (Inter) - June 2008 (2 Marks)**

CS (Executive) - June 2010 (2 Marks)

Ans.: Market abuse includes:

- Abnormal movement in price
- Abnormal movement in volume
- Artificial transactions
- False or misleading impressions
- Insider trading, etc.

In order to detect aberrant movement, it is necessary to know the normal market movements. The department uses various tools to determine normal and abnormal market movements.

The following actions are initiated to control abnormal market movements:

- ◆ Imposition of special margin
- ◆ Reduction of circuit filters
- ◆ Trade to trade settlement
- ◆ Suspensions
- ◆ De-activation of terminals, etc.

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The department carries out investigation and suitable actions are taken against members involved based on the investigation.

Aberrant Movement = Departing from an accepted standard
Example: A simple example of market abuse is seen in the case of James Parker (British Case). He was the financial controller at Pace Micro Technology. With the benefit of inside information and in clear breach of the company's share dealing rules, Parker not only sold shares ahead of a profit warning that led to a dramatic fall in the company's share price, but also carried out an active programme of spread bets on the share price, making an aggregate profit of £ 1,21,742. His claim that this was part of an existing trading strategy uninfluenced by his inside information was not believed, and in August 2006 he was fined £ 2,50,000.

Question 37] Write a short note on: Market Intelligence

Ans.: The rumours floating in the market are verified with the data available with the Exchange. Newspapers, Television news channels are referred to ascertain the national and global factors affecting the market sentiments. This enables the Exchange to avert market problems before it causes a serious damage.

On assessment of the market risk, decisions to call *ad hoc* margins/early pay-in, advising the member to limit his business, summoning him for explanation, placing trading restriction, deactivation of BOLT TWS, etc. are taken.

Question 38] Write a short note on: Clearing **CS (Executive) - June 2013 (3 Marks)**

Ans.: The clearing function of the clearing corporation is designed to work out:

(*a*) what members are due to deliver, and

(*b*) what members are due to receive on the settlement date.

Clearing is the process of determination of obligations, after which the obligations are discharged by settlement.

Question 39] Write a short note on: Clearing Corporation

CS (Executive) - Dec 2011 (3 Marks)

Ans.: An organization associated with an exchange to handle the confirmation, settlement and delivery of transactions, fulfilling the main obligation of ensuring transactions are made in a prompt and efficient manner. They are also referred to as "clearing corporations" or "clearing houses".

In order to make certain that transactions run smoothly, clearing corporations become the buyer to every seller and the seller to every buyer. In other words, they take the offsetting position with a client in every transaction.

There are two clearing corporations in India:

- Indian Clearing Corporation Ltd. (ICCL)
- National Securities Clearing Corporation Ltd. (NSCCL)

As per **Section 8A** of the **Securities Contracts (Regulation) Act, 1956**, a recognized stock exchange may transfer the duties and functions of a clearing house to a clearing corporation, being a company incorporated under the Companies Act, 2013 with the prior approval of SEBI.

Following duties and functions can be transferred to clearing corporation

(*a*) Periodical settlement of contracts

(*b*) Delivery and payment for securities

(*c*) Other incidental or connected matters

Every clearing corporation shall, for the purpose of transfer of the duties and functions of a clearing house to a clearing corporation, make bye-laws and submit the same to the SEBI for its approval.

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The SEBI on being satisfied that grant approval is in the interest of the trade and also in the public interest, approve the transfer of the duties and functions of a clearing house to a clearing corporation.

Net worth requirements: Clearing Corporations are required to maintain minimum net worth requirements of ₹ **100 crores** at all times.

Question 40] Write a short note on: Indian Clearing Corporation Ltd.

Ans.: The Indian Clearing Corporation Ltd. (ICCL) was incorporated in 2007 as a wholly-owned subsidiary of BSE. ICCL carries out the functions of clearing, settlement, collateral management and risk management for various segments of BSE. ICCL undertakes to act as the central counterparty to all the trades it provides clearing and settlement services for.

ICCL settles trades reported on the Indian Corporate Debt Segment and the Mutual Fund Segment of BSE and clears and settles trades executed on all the other segments of BSE, including Equity Cash, Equity Derivatives, BSE SME, Offer for Sale, Securities Lending and Borrowing, Debt Segment, Interest Rate Futures and the Currency Derivatives Segment.

ICCL is the only clearing corporation in India to have been granted "AAA" rating by two rating agencies, India Ratings Ltd. and Care Ratings Ltd.

ICCL has established a robust Risk Management framework which utilizes a Value at Risk model for margining of Equity Cash Segment and a risk based SPAN model for all its derivatives transactions, viz. equity derivatives, currency derivatives and interest rate derivatives. ICCL aims to provide secure, capital-efficient counterparty risk management and post-trade services.

20 banks have been empanelled as Clearing Banks for providing clearing and settlement services for trades executed on the BSE platform; the aggregate lines of credit being more than the average daily funds pay-out.

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Question 41] Write a short note on: National Securities Clearing Corporation Ltd.

Ans.: The National Securities Clearing Corporation Ltd. (NSCCL), a wholly-owned subsidiary of NSE, was incorporated in August 1995. NSCCL commenced clearing operations in April 1996.

NSCCL was set up -

- To bring and sustain confidence in clearing and settlement of securities;
- To promote and maintain, short and consistent settlement cycles;
- To provide counter-party risk guarantee
- To operate a tight risk containment system.

NSCCL carries out the clearing and settlement of the trades executed in the Equities and Derivatives segments and operates Subsidiary General Ledger (SGL) for settlement of trades in government securities. It assumes the counter-party risk of each member and guarantees financial settlement. It also undertakes settlement of transactions on other stock exchanges like, the OTCEI.

NSCCL has successfully brought about an upgradation of the clearing and settlement procedures and has brought Indian financial markets in line with international markets.

NSCCL is connected to NSDL and CDSL and carries out clearing and settlement services for other exchanges as well as for Index Futures.

Question 42] Write a short note on : Straight-through processing

CS (Inter) - Dec 2007 (4 Marks)

CS (Executive) - June 2015 (3 Marks)

Ans.: Straight-Through Processing (STP) enables the entire trade process for capital market and payment transactions to be conducted electronically without the need for manual intervention.

Advantages of Straight Through Processing:

- Facilitates shortening of the settlement cycle.
- Increases transparency
- Avoids costly duplication of work and manual intervention.
- Reduction in risks and errors.
- Faster data capturing, processing and report generation.
- Makes the market cost effective.
- Better regulation by systematic audit trial.
- Automation of manual process minimizing errors
- Improved operational efficiency in handling larger volumes
- Lower cost per trade
- Timely settlement of trades and instructions
- Eliminates paper work and minimizes manual intervention
- Enables increased cross border trading (FII trades)

Straight Through Processing (STP) aims to bring in non-duplication of work, efficiency and automation of the manual procedures right from trade initiation to settlement processes.

SEBI had mandated the use of Straight Through Processing (STP) system for all institutional trades w.e.f. July 2004. In order to regulate the STP service it had also issued **SEBI (STP Centralized Hub and STP Service Providers) Guidelines, 2004** (STP Guidelines) which also prescribes the model agreement between the STP centralized hub and the STP service providers.

STP guidelines prescribes the eligibility criteria and conditions of approval for the STP centralized hub and the STP service providers, obligations and responsibilities of the STP centralized hub and the STP service providers and code of conduct for the STP service providers. The STP centralized hub and the STP service providers are required to abide by these Guidelines. To prescribe contractual obligations between the STP centralized hub and the STP service providers and to facilitate standardization of service, a model agreement between the STP centralized hub and the STP service providers has also been prescribed by SEBI as Schedule II to the Guidelines. The agreement between the STP centralized hub and the STP service provider includes the provisions included in the model agreement.

Question 43] What do you understand by Direct Market Access (DMA)? Also state the advantage of DMA.

Ans.: Direct Market Access (DMA) is a service offered by some stockbrokers that enables sophisticated private investors to place buy and sell orders directly on the Stock Exchange order books. With DMA, a private investor can level the playing field and trade like market professionals.

SEBI has approved providing Direct Market Access facility. *[Circular No. MRD/DoP/SE/Cir-7/2008 dated April 3, 2008]*

Direct Market Access facility through Computer to Computer Link (CTCL) allows members to provide direct trading terminals only to Institutional clients through various connectivity modes. Direct Market Access (DMA) is used to describe clients accessing the market directly using CTCL software of a trading member and routing the orders through the trading member's infrastructure.

Members seeking permission for offering Direct Market Access (DMA) are required to ensure compliance with the minimum conditions specified in the SEBI circular.

Brokers interested to offer DMA facility shall apply to the respective stock exchanges giving details of the software and systems proposed to be used, which shall be duly certified by a Security Auditor as reliable. The stock exchange should grant approval or reject the application as the case may be, and communicate

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its decision to the member within 30 calendar days of the date of completed application submitted to the exchange.

Advantages of DMA:

- Direct control of clients over orders
- Faster execution of client orders
- Reduced risk of errors associated with manual order entry
- Greater transparency
- Increased liquidity
- Lower impact costs for large orders
- Better audit trails
- Better use of hedging and arbitrage opportunities through the use of decision support tools and algorithm trading.

Conditions for DMA : Stock Exchanges may facilitate Direct Market Access for investors subject to the following conditions:

1. **Application for DMA facility :** Brokers interested to offer DMA facility shall apply to the respective stock exchanges giving details of the software and systems proposed to be used, which shall be duly certified by a Security Auditor. The stock exchange should grant approval or reject the application and communicate its decision to the member within 30 days of the date of completed application submitted to the exchange.

2. **Operational specifications :** All DMA orders shall be routed to the exchange trading system through the broker's trading system. The broker's server routing DMA orders to the exchange trading system shall be located in India. The broker should ensure sound audit trail for all DMA orders and trades, and be able to provide identification of actual user-id for all such orders and trades. The audit trail data should available for at least 5 years.

3. **Client Authorization and Broker-Client agreement :** Exchanges shall specify from time to time the categories of investors to whom the DMA facility can be extended. Initially, the permission is restricted to institutional clients. Brokers shall specifically authorize clients for providing DMA facility after fulfilling KYC requirements and carrying out due diligence regarding clients credit worthiness, risk taking ability, track record of compliance and financial soundness. Brokers shall ensure that only those clients who are deemed *'fit and proper'* for this facility are allowed access to the DMA facility. Brokers shall maintain proper records of such due diligence. Individual users at the client end shall also be authorized by the broker based on minimum criteria. The records of user details, user-id and such authorization shall be maintained by the broker. Details of all user-ids activated for DMA shall be provided by the broker to the exchange.

   The broker shall enter into a specific agreement with the clients for whom they permit DMA facility. This agreement will include the following safeguards:

   (*a*) The client shall use the DMA facility only to execute his own trades and shall not use it for transactions on behalf of any other person/entity.

   (*b*) Electronic/Automated Risk management at the broker's level before release of order to the Exchange system. The client shall agree to be bound by the various limits that the broker shall impose for usage of the DMA facility.

   (*c*) Right to withdraw DMA facility if the limits set up are breached or for any other such concerns.

   (*d*) Withdrawal of DMA facility on account of any misuse or on instructions from SEBI or Stock Exchange.

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Exchange has to prepare a model agreement for this purpose. The broker's agreement with clients should not have any clause that is less stringent/contrary to the conditions stipulated in the model agreement.

4. **Risk Management :** The broker shall ensure that trading limits/exposure limits/position limits are set for all DMA clients based on risk assessment, credit quality and available margins of the client. The broker system shall have appropriate authority levels to ensure that the limits can be set up only by persons authorized by the risk/compliance manager. The broker shall ensure that all DMA orders are routed through electronic/automated risk management systems of the broker to carry out appropriate validations of all risk parameters including Quantity Limits, Price Range Checks, Order Value, and Credit Checks before the orders are released to the Exchange. All DMA orders shall be subjected to the following limits:
   (*a*) Order quantity order value limit in terms of price and quantity specified for the client.
   (*b*) All the position limits which are specified in the derivatives segment as applicable.
   (*c*) Net position that can be outstanding so as to fully cover the risk emanating from the trades with the available margins of the specific client.
   (*d*) Appropriate limits for securities which are subject to FII limits as specified by RBI. The broker may provide for additional risk management parameters as they may consider appropriate.
5. **Broker to be liable for DMA trades :** The broker shall be fully responsible and liable for all orders emanating through their DMA systems. It shall be the responsibility of the broker to ensure that only clients who fulfil the eligibility criteria are permitted to use the DMA facility.
6. **Cross Trades :** Brokers using DMA facility for routing client orders shall not be allowed to cross trades of their clients with each other. All orders must be offered to the market for matching.
7. **Other legal provisions :** In addition to the requirements mentioned above, all existing obligations of the broker as per current regulations and circulars will continue without change. Exchanges may also like to specify additional safeguards/conditions as they may deem fit for allowing DMA facilities to their brokers.

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Question 44] Write a short note on: Demutualization of stock exchanges

CS (Inter) - June 2008 (5 Marks)

What is meant by demutualization of stock exchanges? Explain the purpose of demutualization.
CS (Executive) - June 2015 (5 Marks)

Ans.: Historically, most of the stock exchanges, except NSE & OTCEI were formed as 'mutual organization' i.e. formed by trading members for their common benefit. The disadvantage of such organization is that they primarily work for interest of members and those of investors. The office bearers will have access to inside information, which can be misused by them. There is no transparency and no professional approach. Moreover, they cannot raise large funds for modernization or up-gradation by offering equity shares to others.

In view of above shortcomings of 'mutual stock exchanges', a policy decision was taken by the Government of India for corporatization of stock exchange. Corporatization means stock exchange should be organized as a company.

Thus, the process of converting 'mutual stock exchanges' into company form of organization is known as 'Demutualization of Stock Exchanges'.

SEBI had set up a committee under the Chairmanship of Justice Kania for the same which came up with report on demutualization of Stock Exchanges through uniform scheme prescribed. Accordingly, SEBI issued scheme of demutualization to BSE and other Regional Stock Exchanges.

Important features of the demutualization:

(1) The board of a stock exchange should consist of 75% public interest/shareholder directors and only 25% broker directors, and

(2) 51% shareholding of the stock exchange should be divested to public/investors other than trading member brokers and only 49% of shareholding can remain with the trading member brokers. This will transform our broker-owned stock exchanges into professionally-run corporate stock exchanges.

The options prescribed for divestment/dilution of brokers shareholding in a stock exchange are as follows:

- Offer for sale, by issue of prospectus, of shares held by trading member brokers.
- Private placement of shares to any person or group of persons subject to the prior approval of SEBI and the maximum limit of 5% to any single person/group of persons.
- Fresh issue of shares to the public through an IPO.

Purpose of demutualization:

1. Division of ownership between members and outsiders can lead to a balanced approach, remove conflicts of interest, create greater management accountability.
2. Publicly owned stock exchanges can enter into capital market for expansion of business.
3. Publicly owned stock exchange would be more professionally managed than broker owned.
4. Demutualization enhances the flexibility of management.

Question 45] What do you mean by SME Exchange? Discuss the role of Company Secretary in model listing agreement laid down by SEBI for SMEs for the purpose of listing?

CS (Executive) - Dec 2013 (5 Marks)

What is SME Exchange? Explain the benefits of listing on SME exchange.

CS (Executive) - Dec 2015 (4 Marks)

Ans.: An SME Exchange is a stock exchange dedicated for trading the securities of Small & Medium Enterprises (SMEs) who otherwise find it difficult to get listed on the Main Board. *(Main Board means a recognized stock exchange having nationwide trading terminals).* The concept originated from the difficulties faced by SMEs in gaining visibility and attracting sufficient trading volumes when listed along with other stocks on the Main Board of stock exchanges.

World over, dedicated SME trading platforms or exchanges are prevalent, which are known by different names such as 'Alternate Investment markets' or 'growth enterprises market', 'SME Board' etc. Some of the known markets for SMEs are AIM (Alternate Investment Market) in UK, TSX Ventures in Canada, GEM (Growth Enterprise Market) in Hong Kong, MOTHERS (Market of the high-growth and emerging stocks) in Japan, Catalist in Singapore and the latest initiative in China - Chinext. As a matter of fact, NASDAQ also started as an SME exchange.

In India, "SME Exchange" is defined in SEBI (ICDR) Regulations, 2009 as a trading platform of a recognized stock exchange or a dedicated exchange permitted by SEBI to list the securities issued in accordance with SEBI (ICDR) Regulations and this excludes the Main Board.

To be listed on the SME Exchange, the post-issue paid up capital of the company should not exceed **₹ 25 crore**. This means that the SME Exchange is not limited to the Small and Medium Scale enterprises which are defined under the Micro, Small & Medium Enterprises Development Act, 2006 as enterprises where the investment in plant and machinery does not exceed ₹ 10 Crore.

As of now, to get listed on the Main Board of NSE, the minimum paid up capital required is ₹ 10 crore and that of BSE is ₹ 3 crore. Hence, those companies with paid up capital between ₹ 10 Crore to ₹ 25 crore has the option of migrating from SME Exchange to the Main Board or *vice versa*.

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The companies listed on the SME exchange are allowed to migrate to the Main Board as and when they meet the listing requirements of the Main Board and there shall be compulsory migration of SMEs from the SME exchange, in case their post issue paid up capital exceeds ₹ 25 crore.

BSE is the first-one to seize the initiative followed by NSE, both of them have come up with their SME Exchanges to leverage their respective trading platforms developed over the period.

Benefits of listing on SME Exchange:

(1) **Easy access to capital :** SME provides an avenue to raise capital through equity infusion for growth oriented SMEs.

(2) **Enhanced visibility & prestige :** The SME's benefit by greater credibility and enhanced financial status leading to demand in the company's shares and higher valuation of the company.

(3) **Encourages growth of SMEs :** Equity financing provides growth opportunities like expansion, mergers and acquisitions thus being a cost effective and tax efficient mode.

(4) **Ensures Tax Benefits :** In case of listed securities Short Term Gains Tax (STCG) is 15% and there is absolutely no Long Term Capital Gains Tax (LTCG).

(5) **Enables Liquidity for Shareholders :** Equity financing enables liquidity for shareholders, provides growth opportunities like expansion, mergers and acquisitions, thus being a cost effective and tax efficient mode.

(6) **Equity financing through Venture Capital :** Provides an incentive for Venture Capital Funds by creating an Exit Route and thus reducing their lock in period.

(7) **Efficient Risk Distribution :** Capital Markets ensure that the capital flows to its best uses and that riskier activities with higher payoffs are funded.

(8) **Employee Incentives :** Employee Stock Options ensures stronger employee commitment, participation and recruitment incentive.

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Model Listing Agreement for SMEs : To facilitate listing of specified securities in the SME exchange, "Model Equity Listing Agreement" to be executed between the issuer and the Stock Exchange, to list/migrate the specified securities on SME Exchange. The listing agreement covers routine listing compliances. All listed SMEs are required to appoint the Company Secretary as Compliance Officer who will be responsible for monitoring the share transfer process and report to the Issuers board in each meeting.

The Compliance Officer will directly liaise with the authorities such as SEBI, Stock Exchanges, ROC etc., and investors with respect to implementation of various clause, rules, regulations and other directives of such authorities and investor service & complaints related matter. Further, Registrar & Transfer Agents of listed SMEs are required to produce a certificate from a practicing company secretary that all transfers have been completed within the stipulated time and certification regarding compliance of conditions of Corporate Governance.

Question 46] Explain : Practicing Company Secretary certification for SME platform

CS (Executive) - June 2015 (3 Marks)

Ans.: Companies seeking listing on BSE SME platform through IPO are required to comply with the quantitative eligibility norms as prescribed by BSE. Additionally, it will be desirable for the company to file a compliance certificate by a practicing company secretary as per the guidance note issued by the ICSI as and when such a certification is made applicable by the SME platform of BSE Ltd.

Question 47] What is 'algorithm trading'? Enumerate the guideline prescribed by the SEBI for stock brokers in this behalf? **CS (Executive) - June 2014 (5 Marks)**

"High speed of algorithmic trading may damage the structure and health of a stock market. Therefore, it is to be controlled and monitored." In the light of this statement, describe the SEBI guidelines for algorithmic trading. **CS (Executive) - Dec 2016 (4 Marks)**

Ans.: An algorithm is a specific set of clearly defined instructions aimed to carry out a task or process.

Algorithmic trading is the process of using computers programmed to follow a defined set of instructions for placing a trade in order to generate profits at a speed and frequency that is impossible for a human trader. In other words, any order that is generated using automated execution logic shall be known as algorithmic trading.

Algorithmic trading is also known as **automated trading, black-box trading** or **algo-trading**.

Example : Suppose a trader is following a simple trade criteria:

- **Buy 50 shares of a stock when its 50-day moving average goes above the 200-day moving average.**
- **Sell shares of the stock when its 50-day moving average goes below the 200-day moving average**

Using this set of two simple instructions, it is easy to write a computer program which will automatically monitor the stock price (and the moving average indicators) and place the buy and sell orders when the defined conditions are met. The trader no longer needs to keep a watch for live prices and graphs, or put in the orders manually. The algorithmic trading system automatically does it for him, by correctly identifying the trading opportunity.

Benefits of Algorithmic Trading:

- Trades executed at the best possible prices
- Instant and accurate trade order placement
- Trades timed correctly and instantly, to avoid significant price changes
- Reduced transaction costs
- Simultaneous automated checks on multiple market conditions
- Reduced risk of manual errors in placing the trades
- Reduced possibility of mistakes by human traders based on emotional and psychological factors.

Broadly the Guidelines provides for following directions to Stock Exchanges amongst others:

- To have arrangements, procedures and systems to adequately manage the trade load of algorithm orders.
- To put in place effective economic disincentives with regard to high daily order to trade ratio of algorithm orders.
- To ensure all trades are routed through servers of stock brokers located in India only.
- To have appropriate risk control mechanisms covering price band check and quantity limit check.
- To report algorithmic trading details in the Monthly Development Report submitted to SEBI.
- To ensure that the stock brokers provide the facility of algorithmic trading only after obtaining prior permission of the stock exchanges.

For Stock Brokers the new Guidelines provides for following:

- Stock brokers are directed to implement the minimum levels of risk controls and shall ensure that the algorithm orders are not released in breach of price band check, Quantity limit check, Value per order check.
- Stock brokers are directed to prescribe individual client level cumulative open order value check.
- To have pre-defined parameters for algorithm systems, for an automatic stoppage if algorithm execution leads to loop or a runaway situation.
- To tag algorithm orders with a unique identifier which is provided by the Stock Exchanges to establish audit trail.
- To include a specific report ensuring that the checks are in place in the annual system audit report submitted by the Stock brokers to Stock Exchanges.

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- Stock brokers interesting in Algorithmic Trading are required to submit to Stock exchanges undertakings w.r.t. having proper procedures, systems and technical capability to carry such trades, safeguards to protect any misuse, real time monitoring system and logs of all trading to facilitate audit trail etc.

Question 48] Write a short note on: Market Capitalization

CS (Inter) - June 2006 (5 Marks)

Ans.: Market capitalization means the total rupee market value of all of a company's outstanding shares. Market capitalization is calculated by multiplying a company's shares outstanding by the current market price of one share. The investment community uses this figure to determine a company's size, as opposed to sales or total asset figures.

Example: If a company has 35 million shares outstanding, each with a market value of ₹ 100, the company's market capitalization is ₹ 3.5 billion (35,000,000 × ₹ 100).

Following is the list of Top 5 companies by market capitalization (BSE on 16.12.2015):

Name of the company	₹ (in Crores)
TCS	4,71,395.33
Reliance	3,17,232.26
HDFC Bank	2,68,812.31
ITC	2,57,118.70
Infosys	2,50,665.57

Question 49] Explain the term 'Kerb Trading'. **CS (Inter) - June 2006 (2 Marks)**

Ans.: Transactions are often carries out in the stock exchange after official hours, even though such trading among the members is not strictly legal. Such unauthorized trading carried out outside the official hours is known as kerb trading. Kerb trading was possible earlier when physical trading is carried out at stock exchange by exchanging share transfer forms and share certificate. Know trading is computerized and made online by various stock exchanges, hence concept is not relevant.

Question 50] Explain the term 'Odd lot trading'. **CS (Inter) - June 2006 (2 Marks)**

Ans.: Anything less than the standard unit of trading is odd lot. Thus, when the securities are not in marketable lots, they are known as odd lots. However, in computerized trading system in demat form, trading in odd lot lost its relevance. That is to say in cash market, an investor need not place order in lot size like 2,000 shares or 1,000 shares. He can place order for or sale for any quantity like 37 or 543.

Question 51] Define the following term related to security market.

(i) Demat trading

(ii) Floor trading

(iii) Stop loss

(iv) Derivatives trading

(v) Clearing **CS (Inter) - Dec 2006 (1 Mark each)**

Ans.:

(i) Demat Trading : Like the bank account, a demat account holds the certificates of your financial instruments like shares, bonds, government securities and mutual funds. You cannot trade in the stock market without a demat account. Thus, trading through demat account is known as demat trading.

'Demat' refers to dematerialization which is the process by which physical certificates of an investor are converted to an equivalent number of securities in electronic form.

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The main aim of demat trading is to introduce paperless trading and smooth functioning of settlement of security transactions.

(ii) Floor Trading : It is a traditional method of trading, in which buyer & seller comes together at the floor/physical office of the stock exchange and then trading is done for physical delivery of security. Now a days electronic trading replaced physical floor trading in most exchanges around the world.

(iii) Stop Loss : Stop loss is a buy or sell order which gets triggered automatically, once the stock reaches a certain price. The aim here is to limit the loss on a security (buy or sell) position.

> **Example :** *A stop order to sell becomes a market order when the item is offered at or below the specified price.*
>
> If you have bought 1 share of RIL at ₹ 1,050, you will enter stop loss order at a price below ₹ 1,050, say ₹ 1,020. If RIL share price falls to ₹ 1,020, a sell stop loss order will get triggered, which limits your loss on account of purchase to ₹ 30.
>
> *Similarly, a stop order to buy becomes a market order when the item is bid at or above the specified price.*
>
> If you have short-sold 1 share of RIL at ₹ 1,050, you will enter stop loss order at a price above ₹ 1,050, say ₹ 1,070. If RIL share price rises to ₹ 1,070, a buy stop loss order will get triggered, which will limit your loss on account of sale to ₹ 20.

(iv) Derivatives Trading : It means trading of derivatives like futures, options, forward trading etc.

(v) Clearing : The clearing function of the clearing corporation is designed to work out:

(a) what members are due to deliver and

(b) what members are due to receive on the settlement date.

Clearing is the process of determination of obligations, after which the obligations are discharged by settlement.

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Question 52] What is the role and importance of stock market index in Indian capital market?
CS (Inter) - Dec 2006 (4 Marks)

Ans.: A stock market index is a measurement of the value of a section of the stock market. It is computed from the prices of selected stocks (typically a weighted average). It is a tool used by investors and financial managers to describe the market, and to compare the return on specific investments.

Every stock exchange has its own specific market index like for BSE it is called Sensex and for NSE it is called NIFTY.

The importance of stock market indexes:

First, the market indexes provide an historical perspective of stock market performance, giving investors more insight into their investment decisions. Investors who do not know which individual stocks to invest in can use indexing as a method of choosing their stock investments.

The second benefit of stock market indexes is that they provide a yardstick with which investors can compare the performance of their individual stock portfolios. Individual investors with professionally managed portfolios can use the indexes to determine how well their managers are doing in managing their money.

The third major use of stock market indexes is as a forecasting tool. Studying the historical performance of the stock market indexes, you can forecast trends in the market.

Question 53] Distinguish between: 'Buy and hold' and 'buy and trade'
CS (Inter) - June 2008 (4 Marks)

Ans.: Buy and hold : When an investor buys any securities, purely for long term investment purpose and keep it, then it is called 'buy and hold strategy'. Such security may be sold by investor after long term holding or at maturity.

Buy and trade : when as investor buys any security, not for investment purpose, but for trading purpose and makes profit by dealing in it, then it is called as 'buy and trade strategy'.

OBJECTIVE QUESTIONS

Question A] Expand the following abbreviations:

(1) BSE	(6) AI	(11) BOLT	(16) NSCCL	(21) GEM	(26) LTCG
(2) NSE	(7) F&O	(12) CRS	(17) STP	(22) MOTHERS	(27) WDM
(3) OTCEI	(8) CM	(13) CRSS	(18) DMA	(23) ICDR	(28) BTS
(4) SLB	(9) KYC	(14) RSE	(19) CTCL	(24) SME	
(5) SLS	(10) PAN	(15) T2T	(20) AIM	(25) STCG	

Question B] Re-write the following sentences after filling-up the blank spaces with appropriate word(s)/figure(s):

(1) BSE Sensex is based on ____ scrips while Nifty is based on _____ scrips.

(2) The securities admitted for dealing on stock exchange after complying with all the listing requirements and placed by the SEBI on the list of cleared securities are known as _____

(3) The BSE switched to an electronic trading system developed by CMC Ltd. in year _____

(4) If the delivery and payment are to be made on the delivery date fixed by the stock exchange authorities it is said to be ________

(5) For listing on BSE, the minimum post-issue paid-up capital of the applicant company shall be ₹ _______ for Initial Public Offerings (IPOs) & ₹ _______ for Follow-on Public Offerings (FPOs)

(6) _______ means the minimum amount, calculated as a percentage of the transaction value, to be placed by the client, with the broker, before the actual purchase.

(7) Based on ________ report submitted in June, 1991, the National Stock Exchange of India Ltd. was established.

(8) When trend line is upward moving it is called as '_________'. On the other hand, if the trend line is falling it is called as '_________'.

(9) NSE is world's ________ largest stock exchange.

(10) ________ is the sale of a security that is not owned by the seller, or that the seller has borrowed.

(11) For listing on NSE, the paid up equity capital of the applicant shall not be less than ₹ _____ and the capitalization of the applicant's equity shall not be less than ₹ ______

(12) The security listed on one stock exchange, when permitted to be traded by some other stock exchange where it is not listed is called _________

(13) _______ is the designated day on which securities or funds are paid in by the members to clearing house of stock exchange.

(14) _______ enables the entire trade process for capital market and payment transactions to be conducted electronically without the need for manual intervention.

(15) The process of converting 'mutual stock exchanges' into company form of organization is known as '_______'.

(16) ________ is the process of using computers programmed to follow a defined set of instructions for placing a trade in order to generate profits at a speed and frequency that is impossible for a human trader.

(17) _________ is a buy or sell order which gets triggered automatically, once the stock reaches a certain price.

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Question C] Select the correct option.

1. BSE is the oldest stock exchange established in ________

(*a*) July 1975
(*b*) July 1994
(*c*) July 1875
(*d*) July 1920

2. In a spot market, settlement happens in _____ working days.

(*a*) T+4
(*b*) T+2
(*c*) T+1
(*d*) T+3

3. Bombay Stock Exchange is the world's ______ largest stock market by market capitalization

(*a*) 8th
(*b*) 11th
(*c*) 17th
(*d*) 12th

4. Which of the following statement(s) is correct?

(*a*) 20 stocks in SENSEX are 'A' grade stocks while remaining 10 stocks are 'B' grade stocks.
(*b*) 10 stocks in SENSEX are 'A' grade stocks, 10 stocks are 'B' grade stocks, while remaining 10 stocks are 'C' grade stocks.
(*c*) All the 30 stocks in SENSEX are 'A' grade stocks.
(*d*) None of the above

5. The 'T Group' represents securities which are settled on a _____

(*a*) buy and sell basis
(*b*) trade-to-trade basis
(*c*) rolling settlement basis
(*d*) any of the above

6. Which of the following is the first stock exchange to be recognized by the Indian Government under the Securities Contracts Regulation Act, 1956?

(*a*) NSE
(*b*) BSE
(*c*) OTCEI
(*d*) SME

7. Online trading platform of BSE is called _____

(*a*) NEAT
(*b*) VSAT
(*c*) BSELT
(*d*) BOLT

8. For listing on BSE, the minimum market capitalization of the Company shall be ₹ ________

(*a*) 5 crore
(*b*) 10 crore
(*c*) 25 crore
(*d*) 100 crore

9. The "F" Group represents the ______

(*a*) Variable Income Securities
(*b*) Fixed Income Securities
(*c*) Floating Income Securities
(*d*) Non-convertible Preference Shares

10. At present how many stock exchanges are in India?

(*a*) 3
(*b*) 8
(*c*) 19
(*d*) 15

11. In relation to basket trading, if the Sensex is 25,000 and where the value of one Sensex basket is ₹ 40 then value of one basket of Sensex would be ______

(*a*) 25,000 × 40 = i.e. ₹ 10,00,000
(*b*) 25,000 × 0.4 = i.e. ₹ 10,000
(*c*) 25,000 × 50 = i.e. ₹ 12,50,000
(*d*) 25,000 × 75% × 40 = i.e. ₹ 7,50,000

12. If the delivery and payment for securities are to be made on the same day or the next day it is said to be _____

(*a*) spot delivery
(*b*) hand delivery
(*c*) special delivery
(*d*) random delivery

13. One of the most important tools of the surveillance is the Online Real Time Surveillance system which was commissioned in year ______

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(a) 1999
(b) 1994
(c) 2001
(d) 2004

14. As of now, to get listed on the Main Board of NSE, the minimum paid up capital required is ₹ ______ and that of BSE is ₹ ______

(a) 25 crore; 10 crore
(b) 10 crore; 3 crore
(c) 10 crore; 25 crore
(d) 3 crore; 10 crore

15. ________ means the minimum amount, calculated as a percentage of market value of the securities, calculated with respect to last trading day's closing price, to be maintained by client with the broker.

(a) Maintenance margin
(b) Initial margin
(c) Stock margin
(d) Extra margin

16. Trading in Government Securities by the retail investors is done under the ______

(a) T Group
(b) G Group
(c) F Group
(d) Z Group

17. As per Section 91 of the Companies Act, 2013, a company may close the register of members for a maximum of ______ in a year and for not more than ______ at any one time.

(a) 45 days; 30 days
(b) 50 days; 25 days
(c) 60 days; 45 days
(d) 30 days; 15 days

18. Algorithmic trading is also known as ________

(a) Automated trading
(b) Black-box trading
(c) Algo-trading
(d) All of the above

19. A ______ is a period of generally rising prices.

(a) bear market
(b) dear market
(c) crow market
(d) bull market

20. Transactions are often carries out in the stock exchange after official hours, even though such trading among the members is not strictly legal. Such unauthorized trading carried out outside the official hours is known as ______

(a) Un-cleared trading
(b) Floor Trading
(c) Kerb trading
(d) Kobra trading

21. ______ describes the market practice whereby securities are temporarily transferred by one party (the lender) to another (the borrower) via an approved intermediary.

(a) Securities Loan (SL)
(b) Securities Portfolio Borrowing (SPB)
(c) Securities Lending & Borrowing (SLB)
(d) Securities Transfer Scheme (STS)

22. Bad delivery reporting happens in ______ working days.

(a) T+4
(b) T+5
(c) T+3
(d) T+6

23. Auction settlement happens in _____ working days.

(a) T+6
(b) T+8
(c) T+7
(d) T+5

24. Where the delivery is to be made after the delivery period fixed by the stock exchange authorities it is said to be a _____

(a) rolling delivery
(b) special delivery
(c) floor delivery
(d) random delivery

25. The listed company is required to give notice of book closure in a newspaper at least ______ before the commencement of the book closure.

(a) 7 days

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(*b*) 10 days

(*c*) 8 days

(*d*) 3 days

26. The minimum time gap between the two book closures and/or record dates would be at least ________

(*a*) 10 days

(*b*) 30 days

(*c*) 40 days

(*d*) 15 days

Answer to Question A:

Abbreviation	Long Form
BSE	Bombay Stock Exchange
NSE	National Stock Exchange
OTCEI	Over-the-Counter Exchange of India
SLB	Securities Lending & Borrowing
SLS	Securities Lending Scheme
AI	Approved Intermediary
F&O	Future & Options
CM	Clearing Members
KYC	Know Your Client
PAN	Permanent Account Number
BOLT	BSE On-Line Trading
CRS	Compulsory Rolling System
CRSS	Compulsory Rolling Settlement Segment
RSE	Regional Stock Exchanges
T2T	Trade to Trade
NSCCL	National Securities Clearing Corporation Ltd.
STP	Straight-Through Processing
DMA	Direct Market Access
CTCL	Computer to Computer Link
AIM	Alternate Investment Market
GEM	Growth Enterprise Market
MOTHERS	Market of the High-growth and Emerging Stocks
ICDR	Issue of Capital & Disclosure Requirements
SME	Small & Medium Enterprises
STCG	Short Term Capital Gains
LTCG	Long Term Capital Gains
WDM	Wholesale Debt Market
BTS	Basket Trading System

Answer to Question B:

(1) 30; 50 **(2)** listed cleared securities **(3)** 1995 **(4)** hand delivery **(5)** 10 crore; 3 crore **(6)** Initial margin **(7)** Pherwani Committees **(8)** bullish trend; bearish trend **(9)** 12th **(10)** Short selling **(11)** 10 crores; 25 crores **(12)** permitted security **(13)** Pay-in day **(14)** Straight-through processing (STP) **(15)** Demutualization of Stock Exchanges **(16)** Algorithmic trading **(17)** Stop loss.

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Answer to Question C:

1.	*(c)*	**6.**	*(b)*	**11.**	*(a)*	**16.**	*(b)*	**21.**	*(c)*	**26.**	*(b)*
2.	*(b)*	**7.**	*(d)*	**12.**	*(a)*	**17.**	*(a)*	**22.**	*(a)*		
3.	*(b)*	**8.**	*(c)*	**13.**	*(a)*	**18.**	*(d)*	**23.**	*(d)*		
4.	*(c)*	**9.**	*(b)*	**14.**	*(b)*	**19.**	*(d)*	**24.**	*(b)*		
5.	*(b)*	**10.**	*(c)*	**15.**	*(a)*	**20.**	*(c)*	**25.**	*(a)*		

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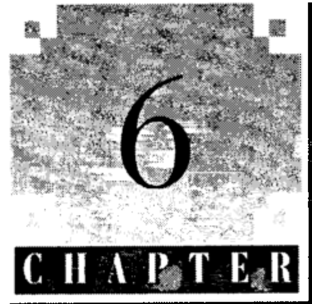

DEBT MARKET

Question 1] What is 'Debt Security'? **CS (Executive) - Dec 2011 (2 Marks)**

Write a short note on: Debt Securities **CS (Executive) - June 2011 (4 Marks)**

Ans.: Debt security represents borrowed funds that must be repaid. In other words, debt securities are interest-paying Bonds, Notes, Bills, or Money Market Instruments that are issued by governments or corporations.

Some debt securities pay a fixed rate of interest over a fixed time period in exchange for the use of the principal. In that case, that principal, or par value, is repaid at maturity.

Some are pass-through securities, with principal and interest repaid over the term of the loan. Still other issues are sold at discount, with interest included in the amount paid at maturity.

Example of debt securities includes:

- Debentures
- Bonds
- Notes
- Certificates of deposit (CD)
- Commercial paper (CP)
- Treasury bills
- Mortgage-backed bonds

Question 2] Define 'Debt Market'? What are the segments of debt market in India?

Debt market in India is comprises of two segments. Comment.

CS (Executive) - Dec 2010 (2 Marks), Dec 2011 (3 Marks)

Ans.: Meaning of Debt Market : Debt markets are markets for the issuance, trading and settlement of various types and features of fixed income securities. Fixed income securities can be issued by any legal entity like Central and State Governments, public bodies, statutory corporations, banks and institutions and corporate bodies.

Segment of Debt Market : The debt market in India comprises mainly of two segments:

- Government securities market consisting of Central and State Governments securities
- Zero Coupon Bonds (ZCBs), Floating Rate Bonds (FRBs), T-Bills and the corporate securities market consisting of FI bonds, PSU bonds, and Debentures/Corporate bonds.

Government securities form the major part of the market in terms of outstanding issues, market capitalization and trading value.

The trading of government securities on the Stock exchanges is currently through Negotiated Dealing System using members of BSE/NSE.

The bulk of the corporate bonds, being privately placed and are not listed on the stock exchanges.

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Records of debt market : Two Depositories, NSDL and CDSL maintain records of holding of securities in a dematerialized form.

Records of holding of government securities for wholesale dealers like Banks/Primary Dealers and other financial institutions are maintained by the RBI.

Question 3] What do you understand by "Negotiated Dealing System"?

Ans.: Negotiated Dealing System (NDS) is an electronic platform for facilitating dealing in Government Securities and Money Market Instruments. NDS facilitates electronic submission of bids/application by members for primary issuance of Government Securities by RBI through auction and floatation. It will provide an interface to the Securities Settlement System.

Question 4] Discuss how the debt market and its instruments helps the companies in raising funds.

CS (Executive) - June 2012 (5 Marks)

Ans.: Just as people need money, so do companies and governments. A company needs funds to expand into new markets, while governments need money for everything from infrastructure to social programs. The solution is to raise money by issuing bonds (or other debt instruments) to a public market. Thousands of investors then each lend a portion of the capital needed. Really, a bond is nothing more than a loan for which you are the lender. The organization that sells a bond is known as the issuer.

Debt market and its instruments help the companies in raising funds in following ways:

- Debt securities are considered to have very less risk.
- Debt securities do not require fulfil too much condition like Initial Public Offering (IPO) or Follow on Public Offering (FPO).
- The privately held companies can raise money through corporate bond very easily.
- Debt subscribers and bond buyers get the maximum priority over the assets of the company in times of liquidation. This priority helps the investors to invest more in the corporate bonds of the company of good fundamentals.
- Raising money through debt securities or bonds is cheap compared to any other source of money like equity, loan or preference shares and it carries much interest rate. That's why companies use this as cheap source of money.
- For most of the cases, the bonds or debts issued by the companies are backed by some assets which also increase investor's confidence to invest in corporate bonds or debts.
- Debt instruments are highly related to interest rate changes as the yield rate move with interest rate, which helps investors to predict future interest rate changes.

Question 5] Write a short note on: Fixed Income Products

CS (Executive) - June 2011 (4 Marks), Dec 2011 (4 Marks)

CS (Executive) - Dec 2012 (4 Marks)

Ans. : Following are the fixed income products:

Deposit : Deposit includes any receipt of money by way of deposit. Deposits serve as medium of saving and as a means of payment and are a very important variable in the national economy.

A bank basically has three types of deposits:

- Time Deposit
- Savings Deposit
- Current Account

Fixed Deposit : A fixed deposit (FD) is a financial instrument provided by NBFCs and banks which provides investors with a higher rate of interest than a regular savings account, until the given maturity date.

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The amount of deposits that may be raised by NBFCs is linked to its net worth and rating. However, the interest rate that may be offered by a NBFC is regulated. The deposits offered by NBFCs are not insured whereas the deposits accepted by most banks are insured up to a maximum of **₹ 1,00,000**.

Question 6] Write a short note on: Interest Based Bonds

Ans.: Coupon Bonds : A coupon bond, frequently referred to as a bearer bond, is a bond with a certificate that has small detachable coupons. The coupons entitle the holder to interest payments from the borrower.

Actual coupon bonds are rare today because most bonds are not issued in certificate form; rather, they are registered electronically (although some bondholders still choose to hold paper certificates). Thus, these days the term coupon refers to the rate of interest on a bond rather than the physical nature of the certificate.

In the 1980s, some financial institutions began purchasing coupon bonds and selling the coupons as separate securities, called strips.

Example: Let's assume you purchase ₹ 1,000 XYZ Company coupon bond. The coupon rate on the bond is 5%, which means the issuer will pay you 5% interest per year, or ₹ 50, on the face value of the bond (₹ 1,000 × 5%). Even if your bond trades for less than ₹ 1,000 (or more than ₹ 1,000), the issuer is still responsible for paying you ₹ 50 per year. To claim your interest payment, you would simply clip off the appropriate coupon from the bond certificate and present it to an agent of the issuer.

Zero Coupon Bonds : A zero-coupon bond (also discount bond or deep discount bond) is a bond bought at a price lower than its face value, with the face value repaid at the time of maturity.

It is known as 'zero coupon' as no interest is paid during the tenure of the bond.

A zero coupon bond is issued at a discount to its face value, fetches no periodic interest and is redeemed at the face value at maturity.

Example: Sardar Sarovar Nigam Ltd. issued a bond at ₹ 3,600 redeemable on face value of ₹ 1,11,000 after 21 years.

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Question 7] Write a short note on: Derived Instrument

Explain the term: Pass Through Certificates

CS (Executive) - Dec 2008 (2 Marks), June 2010 (2 Marks)

Distinguish between: 'Pass through certificate' and 'participation certificate'.

CS (Executive) - June 2016 (2 Marks)

Ans.: Derived instruments are not direct debt instruments. Instead they derive value from various debt instruments. Mortgage bonds, Pass Through Certificates, Securitized Debt Instruments etc. fall under this category.

(1) **Mortgage Bonds :** A bond secured by a mortgage on one or more assets. These bonds are typically backed by real estate holdings and/or real property such as equipment. In a default situation, mortgage bondholders have a claim to the underlying property and could sell it off to compensate for the default.

Example: Suppose bond ABC is backed by a mortgage on property XYZ. If bond ABC goes into default, the holders of the bond may liquidate property XYZ as compensation.

Mortgage bonds can pay interest in monthly, quarterly or semi-annual periods. Mortgage bonds offer the investor a great deal of protection in that the principal is secured by a valuable asset that could theoretically be sold off to cover the debt. However, because of this inherent safety, the average mortgage bond tends to yield a lower rate of return than traditional corporate bonds that are backed only by the corporation's promise and ability to pay.

(2) **Pass-through Certificates :** When mortgages are pooled together and undivided interest in the pool are sold, pass-through securities are created. The pass-through securities promise that the cash flow

from the underlying mortgages would be passed through to the holders of the securities in the form of monthly payments of interest and principal.

Pass-through security is a derived security representing the receivables on some debt. That is, a holder of a pass-through security is entitled to a portion of the income from the debt. Generally, a pass-through security has a large number of debts underlying it; for example, a pass-through may represent a portion of several hundred car loans. The most common type of pass-through is a mortgage-backed security.

Pass-through security: When a corporation buys loans from lenders to pool and package as securities for resale to investors, the products may be pass-through securities.

That means regular payments of interest and return of principal that borrowers make on the original loans are funnelled, or passed through, to the investors.

The best known pass-throughs are the mortgage-backed bonds offered by Fannie Mae, Freddie Mac, and Ginnie Mae. However, you can also buy pass-through securities backed by car loans, credit card debt, and other types of borrowing. Those are known as asset-backed securities.

(3) Participation Certificates : These are inter-bank instruments confined to the Scheduled Commercial Banks. This instrument is a money market instrument with a tenure not exceeding 90 days. The interests on such participation certificate are determined by the two contracting banks. *(For more details, please refer to Money Market Chapter)*

Question 8] Write a short note on: Benchmarked Instruments

CS (Executive) - Dec 2008 (2 Marks), June 2010 (2 Marks)

Explain the term: Inflation Linked Bonds

CS (Executive) - Dec 2008 (2 Marks), June 2010 (2 Marks)

Explain the term: Floating Interest Rate

CS (Executive) - Dec 2008 (2 Marks), June 2010 (2 Marks)

Ans.: There are certain debt instruments wherein the fixed income earned is based on a benchmark. For instance, the Floating Interest Rate Bonds are benchmarked to either the LIBOR, MIBOR etc.

Floating Interest Rate : Floating rate of interest simply means that the rate of interest is variable. Some bonds pay an interest rate that varies and is typically adjusted periodically according to an index tied to short-term T-bills or money markets. Periodically the interest rate payable for the next period is set with reference to a benchmark market rate agreed upon by both the lender and the borrower. The benchmark market rate is the SBI Prime Lending Rate in domestic markets and LIBOR or US Treasury Bill Rate in the overseas markets. *(For more details, please refer to "Capital Market Instrument Chapter")*

Inflation Linked Bonds : An inflation indexed bonds links the interest rate of bond to changes in some specified price index. In an inflation indexed bonds, the principle amount is adjusted against inflation periodically and the interest is calculated on the inflation adjusted principal.

Example: Suppose a company issues a 10 years bond with 6% coupon on 5.1.2015. An investor purchases the bond by paying the principal amount of ₹ 5,000. The interest become due on 5.7.2015 during that period, the inflation rate in the country rises by 5%. So inflation adjusted principal on 5.7.2015, becomes ₹ 5,250 and accordingly, the interest payment is calculated on ₹ 5,250 at 6%. Thus, investor return is protected against rising inflation. In other words, inflation indexed bonds provide the hedge against the principal and not the coupon.

The RBI issued inflation indexed bonds in 1997 for 5 years; called 6% Capital Indexed Bond 2002.

Question 8A] Distinguish between: 'benchmarked instruments' and 'pure instruments'

CS (Executive) - Dec 2015 (2 Marks)

Ans.: Benchmarked instruments: There are certain debt instruments wherein the fixed income earned is based on a benchmark. For instance, the Floating Interest rate Bonds are benchmarked to either the LIBOR, MIBOR etc.

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Pure Instruments: Equity shares, preference shares, debenture and bonds which are issued with the basic characteristics without mixing the features of other instruments are called pure instrument.

Question 9] Describe the various investors in the debt market.

CS (Executive) - Dec 2010 (3 Marks), Dec 2011 (3 Marks)

CS (Executive) - Dec 2012 (4 Marks)

Debt market in India is comprises mainly of two segments, i.e. the government securities market and corporate securities market. Discuss in brief.

CS (Executive) - Dec 2015 (5 Marks)

Ans.: In the debt market investors are the entities who invest in fixed income instruments. The investors in such instruments are generally Banks, Financial Institutions, Mutual Funds, Insurance companies, Provident Funds etc. The individual investors invest to a great extent in Fixed Income products.

(1) **Banks :** Collectively all the banks put together are the largest investors in the debt market. They invest in all instruments ranging from T-Bills, CPs and CDs to GOISECs, private sector debentures etc. Banks lend to corporate sector directly by way of loans and advances and also invest in debentures issued by the private corporate sector and in PSU bonds.

(2) **Insurance Companies :** The second largest categories of investors in the debt market are the insurance companies.

(3) **Provident Funds :** Provident funds are estimated to be the third largest investors in the debt market. Investment guidelines for provident funds are being progressively liberalized and investment in private sector debentures is one step in this direction.

(4) **Mutual Funds :** Mutual funds represent an extremely important category of investors. Mutual funds include the Unit Trust of India, the mutual funds set up by nationalized banks and insurance companies as well as the private sector mutual funds set up by corporate and overseas mutual fund companies.

(5) **Trusts :** Trusts include religious and charitable trusts as well as statutory trusts formed by the government and quasi government bodies. There are very few instruments in which trusts are allowed to invest. Most of the trusts invest in CDs of banks and bonds of financial institutions and units of UTI.

(6) **Corporate Treasuries :** Corporate Treasuries have become prominent investors only in the last few years.

(7) **Foreign Institutional Investors (FIIs) :** FIIs have to be specifically and separately approved by SEBI for equity and debt. Each FII is allocated a limit every year up to which it can invest in Indian debt securities. They are also free to disinvest any of their holdings, at any point of time, without prior permission.

(8) **Retail Investors :** Since January 2002, retail investors have been permitted to submit non-competitive bids at primary auction through any bank or Primary Dealers (PDs).

Question 10] Explain the regulatory framework for debt market in India.

CS (Executive) - Dec 2009 (5 Marks)

Ans.: The following are the important statutes, which governs the debt market in India:

- The Securities & Exchange Board of India Act, 1992
- The Securities Contracts (Regulation) Act, 1956
- The Depositories Act, 1996
- The Companies Act, 2013

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- The Foreign Exchange Management Act, 1999 (FEMA)
- The Government Securities Act, 2006

Important Regulations that governs the debt market are as follows:

- SEBI (Issue of Capital & Disclosure Requirements) Regulations, 2009
- SEBI (Debenture Trustees) Regulations, 1993
- SEBI (Issue & Listing of Debt Securities) Regulations, 2008
- SEBI (Public Offer and Listing of Securitized Debt Instruments) Regulations, 2008

The agencies involved in relation of debt market are:

- Ministry of Finance
- Ministry of Corporate Affairs (MCA)
- Department of Economic Affairs (DEA)
- The Reserve Bank of India (RBI)
- The Securities Exchange Board of India (SEBI)
- Stock Exchanges

Question 11] Write a short note on: Debt Market Intermediaries/Participants

Ans.: Following are the intermediaries in debt market in India:

(1) **Primary Dealers :** Primary dealers are important intermediaries in the government securities markets. They act as underwriters in the primary market, and as market makers in the secondary market. PDs underwrite a portion of the issue of government security that is floated for a predetermined amount. The underwriting commitment of each PD is broadly decided on the basis of its size in terms of its net owned funds, its holding strength, the committed amount of bids and the volume of turnover in securities.

(2) **Brokers :** Brokers play an important role in secondary debt market by bringing together counterparties and negotiating terms of the trade. It is through them that the trades are entered on the stock exchanges. The brokers are regulated by the stock exchanges and also by SEBI.

Question 11A] Distinguish between: 'Primary dealers' and 'corporate treasury'

CS (Executive) - Dec 2016 (4 Marks)

Ans.: Primary dealers (PDs) are important intermediaries in the government securities markets. They act as underwriters in the primary market, and as market makers in the secondary market. PDs underwrite a portion of the issue of government security that is floated for a predetermined amount. The underwriting commitment of each PD is broadly decided on the basis of its size in terms of its net owned funds, its holding strength, the committed amount of bids and the volume of turnover in securities.

The corporate treasury is responsible for:

- Cash management
- Liquidity planning and control
- Management of interest, currency and commodity risks
- Procurement of finance and financial investments
- Contacts with banks and rating agencies
- Corporate finance.

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Question 12] XYZ Ltd. proposes to issue ₹ 50 crore non-convertible debentures of ₹ 100. Advise the company about the credit rating provisions of the SEBI (Issue of Capital & Disclosure Requirements) Regulations, 2009.

Ans.: An issuer can make an initial public offer of convertible debt instruments without making a prior public issue of its equity shares and listing thereof, subject to the following conditions:

- A company cannot make a public issue or rights issue of convertible debt instruments unless it obtains credit rating from one or more agencies i.e. credit rating is mandatory.
- The company is required to give the following details of credit ratings in case of a public issue or rights issue of convertible debt instruments:
  (*a*) The names of all the credit rating agencies from which credit rating including unaccepted rating has been obtained for the issue of convertible debt instruments.
  (*b*) All the credit ratings obtained during 3 years prior to the filing the offer document for any of the issuer's listed convertible debt instruments at the time of accessing the market through a convertible debt instrument.

Question 13] Write a short note on: Appointment of debenture trustees

Ans.: Appointment of debenture trustees [Section 71(5) & Rule 18(2) of the Companies (Share Capital & Debentures) Rules, 2014] : Appointment of debenture trustees is mandatory if a company wants to issue prospectus or make an offer to public or its members exceeding 500. Such appointment must be made before issue of debentures.

The company shall appoint debenture trustees, after complying with the following conditions:

◆ Names of the debenture trustees shall be stated in **letter of offer** inviting subscription for debentures and also in all the subsequent notices or other communications sent to the debenture holders.

◆ Before appointment a **written consent** form the debenture trustee shall be taken and a statement to that effect shall appear in the letter of offer.

◆ The Board may fill any casual vacancy in the office of the trustee but while any such vacancy continues, the remaining trustee may act. When such vacancy is caused by the resignation of the debenture trustee, the vacancy shall only be filled with the written consent of the majority of the debenture holders.

◆ Any debenture trustee may be removed from office before the expiry of his term only if it is approved by the holders of not less than 3/4th (75%) in value of the debentures outstanding, at their meeting.

Question 14] Write a short note on: Debenture Redemption Reserve

Ans.: Debenture Redemption Reserve [Section 71(4) & Rule 18(7) of the Companies (Share Capital & Debentures) Rules, 2014] : When debentures are issued by a company, the company shall create a Debenture Redemption Reserve (DRR) Account out of the profits of the company available for payment of dividend. The amount credited to Debenture Redemption Reserve Account shall not be utilized by the company except for the redemption of debentures.

The company shall create a DRR for the purpose of redemption of debentures, in accordance with the conditions given below—

(*a*) Company shall create DRR equivalent to at least 25% of the amount raised through the debenture issue.

(*b*) Every company shall before the 30th day of April, invest or deposit at least 15% of the amount of its debentures maturing during the year ending on the 31st March of the next year, in any of the following methods:

◆ In deposits with any scheduled bank, free from any charge or lien

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- In unencumbered securities of the Central or State Government
- In unencumbered securities mentioned or notified in Section 20 of the Indian Trusts Act, 1882
- Amount invested or deposited as above shall not be used for any purpose other than for redemption of debentures maturing during the year.
- The amount remaining invested or deposited, shall not at any time fall below 15% of the amount of the debentures maturing during the year ending on the 31st day of March of that year.

(*c*) In case of partly convertible debentures, DRR shall be created in respect of non-convertible portion of debenture issued.

(*d*) Amount credited to the DRR shall not be utilized by the company except for the purpose of redemption of debentures.

Question 15] Explain the roll-over of non-convertible portion of partly convertible debentures under the SEBI (Issue of Capital & Disclosure Requirements) Regulations, 2009.

CS (Executive) - June 2013 (5 Marks)

Ans.: Roll over of non-convertible portion of partly convertible debt instruments: The non-convertible portion of partly convertible debt instruments issued by a listed issuer, the value of which exceeds ₹ 50 lakhs can be rolled over without change in the interest rate, subject to compliance with the provisions of the Companies Act, 2013 and the following conditions–

(*a*) 75% of the holders of the convertible debt instruments of the issuer have, through a resolution through postal ballot, approved the roll over.

(*b*) The issuer has along with the notice for passing the resolution, sent to all holders of the convertible debt instruments, an auditors' certificate on the cash flow of the issuer and with comments on the liquidity position of the issuer.

(*c*) The issuer has undertaken to redeem the non-convertible portion of the partly convertible debt instruments of all the holders of the convertible debt instruments who have not agreed to the resolution.

(*d*) Credit rating has been obtained from at least one credit rating agency registered with the SEBI within a period of six months prior to the due date of redemption and has been communicated to the holders of the convertible debt instruments, before the roll over.

SEBI (ISSUE & LISTING OF DEBT SECURITIES) REGULATIONS, 2008

Question 16] State the applicability of SEBI (Issue & Listing of Debt Securities) Regulations, 2008.

Ans.: Applicability [Regulation 3] : SEBI (Issue & Listing of Debt Securities) Regulations, 2008 shall apply to—

(*a*) Public issue of debt securities and

(*b*) Listing of debt securities issued through public issue or on private placement basis on a recognized stock exchange.

Question 17] What are the "general conditions" applicable for issuance of debt securities as provided in SEBI (Issue & Listing of Debt Securities) Regulations, 2008?

Ans.: General Conditions [Regulation 4] : No issuer shall make any public issue of debt securities if the issuer or the person in control of the issuer, or its promoter, has been restrained or prohibited or debarred by the SEBI from accessing the securities market or dealing in securities and such direction or order is in force. Similarly, if issuer or any of its promoters or directors are wilful defaulter of payment of interest or repayment of principal amount of debt securities for more than 6 months then new debt securities cannot be issued.

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No issuer shall make a public issue of debt securities unless following conditions are satisfied:

(*a*) It has made an application to one or more recognized stock exchanges for listing of debt securities. However, where the application is made to more than one recognized stock exchanges, the issuer shall choose one of them as the designated stock exchange.

(*b*) It has obtained in-principle approval for listing of its debt securities on the recognized stock exchanges where the application for listing has been made.

(*c*) Credit rating has been obtained from at least one credit rating agency and is disclosed in the offer document. Where credit ratings are obtained from more than one credit rating agencies, all the ratings, including the unaccepted ratings, shall be disclosed in the offer document.

(*d*) It has entered into an arrangement with a depository registered with the SEBI for dematerialization of the debt securities in accordance with the Depositories Act, 1996.

The issuer shall appoint one or more merchant bankers registered with the SEBI at least one of whom shall be a lead merchant banker.

The issuer shall appoint one or more debenture trustees in accordance with the provisions of the Companies Act, 2013 and **SEBI (Debenture Trustees) Regulations, 1993**.

The issuer shall not issue debt securities for providing loan to or acquisition of shares of any person who is part of the same group or who is under the same management.

Question 18] Discuss the provisions of the SEBI (Issue & Listing of Debt Securities) Regulations, 2008 "disclosure and filing of offer document".

Ans.: Disclosures in the offer document [Regulation 5] : The offer document shall contain all material disclosures which are necessary for the subscribers of the debt securities to take an informed investment decision.

The issuer and the lead merchant banker shall ensure that the offer document contains the following:

(*a*) Disclosures as specified in the Companies Act, 2013;

(*b*) Disclosures specified by the SEBI.

Filing of draft offer document [Regulation 6] :

(1) Issuer shall not make a public issue of debt securities unless a draft offer document has been filed with the designated stock exchange through the Lead Merchant Banker.

(2) The draft offer document filed with the designated stock exchange shall be made public by posting the same on the website of the designated stock exchange for seeking public comments for a period of 7 working days from the date of filing the draft offer document with exchange.

(3) The draft offer document may also be displayed on the website of the issuer, merchant bankers and the stock exchanges where the debt securities are proposed to be listed.

(4) The Lead Merchant Banker shall ensure that the draft offer document clearly specifies the names and contact particulars of the compliance officer of the Lead Merchant Banker and the issuer including the postal and email address, telephone and fax numbers.

(5) The Lead Merchant Banker shall ensure that all comments received on the draft offer document are suitably addressed prior to the filing of the offer document with the ROC.

(6) A copy of draft and final offer document shall also be forwarded to the SEBI for its records, simultaneously with filing of these documents with designated stock exchange.

(7) The Lead Merchant Banker shall furnish to the SEBI a due diligence certificate as per **Schedule II** of these Regulations.

(8) The debenture trustee shall furnish to the SEBI a due diligence certificate as per **Schedule III** of these regulations.

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Mode of disclosure of offer document [Regulation 7] :

(1) The draft and final offer document shall be displayed on the websites of stock exchanges and shall be available for download in PDF/HTML formats.

(2) The offer document shall be filed with the designated stock exchange, simultaneously filing with ROC, for dissemination on its website prior to the opening of the issue.

(3) Where any person makes a request for a physical copy of the offer document, the same shall be provided to him by the issuer or lead merchant banker.

Prohibitions of misstatements in the offer document [Regulation 14] : The offer document shall not omit disclosure of any material fact which may make the statements misleading.

The offer document or abridged prospectus or any advertisement in connection with issue of debt securities shall not contain any false or misleading statement.

Question 19] As a Company Secretary advice the XYZ Ltd. regarding provisions relating to advertisements for public issues of debt securities.

Ans.: Advertisements for public issues of debt securities [Regulation 8] :

(1) The issuer shall make advertisement in national daily with wide circulation before the issue opening date and such advertisement shall contain the disclosures as per **Schedule IV**.

(2) No issuer shall issue an advertisement which is misleading in material particular or which contains any information in a distorted manner or which is manipulative or deceptive.

(3) The advertisement shall be truthful, fair and clear and shall not contain a statement, promise or forecast which is untrue or misleading.

(4) Any advertisement issued by the issuer shall not contain any matters which are extraneous to the contents of the offer document.

(5) The advertisement shall urge the investors to invest only on the basis of information contained in the offer document.

(6) Any corporate or product advertisement issued by the issuer during the subscription period shall not make any reference to the issue of debt securities or be used for solicitation.

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Question 20] State the provisions relating to "Abridged Prospectus & Application Forms" under the SEBI (Issue & Listing of Debt Securities) Regulations, 2008.

Ans.: Abridged Prospectus & Application Forms [Regulation 9] : The issuer and lead merchant banker shall ensure that:

(*a*) Every application form issued by the issuer is accompanied by a copy of the abridged prospectus.

(*b*) The abridged prospectus shall not contain matters which are extraneous to the contents of the prospectus.

(*c*) Adequate space shall be provided in the application form to enable the investors to fill in various details like name, address, etc.

The issuer may provide the facility for subscription of application in electronic mode.

Electronic Issuances [Regulation 10] : An issuer proposing to issue debt securities to the public through the online system of the designated stock exchange shall comply with the relevant applicable requirements as may be specified by the SEBI.

Price discovery through Book Building [Regulation 11] : The issuer may determine the price of debt securities in consultation with the Lead Merchant Banker and the issue may be at fixed price or the price may be determined through book building process in accordance with the procedure as may be specified by the SEBI.

Question 21] Write a short note on: Minimum Subscription for debt securities

Ans.: Minimum Subscription [Regulation 12] : The issuer may decide the amount of minimum subscription which it seeks to raise by issue of debt securities. Minimum subscription has to be disclosed in the offer document.

In the event of non-receipt of minimum subscription all application moneys received in the public issue shall be refunded forthwith to the applicants.

Question 22] Write a short note on: Underwriting of debt securities

Ans.: Underwriting [Regulation 13] : A public issue of debt securities may be underwritten by an underwriter registered with the SEBI and in such a case adequate disclosures regarding underwriting arrangements shall be disclosed in the offer document.

Question 23] Briefly discuss the provisions relating to 'trust deed' as provided in the SEBI (Issue & Listing of Debt Securities) Regulations, 2008.

Ans.: Trust Deed [Regulation 15] :

(1) A trust deed for securing the issue of debt securities shall be executed by the issuer in favour of the debenture trustee within three months of the closure of the issue.

(2) The trust deed shall contain clauses as may be prescribed under the Companies Act, 2013 and those mentioned in **Schedule IV** of the **SEBI (Debenture Trustees) Regulations, 1993.**

(3) The trust deed shall not contain following clauses:

(*i*) A clause which limit or extinguish the obligations and liabilities of the debenture trustees or the issuer in relation to any rights or interests of the investors.

(*ii*) A clause which limiting or restrict or waive the provisions of the Companies Act, 2013, these regulations and circulars or guidelines issued by the SEBI.

(*iii*) A clause which indemnify the debenture trustees or the issuer for loss or damage caused by their act of negligence or commission or omission.

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Question 24] Discuss the provisions of the SEBI (Issue & Listing of Debt Securities) Regulations, 2008 in relation to creation of DRR & Security for issuance of debt securities.

Ans.: Debenture Redemption Reserve (DRR) [Regulation 16] : For the redemption of the debt securities, the issuer shall create DRR in accordance with the provisions of the Companies Act, 2013.

Where the issuer has defaulted in payment of interest on debt securities or redemption or in creation of security as per the terms of the issue of debt securities, any distribution of dividend shall require approval of the debenture trustees.

Creation of security [Regulation 17] : The proposal to create a charge or security in respect of secured debt securities shall be disclosed in the offer document along with its implications.

The issuer shall give an undertaking in the offer document that the assets on which charge is created are free from any encumbrances and if the assets are already charged to secure a debt, the permissions or consent to create second or *pari passu* charge on the assets of the issuer have been obtained from the earlier creditor.

The issue proceeds shall be kept in an escrow account until the documents for creation of security as stated in the offer document, are executed.

Question 24A] State the provisions relating to right to recall or redeem of debt securities by issuer prior to maturity.

Ans.: Right to recall or redeem prior to maturity [Regulation 17A]: An issuer making public issue of debt securities may

- recall such securities prior to maturity date at his option *(call)* or
- provide such right of redemption prior to maturity date *(put)*

to all the investors or only to retail investors, at their option, subject to the following:

(i) Such right to recall or redeem debt securities prior to maturity date is exercised in accordance with the terms of issue. Detailed disclosure in this regard has to be made in offer document including date from which such right is exercisable, period of exercise (which shall not be less than **3 working days**), redemption amount (including the premium or discount at which such redemption shall take place).

(ii) The issuer or investor may exercise such right with respect to all the debt securities issued or held by them respectively or with respect to a part of the securities so issued or held.

(iii) In case of partial exercise of such right in accordance with the terms of the issue by the issuer, it shall be done on proportionate basis only.

(iv) No such right shall be exercisable before expiry of **24 months** from the date of issue of such debt securities.

(v) Issuer shall send notice to all the eligible holders of such debt securities at least 21 days before the date from which such right is exercisable.

(vi) Issuer shall also provide a copy of such notice to the stock exchange where such debt securities are listed for wider dissemination and shall make an advertisement in the national daily having wide circulation indicating the details of such right and eligibility of the holders who are entitled to avail such right.

(vii) Issuer shall pay the redemption proceeds to the investors along with the interest due to the investors within **15 days** from the last day within which such right can be exercised.

(viii) Issuer shall pay interest at the rate of **15% p.a.** for the period of delay.

(ix) After the completion, the issuer shall submit a detailed report to the stock exchange for public dissemination regarding the debt securities redeemed during the exercise period and details of redemption.

Meaning of 'retail investor': For the purpose of this regulation, retail investor shall mean the holder of debt securities having face value not more than ₹ **2,00,000**.

Meaning of 'call' & 'put' for above regulation:
In a "call option" issuer company recall debt security i.e. buys back before maturity. In a put option, holder of debt security has option but not the obligation, to sell debt security to the company at a specified amount.

Question 25] Discuss briefly the regulations relating to redemption and roll-over of debt securities.
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Ans.: Redemption and Roll-over [Regulation 18] :

(1) The issuer shall redeem the debt securities in terms of the offer document.

(2) Where the issuer desires to roll-over the debt securities issued by it, it shall do so only upon passing of a special resolution of holders of such securities and give 21 days notice of the proposed roll-over to them.

(3) The notice shall contain disclosures with regard to credit rating and rationale for roll-over.

(4) The issuer shall, prior to sending the notice to holders of debt securities, file a copy of the notice and proposed resolution with the stock exchanges where such securities are listed, for dissemination of the same to public on its website.

(5) The debt securities issued can be rolled over subject to the following conditions:

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