(*a*) The roll-over is approved by a **special resolution** passed by the holders of debt securities through postal ballot having the consent of not less than 75% of the holders by value of such debt securities.

(*b*) At least one credit rating is obtained from a rating agency within a period of 6 months prior to the due date of redemption and is disclosed in the notice.

(*c*) Fresh trust deed shall be executed at the time of such roll-over or the existing trust deed may be continued if the trust deed provides for such continuation.

(*d*) Adequate security shall be created or maintained in respect of rolled-over debt securities.

(6) The issuer shall redeem the debt securities of all the debt securities holders, who have not given their positive consent to the roll-over.

Question 26] Write a short note on: Mandatory Listing of debt securities

Ans.: Mandatory Listing [Regulation 19] :

(1) An issuer desirous of making an offer of debt securities to the public shall make an application for listing to one or more recognized stock exchanges.

(2) The issuer shall comply with Listing Agreement of such debt securities as specified by the stock exchange where debt securities are sought to be listed.

Question 27] A company is planning to place privately 10 years, 11.50% Debentures. Most of such debentures would be issued to a venture capitalist who is looking for an exit route. Write a brief note advising the company as to how it can proceed for listing of such debentures on a recognized stock exchange. **CS (Executive) - Dec 2013 (5 Marks)**

Ans.: Conditions for listing of debt securities issued on private placement basis [Regulation 20]:

(1) An issuer may list its debt securities issued on private placement basis on a recognized stock exchange subject to the following conditions:

(*a*) The issuer has issued debt securities in compliance with the provisions of the Companies Act, 2013, Rules prescribed thereunder and other applicable laws.

(*b*) Credit rating has been obtained in respect of debt securities from at least one credit rating agency registered with the SEBI.

(*c*) The debt securities proposed to be listed are in dematerialized form.

(*d*) The disclosures as provided in Regulation 21 have been made.

(2) The issuer shall comply with Listing Agreement as specified by the stock exchange where such debt securities are sought to be listed.

Disclosures in respect of private placements of debt [Regulation 21] : The issuer making a private placement of debt securities and seeking listing thereof on a recognized stock exchange shall make disclosures as specified in **Schedule I** accompanied by the latest Annual Report of the issuer.

The disclosures shall be made on the websites of stock exchanges where such securities are proposed to be listed and shall be available for download in PDF/HTML formats.

Continuous Listing Conditions [Regulation 23] :

(1) All the issuers making public issues of debt securities or seeking listing of debt securities issued on private placement basis shall comply with the conditions of listing specified in the respective listing agreement for debt securities.

(2) Every rating obtained by an issuer shall be periodically reviewed by the registered credit rating agency and any revision in the rating shall be promptly disclosed by the issuer to the stock exchange(s) where the debt securities are listed.

(3) Any change in rating shall be promptly disseminated to investors and prospective investors from time to time.

(4) The issuer, the respective debenture trustees and stock exchanges shall disseminate all information and reports on debt securities including compliance reports filed by the issuers and the debenture trustees regarding the debt securities to the investors and the general public by placing them on their websites.

(5) Debenture trustee shall disclose the information to the investors and the general public by issuing a press release in any of the following events:

(*a*) default by issuer to pay interest on debt securities or redemption amount;

(*b*) failure to create a charge on the assets;

(*c*) revision of rating assigned to the debt securities.

(6) The information referred to in clause (5) shall also be placed on the websites of the debenture trustee, the issuer and the stock exchanges.

Question 27A] State whether issuer of debt securities can carry out consolidation and re-issuance.

Ans.: Consolidation and re-issuance [Regulation 20A]: An issuer may carry out consolidation and re-issuance of its debt securities, subject to the fulfilment of the following conditions:

(*a*) There is such an enabling provision in its AOA under which it has been incorporated.

(*b*) The issue is through private placement.

(*c*) The issuer has obtained fresh credit rating for each re-issuance from at least one credit rating agency registered with the SEBI and is disclosed.

(*d*) Such ratings shall be revalidated on a periodic basis and the changes shall be disclosed.

(*e*) Appropriate disclosures are made with regard to consolidation and re-issuance in the Term Sheet.

Meaning of 'Consolidation' & 'Reissuance' for above regulation:
Consolidation: *If 10 units of debt securities having face value of ₹ 10 are converted into 1 unit of debt security having face value of ₹ 100, it is known as consolidation.*
Reissuance: *If debt security is issued for 10 years and on completion of 10 years it again renewed for another 10 years, it is known as reissuance of security.*

Question 28] Write a short note on: Trading of debt securities

Ans.: Trading of debt securities [Regulation 24] :

(1) The debt securities issued to the public or on a private placement basis, which are listed in recognized stock exchanges, shall be traded and such trades shall be cleared and settled in recognized stock exchanges subject to conditions specified by the SEBI.

(2) In case of trades of debt securities which have been made over the counter, such trades shall be reported on a recognized stock exchange having a nationwide trading terminal or such other platform as may be specified by the SEBI.

(3) The SEBI may specify conditions for reporting of trades on the recognized stock exchange or other platform.

Question 29] Write a short note on: Obligations of Debenture Trustee

Ans.: Obligations of Debenture Trustee [Regulation 25] :

(1) The debenture trustee shall be vested with the requisite powers for protecting the interest of holders of debt securities including a right to appoint a nominee director on the Board of the issuer in consultation with institutional holders of such securities.

(2) The debenture trustee shall carry out its duties and perform its functions under these regulations, the SEBI (Debenture Trustees) Regulations, 1993, the trust deed and offer document, with due care, diligence and loyalty.

(3) The debenture trustee shall ensure disclosure of all material events on an ongoing basis.

(4) The debenture trustees shall supervise the implementation of the conditions regarding creation of security for the debt securities and debenture redemption reserve.

Question 30] State the obligations of the Issuer and Lead Merchant Banker under the SEBI (Issue & Listing of Debt Securities) Regulations, 2008.

Ans.: Obligations of the Issuer, Lead Merchant Banker [Regulation 26] :

(1) The issuer shall disclose all the material facts in the offer documents issued or distributed to the public and shall ensure that all the disclosures made in the offer document are true, fair and adequate and there is no misleading or untrue statements or misstatement in the offer document.

(2) The Merchant Banker shall verify and confirm that the disclosures made in the offer documents are true, fair and adequate and ensure that the issuer is in compliance with these regulations as well as all transaction specific disclosures required in Schedule I of these regulations and Schedule II of the Companies Act, 1956.

(3) The issuer shall treat the applicants in a public issue of debt securities in a fair and equitable manner as per the procedures as may be specified by the Board.

(4) The intermediaries shall be responsible for the due diligence in respect of assignments undertaken by them in respect of issue, offer and distribution of securities to the public.

(5) No person shall employ any device, scheme or artifice to defraud in connection with issue or subscription or distribution of debt securities which are listed or proposed to be listed on a recognized stock exchange.

(6) The issuer and the merchant banker shall ensure that the security created to secure the debt securities is adequate to ensure 100% asset cover for the debt securities.

Question 31] Write a short note on: Simplified listing agreement for debt securities

Ans.: Continuing with rationalization of disclosure norms for listing of debt issuances, SEBI has put in place a simplified Listing Agreement for debt securities.

The disclosures in the draft listing agreement are based on the principle that if an issuer has his equity already listed such issuer is required to make only minimal incremental disclosures specific to its debt issuance. Issuers who have only listed its debt securities listed and not equity, reasonably elaborate disclosures are prescribed.

The Listing Agreement has two parts:

- Part A is applicable where equity shares of the issuer are already listed on the exchange and continues to comply with the listing agreement for equity.
- Part B is applicable for issuers who do not have their equity shares already listed on the exchange.

An issuer complying with Part B would move to compliance with Part A in case its equity shares listed at a future date. Similarly, an issuer delisting equity need to comply with Part B.

Question 32] Write a short note on: Role of Company Secretary in simplified debt listing agreement

Ans.: The Debt Listing Agreement authorizes Company Secretaries to issues half yearly certificate regarding maintenance of 100% security cover in respect of listed secured debt securities. Clauses 2 and 13 of the Listing agreement reads as under:

Part A of the Debt Listing Agreement applicable to the Issue of Debt Securities where equity shares of the Issuer are listed.

"The Issuer agrees that it shall forward to the debenture trustee promptly, whether a request for the same has been made or not:

Half-yearly certificate regarding maintenance of 100% asset cover in respect of listed debt securities, by either a practicing company secretary or a practicing chartered accountant, along with the half yearly financial results. (not applicable for Bank or NBFC Issuers registered with RBI or where bonds are secured by a Government guarantee)."

Part B of the Debt Listing Agreement applicable to the Issue of Debt Securities where equity shares of the Issuer are not listed on the Exchange.

"The Issuer agrees that it shall forward to the debenture trustee promptly, whether a request for the same has been made or not:

A half-yearly certificate regarding maintenance of 100% asset cover in respect of listed debt securities, by either a practicing company secretary or a practicing chartered accountant, along with the half yearly financial results. (not applicable for Bank or NBFC Issuers registered with RBI or where bonds are secured by a Government guarantee)".

Further Clause 22 of the Debt Listing Agreement requires the issuer to designate Company Secretary or any other person as Compliance Officer responsible for ensuring compliance with the regulatory provisions applicable to such issuance of debt securities, reporting to various authorities etc.

Question 33] Your company is proposing to issue debt securities on private placement basis through electronic book mechanism. Prepare a detailed note for your directors in this regard.

Ans.: Electronic book mechanism for issuance of debt securities on private placement basis: Regulation 31(2) of SEBI (Issue & Listing of Debt Securities) Regulations, 2008 governs public issue of debt securities and listing of debt securities through electronic book mechanism.

When mandatory: Electronic book mechanism would be mandatory for all private placements of debt securities in primary market with an issue size of ₹ **500 Crores** and above, inclusive of green shoe option, if any.

Eligible Issuer: The following issuers shall have an option to follow either electronic book mechanism or the existing mechanism:

- Issues with a single investor and where coupon rate are fixed. However, arrangers acting as underwriters shall not be considered as single investors.
- Issues wherein the issue size is less than ₹ 500 Crores, inclusive of green shoe option, if any.

However, for all issues below ₹ 500 Crore, issuer shall disclose the coupon, yield, amount raised, number of investors and category of investors to the Electronic Book Provider and/or to the information repository for corporate debt market as notified by SEBI.

Electronic book provider (EBP): The electronic book mechanism shall be provided by recognized stock exchange only after obtaining prior approval from SEBI.

The following shall be eligibility conditions for a recognized stock exchange to act as EBP:-

- EBP shall provide an online platform for receiving bids in private placement of debt securities.
- EBP shall own website/URL (i.e. bidding portal) on which it proposes to offer its services.
- EBP shall have all necessary infrastructure like adequate office space, equipment's, risk management capabilities, manpower and other information technology infrastructure to effectively discharge the activities of EBP.
- EBP shall ensure that there is adequate backup, disaster management and recovery plans for the electronic book mechanism so provided by EBP.
- The EBP shall ensure safety, secrecy, integrity and retrievability of data.

- The electronic book mechanism so provided by EBP would be subject to periodic audit by Certified Information Systems Auditor (CISA) under Annual System Audit prescribed by SEBI.

Participants in Electronic book mechanism:

(1) **Arranger**, if any, appointed by the issuer, merchant bankers, RBI registered primary dealers or any other registered intermediaries, may act as the arranger. Arranger shall be categorized as a Category-1 Participant who may enter bids on EBP either on proprietary basis or for other participants such as High Networth Individuals (HNIs), Institutional investors etc.

(2) **Sub-arranger** appointed by the arranger, any broker registered with SEBI may act as a sub-arranger. Sub-arranger shall be categorized as a Category 1 Participant who may enter bids on EBP either on proprietary basis or for other participants such as High Networth Individuals (HNIs), Institutional investors etc.

(3) **Institutional investors** shall be categorized as Category 2 Participants who may enter bids on proprietary basis or may participate through an arranger/sub-arranger.

Procedure for electronic book mechanism: The procedure to be followed for electronic book mechanism is as follows:

Pre-Bid Procedure

Participants shall be required to enroll with EBP before entering bids and only eligible participants may participate in the bidding process.

- Qualified Institutional Buyer and other eligible bidders may participate in the bidding process. However, in case the issuer is NBFC which are registered with RBI and HFCs registered with National Housing Bank, QIBs, eligible bidders and other participants enrolled with EBP, may participate in the bidding process subject to the RBI requirements, if any prescribed in this regard.
- The EBP shall provide the details of QIBs and other participants enrolled with EBP to the issuer.
- All enrolled participants (other than QIBs) who wish to participate on any issue either directly or through arranger, as applicable would be required to pre-register before being allowed to access to the PPM or other information with respect to issue. However, if the number of such pre-registration of participants exceeds 200 in a year, then the eligible bidders would be determined by draw of lots or first come first served basis undertaken by the EBP in consultation with issuer so as to limit participants to 200 in a year.
- The bidding time window (bidding time, cooling period, renegotiation window etc.) shall be decided by issuer in consultation with the EBP which shall be disclosed to the bidders by EBP in advance.

Bidding Procedure

- Bidding shall be allowed in the bidding time window specified by the issuer.
- Bid shall be made by way of entering bid amount in Rupees (INR) and coupon/yield in basis points.
- Participants shall be allowed to enter multiple bids i.e. single participant may enter more than one bid.
- EBP shall provide a facility for generation of acknowledgement number against such bids.

Post Bidding Procedure

- All bids received within bidding time window shall be provided by EBP to the issuer after bidding process is over.
- Issuer shall have the option to accept or reject bids received, if the issuer agrees to the yield so discovered.
- Issuer shall provide details of accepted bids to depositories to make allotment.
- EBP shall display bid details on the end of the bidding time window.

- At the end of the bidding time window, EBP shall on an anonymous basis, disclose the aggregate volume data, including yield, amount including the amount of oversubscription, total bids received, ratings, category of investor etc. to avoid any speculations.
- For issues below ₹ 500 Crore, issuer shall upload details as mentioned above with EBP and/or with information repository for corporate debt market as notified by SEBI, in the format as specified.
- EBP shall upload the allotment data on its website to be made available to the public.

SEBI (PUBLIC OFFER & LISTING OF SECURITIZED DEBT INSTRUMENTS) REGULATIONS, 2008

Question 34] Discuss in detail eligibility criteria specified in SEBI (Public Offer & Listing of Securitized Debt Instruments) Regulations, 2008

Ans.: Eligibility criteria [Regulation 4]: No person shall make a public offer of securitized debt instruments or seek listing for such securitized debt instruments unless -

(*a*) it is constituted as a *Special Purpose Distinct Entity*

(*b*) all its trustees are registered with the SEBI and

(*c*) it complies with all applicable provisions of the regulations and the SEBI Act, 1992.

The requirement of obtaining registration shall not apply to the following persons, who may act as trustees of special purpose distinct entities, namely:

(*i*) Any person registered as a debenture trustee with the SEBI.

(*ii*) Any person registered as a securitization company or a reconstruction company with the RBI under the Securitization and Reconstruction of Financial Assets & Enforcement of Security Interest Act, 2002.

(*iii*) NHB established by the National Housing Bank Act, 1987.

(*iv*) NABARD established by the National Bank for Agriculture & Rural Development Act, 1981.

(*v*) Any scheduled commercial bank other than a regional rural bank.

(*vi*) Any public financial Institution as defined in Section 2 (72) of the Companies Act, 2013

(*vii*) Any other person as may be specified by SEBI.

Eligibility for trustee: An applicant seeking registration to act as a trustee shall have -

(*a*) Net worth of not less than **₹ 2 Crore**.

(*b*) In its employment a minimum of 2 persons who, between them, have at least 5 years experience in activities related to securitization and at least one among them shall have a professional qualification in law from any university or institution recognized by the Central or State Government or a foreign university.

Form & Fee for registration: An application for registration shall be made by the trustee to the SEBI in **Form A** of **Schedule I** along with non-refundable application fees as specified in **Schedule II**.

Any application which is not complete in all respects and does not conform to the instructions specified in Form A of Schedule I or which is incorrect, false or misleading in nature shall be liable to be rejected. However, before rejecting any such application, the SEBI shall give an opportunity to the applicant to remove the objections pointed out by the SEBI within the time specified by the SEBI.

The SEBI may require the applicant to furnish such further information or explanation as is necessary in the opinion of the SEBI to take a decision on the application.

Question 35] What are the provisions for issuance of securitized debt instruments by special purpose distinct entity by way of launching of scheme.

Ans.: Launching of schemes [Regulation 12]:

(1) A special purpose distinct entity may raise funds by making an offer of securitized debt instruments through formulating schemes in accordance with these regulations.

(2) Where there are multiple schemes, the special purpose distinct entity shall maintain separate and distinct accounts in respect of each such scheme and shall not commingle asset pools or realizations of a scheme with those of other schemes.

(3) A special purpose distinct entity and trustees thereof shall ensure that realizations of debts and receivables are held and correctly applied towards redemption of securitized debt instruments issued under the respective schemes or towards payment of returns on such instruments or towards other permissible expenditure of the scheme.

(4) The terms of issue of the securitized debt instruments may provide for exercise of a clean-up call option by the special purpose distinct entity, subject to adequate disclosures.

(5) No expenses shall be charged to the scheme in excess of the allowable expenses as may be specified in the scheme and any such expenditure, if incurred, shall be borne by the trustees.

Question 36] Under which circumstance scheme of securitized debt instrument may wound-up under the SEBI (Public Offer & Listing of Securitized Debt Instruments) Regulations, 2008?

Ans.: Winding up of schemes [Regulation 20]: A scheme may be wound up in the event of the following:

(*a*) When the securitized debt instruments have been fully redeemed as per the scheme.

(*b*) Upon legal maturity as stated in the terms of issue of the securitized debt instrument. However, if any debt or receivable is outstanding on legal maturity, the trustees shall dispose off the same in accordance with the scheme and distribute the proceeds.

(*c*) By vote of investors by a special resolution.

Question 37] Whether securitized debt instruments are freely transferable?

Ans.: Transferability [Regulation 33]: The securitized debt instruments issued to the public or listed on recognized stock exchange in accordance with SEBI (Public Offer & Listing of Securitized Debt Instruments) Regulations, 2008 shall be *freely transferable.*

Question 38] State the provisions relating listing of securitized debt instrument under the SEBI (Public Offer & Listing of Securitized Debt Instruments) Regulations, 2008.

Ans.: Application for listing [Regulation 35]: A special purpose distinct entity desirous of making an offer of securitized debt instruments to the public shall make an application for listing to one or more recognized stock exchanges in terms of Section 17A(2) of the Securities Contracts (Regulation) Act, 1956.

Listing Agreement [Regulation 35A]: Every special purpose distinct entity desirous of listing securitized debt instruments on recognized stock exchange, shall execute an agreement with such stock exchange.

Minimum public offering for listing [Regulation 36]: For the public offers of securitized debt instruments, the special purpose distinct entity or trustee should satisfy the recognized stock exchange that each scheme of securitized debt instruments was offered to the public for subscription through advertisements in newspapers for a period of not less than 2 days, and that the applications received in pursuance of the offer were allotted in accordance with these regulations and the disclosures made in the offer document.

In the case of a private placement of securitized debt instruments, the special purpose distinct entity should ensure that it has obtained credit rating from a registered credit rating agency for its securitized debt instruments. In the case of a private placement of securitized debt instruments, the special purpose distinct entity should file the listing particulars with the recognized stock exchange, along with the application containing such information as may be necessary for any investor in the secondary market to make an informed investment decision related to its securitized debt instruments.

All the credit ratings obtained, including the unaccepted ratings, should be disclosed in the listing particulars filed with the recognized stock exchange.

Continuous listing conditions [Regulation 37]: The special purpose distinct entity or its trustee should provide information, including financial information relating to the schemes, to the stock exchanges and investors and comply with such other continuing obligations as may be stipulated in the listing agreement.

Trading of securitized debt instruments [Regulation 38]: The securitized debt instruments issued to the public or on a private placement basis that are listed in recognized stock exchanges shall be traded, and such trades shall be cleared and settled in the recognized stock exchanges, subject to the conditions specified by SEBI.

Question 39] State the provisions relating to making of public offer of securitized debt instruments under the SEBI (Public Offer & Listing of Securitized Debt Instruments) Regulations, 2008.

Ans.: Offer to the public [Regulation 21]: No offer shall be treated as made to the public, if the offer can properly be regarded, in all the circumstances -

(*a*) as not being likely to result, directly or indirectly, in the securitized debt instruments becoming available for subscription or purchase by persons other than those receiving the offer;

(*b*) otherwise as being the domestic concern of the persons making and receiving the offer.

However, it applies only in respect of securitized debt instruments which belong to the same tranche and which are *pari passu* in all respects.

Any offer of securitized debt instruments made to **50 or more persons** in a financial year shall always be deemed to have been made to the public.

Submission of draft offer document and filing of final offer document [Regulation 22]:

(1) No special purpose distinct entity or trustee shall make an offer of securitized debt instruments to the public unless it files a draft offer document with SEBI at least 15 working days before the proposed opening of the issue.

(2) Such offer document shall be filed along with the minimum filing fee as mentioned in Schedule II of these regulations. However, the balance filing fee provided in Schedule II shall be paid to SEBI within 7 days of closure of the public offer.

(3) If SEBI specifies any changes to be made in the offer document within the said period of 15 working days, the special purpose distinct entity and trustee thereof shall carry out such changes in the draft offer document prior to filing it with the designated stock exchange or issuing it.

(4) The final offer document shall be filed with SEBI and with every recognized stock exchange to which an application for listing of the securitized debt instruments is proposed to be made prior to its issuance to public.

Arrangements for dematerialization [Regulation 23]: Prior to submitting the draft offer document with SEBI, the special purpose distinct entity shall enter into an arrangement with a registered depository for dematerialization of the securitized debt instruments that are proposed to be issued to the public.

The special purpose distinct entity shall give an option to the investors to receive the securitized debt instruments either in the physical form or in dematerialized form.

The holders of dematerialized instruments shall have the same rights and liabilities as holders of physical instruments.

Offer period [Regulation 29]: A public offer of securitized debt instruments shall not remain open for more than **30 days**.

Minimum subscription [Regulation 30]: The offer document shall disclose the minimum subscription it seeks to raise under the scheme.

No securitized debt instruments shall be allotted under the public offer unless subscriptions have been received in respect of the minimum number of securitized debt instruments which will constitute minimum subscription.

Here, minimum subscription refers to the amount which, in the opinion of the directors of the originator and trustees of the special purpose distinct entity, must be raised by issue of securitized debt instruments.

In the event of non-receipt of minimum subscription or refusal of listing by any recognized stock exchange, all application moneys received in the public offer shall be refunded forthwith to the applicants.

Allotment and other obligations [Regulation 31]:

(1) The securitized debt instruments shall be allotted to the investors within the following time periods:

(*a*) In case of dematerialized securitized debt instruments - within **5 days** of closure of the offer;

(*b*) In case of securitized debt instruments in the physical form - the certificates shall be dispatched within **8 days** of closure of the offer.

(2) No special purpose distinct entity shall retain any oversubscription received in any public offer.

(3) In the event of oversubscription, the allotment shall be made as per the basis of allotment finalized in consultation with the recognized stock exchanges to which an application for listing was made.

(4) The special purpose distinct entity shall dispatch refund orders to unsuccessful or partially successful applicants within 8 days of closure of the offer.

(5) In a case where the issue proceeds become liable to be refunded in accordance with the disclosures made in the offer document, the special purpose distinct entity shall dispatch refund orders to the applicants within eight days of closure of the offer.

(6) Where the allotment is not made within the time period mentioned or where the certificates are not dispatched within the time, the special purpose distinct entity and every trustee thereof, and where any such trustee is a body corporate, every director thereof, who is in default shall, on and from the expiry of such period, be jointly and severally liable to pay interest at the rate of 15% p.a. to the concerned applicants.

(7) Where the refund orders are not dispatched within the time mentioned, the special purpose distinct entity and every trustee and where any such trustee is a body corporate, every director, who is in default shall, on and from the expiry of the eighth day, be jointly and severally liable to repay that money with interest at the rate of 15% p.a.

(8) This shall have effect without prejudice to any other provisions of these regulations or any other law.

(9) Credit to demat accounts of the allottees shall be made by the issuer within 2 working days from the date of allotment.

Question 40] What are the rights of investors of securitized debt instruments?

Ans.: Rights of investors in securities issued by special purpose distinct entity [Regulation 34]:

(1) The trust deed or other instrument comprising the terms of issue of the securitized debt instruments issued by a special purpose distinct entity shall provide that investors holding such securitized debt instruments have such beneficial interest in the underlying debt or receivables as may have been conferred by the scheme.

(2) In the event of failure of the special purpose distinct entity to redeem any securitized debt instruments offered through an offer document or listed, within the time and in accordance with the conditions stated in the offer document or other terms of issue, the investors holding not less than 10% in nominal value of such securitized debt instruments shall be entitled to call a meeting of all such investors.

(3) The investors shall be deemed to have given their consent to variation if and only if 21 days notice is given to them of the proposed variation and it is approved by a special resolution passed by them through postal ballot.

(4) Sections 114 and 117 of the Companies Act, 2013 and the rules framed thereunder shall *mutatis mutandis* apply to the special resolution referred above.

(5) Any reasonable expenses incurred in calling and holding a meeting and any reasonable expenses incurred by the trustee or the new trustee in winding up the scheme and incidental activities shall be met from or reimbursed out of realizations from the asset pool.

(6) The terms of issue of securitized debt instruments shall not be adversely varied without the consent of the investors.

SEBI (ISSUE & LISTING OF DEBT SECURITIES BY MUNICIPALITY) REGULATIONS, 2015

Question 41] Write a short note on: Municipal Bonds

Ans.: The debt market in India for municipal securities has grown considerably since the issuance of Municipal Bonds by Ahmedabad Municipal Corporation. Since 1998, other cities that have accessed the capital markets through municipal bonds without State Government guarantee which include *Nashik, Nagpur, Ludhiana,* and *Madurai*. In most cases, bond proceeds have been used to fund water and sewerage schemes or road projects. India's city governments have thus mobilized about ₹ 4,450 million from the domestic capital market through taxable municipal bonds. The last issuance was done by Greater Vishakhapatnam Municipal Corporation for ₹ 30 Crores in 2010.

The Government of India, in order to boost the municipal bond market, allowed the municipalities to issuer tax-free municipal bonds. The central government amended the Income Tax Act, 1961 vide the Finance Act, 2000, whereby interest income from bonds issued by local authorities was exempted from income tax. The GOI issued guidelines for issue of tax-free municipal bonds in February 2001. These guidelines stipulate eligible issuers, use of funds, essential pre-conditions, maturing period, buy-back, nature of issue and tax benefits, ceiling amount for a project, compulsory credit rating, and external monitoring of the tax-free municipal bond.

Taking into consideration the above, SEBI has introduced **SEBI (Issue & Listing of Debt Securities by Municipality) Regulations, 2015**.

Question 42] Which Municipalities are eligible to issue debt securities to public under the SEBI (Issue & Listing of Debt Securities by Municipalities) Regulations, 2015?

Ans.: Eligible Municipalities [Regulation 4]: No issuer shall be eligible to issue debt securities to public under these regulations, unless the following criteria are complied with:

(*a*) Municipality, whether proposing to issue debt securities itself or through corporate municipal entity, should be eligible to raise funds under its Constitution.

(*b*) Accounts of municipality shall be prepared in accordance with National Municipal Accounts Manual or in accordance with similar Municipal Accounts Manual adopted by the respective State Government for at least three immediately preceding financial years.

(*c*) Municipality shall not have negative net worth in last 3 financial years.

(*d*) Municipality shall not have defaulted in repayment of debt securities or loans obtained from banks or financial institutions in last 365 days.

However, where the issuer is a corporate municipal entity, the requirements at (b), (c) and (d) shall be complied by the Municipality which is being financed.

(*e*) No order or direction of restraint, prohibition or debarment by SEBI against the corporate municipal entity or its directors is in force.

(*f*) The corporate municipal entity, its promoter, group company or directors, should not have been named in the list of the wilful defaulters published by the RBI or should not have defaulted of payment of interest or repayment of principal amount in respect of debt instruments issued by it to the public.

Question 43] What conditions are required to be complied by the Municipalities while making public issue of debt securities?

Ans.: General Conditions [Regulation 5]:

(1) An issuer making public issue of debt securities shall only issue **revenue bonds**.

(2) No issuer shall make a public issue of revenue bonds unless following conditions are complied with:

(*a*) It has made an application to one or more recognized stock exchanges for listing of such securities. However, if the application is made to more than one recognized stock exchanges, the issuer shall choose one of them as the designated stock exchange which have nationwide trading terminals. For any subsequent public issue, the issuer may choose a different stock exchange as a designated stock exchange subject to the requirements of the regulation.

(*b*) It has obtained in-principle approval for listing of its revenue bonds 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 registered with the SEBI and is disclosed in the offer document. However, the revenue bonds intended to be issued shall have a minimum investment grade rating. If the 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 registered depository for dematerialization of the revenue bonds that are proposed to be issued to the public, in accordance with the Depositories Act, 1996 and regulations made thereunder.

(3) The revenue bonds shall have a minimum tenure of **3 years** or such period as specified by the SEBI from time to time.

(4) The revenue bonds shall have a maximum tenure of **30 years** or such period as specified by the SEBI from time to time.

(5) The issuer shall appoint one or more merchant bankers registered with the SEBI at least one of whom shall be a lead merchant banker.

(6) The issuer shall create a separate escrow account for servicing of revenue bonds with earmarked revenue.

(7) The issuer shall appoint a monitoring agency such as public financial institution or a scheduled commercial bank to monitor the earmarked revenue in the escrow account. However, if the issuer is corporate municipal entity, it shall appoint a debenture trustee registered with the SEBI in accordance with the provisions of the SEBI (Debenture Trustees) Regulations, 1993 and Companies Act, 2013.

Question 44] What are the restriction on Municipalities while making advertisement for issuance of debt securities to the public?

Ans.: Advertisements for public issues [Regulation 9]:

(1) The issuer may make an advertisement in a national daily with wide circulation, on or before the issue opening date and such advertisement shall contain the disclosures as per **Schedule IV**.

(2) Advertisement shall not be misleading in material particular and shall not contain 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 promotional or educative advertisement issued by the issuer during the subscription period shall not make any reference to the issue of revenue bonds or be used for solicitation.

Question 45] State the requirements relating to minimum subscription for issuance of debt securities by Municipalities?

Ans.: Minimum subscription [Regulation 11]:

(1) The issuer may decide the amount of minimum subscription which it seeks to raise by issue of debt securities and disclose the same in the offer document. However, such minimum subscription limit shall not be less than **75% of the issue size**.

(2) In the event of non-receipt of minimum subscription as specified above, all application moneys received in the public issue shall be refunded forthwith to the applicants, within **12 days** from the date of the closure of the issue.

(3) In the event, there is a delay by the issuer in making the aforesaid refund, then the issuer shall refund the subscription amount along with interest at the rate of **10% p.a.** for the delayed period.

Question 46] For what purpose proceeds received by issuance of debt securities by Municipalities can be utilized?

Ans.: Utilization of issue proceeds [Regulation 12]:

(1) The funds raised from public issue of debt securities shall be used only for projects that are specified under objects in the offer document.

(2) The proceeds of the issue shall be clearly earmarked for a defined project or a set of projects for which requisite approvals have been obtained from concerned authorities.

(3) The issuers shall maintain a bank account in which the amount raised from the issue shall be transferred immediately after the closure of the issue and such amount shall only be utilized for specified projects. However, where the issuer is a Corporate Municipal Entity, the issue proceeds, net of issue expenses, shall be used only for onward lending to municipalities as disclosed in the offer document. If the issuer is a corporate municipal entity, it shall maintain sufficient interest margin while onward lending to the municipalities, to meet its operating expenses and obligations.

(4) The issuer shall establish a separate project implementation cell and designate a project officer who shall not be below the rank of deputy commissioner, who shall monitor the progress of the projects and shall ensure that the funds raised are utilized only for the projects for which the debt securities were issued. If the issuer is a corporate municipal entity, such requirement shall be complied by the Municipality which is being financed.

(5) Issuer's contribution for each project shall not be less than 20% of the project costs, which shall be contributed from their internal resources or grants. If the issuer is a corporate municipal entity, contribution of the concerned municipality, which is being financed by the corporate municipal entity, shall not be less than 20% of the project costs, which shall be contributed from its internal resources or grants.

(6) The issuer shall disclose the schedule of implementation of the project in the offer document in a tabular form and the funds raised by the issuer shall be utilized in accordance with the said schedule.

Question 47] State the requirement relating to listing of debt securities issued by Municipalities.

Ans.: Mandatory listing [Regulation 14]: An issuer desirous of making an offer of debt securities to the public shall make an application for listing to one or more recognized stock exchanges. If the issuer is corporate municipal entity, such an application shall be made in terms Section 40(1) of the Companies Act, 2013.

Conditions for listing of debt securities issued on private placement basis [Regulation 15]: An issuer may list its debt securities issued on private placement basis on a recognized stock exchange subject to the following conditions:

(*i*) An issuer may issue general obligation bonds or revenue bonds.

(*ii*) Accounts of municipality being the issuer, shall be prepared in accordance with National Municipal Accounts Manual or in accordance with similar Municipal Accounts Manual adopted by the respective State Government for last 3 financial years.

(*iii*) No order or direction of restraint, prohibition or debarment by SEBI against the corporate municipal entity or its directors is in force.

(*iv*) The issuer, being a corporate municipal entity, has issued such debt securities in compliance with the provisions of Companies Act, 2013 and particularly Section 42 of the Companies Act, 2013 and rules prescribed thereunder and other applicable laws.

(*v*) The issuer shall not solicit or collect funds by issue of debt securities, except by way of private placement.

(*vi*) The minimum subscription amount per investor shall not be less than ₹ 5 lakh or such amount as may be specified by SEBI from time to time.

(*vii*) Credit rating has been obtained in respect of such debt securities from at least one credit rating agency registered with the SEBI.

(*viii*) The debt securities proposed to be listed are in dematerialized form.

(*ix*) The disclosures as provided in Schedule I of the regulations have been made.

Continuous listing conditions [Regulation 23]:

(1) All the issuers making public issues of debt securities or seeking listing of debt securities issued on private placement basis, shall comply with conditions of listing including continuous disclosure and other requirements specified by the SEBI in general and those specified in **Schedule V** to this regulations.

(2) Where the issuer is corporate municipal entity, one-third of its SEBI shall comprise of independent directors, as defined in Section 149 of the Companies Act, 2013.

(3) Every rating obtained by an issuer shall be periodically reviewed by the registered credit rating agency and any revision in the rating shall be promptly disclosed by the issuer to the stock exchanges where the debt securities are listed.

(4) In the event of credit rating being downgraded by two or more notches below the rating assigned at the time of issue, the issuer shall present to all bondholders, the reasons for fall in rating and the steps, if any, it intends to take to recover the rating.

(5) Any change in rating shall be promptly disseminated in such manner as the stock exchange where such securities are listed may determine from time to time.

(6) The issuer, the respective debenture trustees, wherever appointed, and stock exchanges shall disseminate all information and reports regarding debt securities including compliance reports filed by the issuers and the debenture trustees, if appointed, to the investors and the general public by placing them on their websites.

(7) The information referred to in (5) shall also be placed on the websites of the debenture trustee, the issuer and the stock exchanges.

Question 48] What are the requirement in relation to 'execution of trust deed' and 'creation of debenture redemption reserve' under the SEBI (Issue & Listing of Debt Securities by Municipality) Regulations, 2015?

Ans.: Trust deed [Regulation 20]:

(1) A trust deed for securing the issue of debentures shall be executed by the issuer in favour of the independent trustee or debenture trustee, as applicable, within three months of the closure of the issue.

(2) The trust deed shall contain such clauses as may be prescribed in **Schedule IV** of the SEBI (Debenture Trustees) Regulations, 1993. In case of private placement by a corporate municipal entity, the trust deed shall, in-addition, contain such clauses as prescribed under Section 71 of the Companies Act, 2013 and Companies (Share Capital and Debentures) Rules 2014.

(3) The trust deed shall not contain a clause which has the effect of:

(*a*) limiting or extinguishing the obligations and liabilities of the debenture trustees or the issuer in relation to any rights or interests of the investors;

(*b*) limiting or restricting or waiving the provisions of the SEBI Act, 1992, the regulations and circulars or guidelines issued by the SEBI;

(*c*) indemnifying the debenture trustees or the issuer for loss or damage caused by their act of negligence or commission or omission.

Debenture redemption reserve [Regulation 22]:

(1) For the redemption of the debentures issued by a corporate municipal entity, the issuer shall create debenture redemption reserve in accordance with the provisions of the Companies Act, 2013 and the Rules made thereunder.

(2) Where the issuer is a corporate municipal entity and the issuer has defaulted in payment of interest on debt securities or redemption thereof 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.

Question 49] Write a short note on: Trading and reporting of debt securities under the SEBI (Issue & Listing of Debt Securities by Municipality) Regulations, 2015

Ans.: Trading and reporting of debt securities [Regulation 25]:

(1) The debt securities issued to public or on a private placement basis, which are listed in recognized stock exchanges, shall be traded. Such trades shall be cleared and settled in recognized Clearing Corporation subject to conditions specified by the SEBI.

(2) The trading lot for privately placed debt securities shall be **₹ 1 lakh** or such amount as may be specified by the SEBI.

(3) In case of trades of debt securities which have been made over the counter, such trades shall be reported on a recognized stock exchange having a nationwide trading terminal or such other platform as may be specified by the SEBI from time to time.

(4) The information in respect of issues such as issuer details, instrument details, ratings, rating migration, coupon, buyback, redemption details, shall be required to be reported to a common database with depositories or any other platform as may be specified by the SEBI.

OBJECTIVE QUESTIONS

Question A] Expand the following abbreviations:

(1)	CD	(6)	FD	(11)	PD
(2)	CP	(7)	NBFC	(12)	FII
(3)	ZCB	(8)	PTS	(13)	MCA
(4)	FRB	(9)	LIBOR	(14)	DEA
(5)	NDS	(10)	MIBOR	(15)	DRR

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

(1) ______ represents borrowed funds that must be repaid.

(2) ________ are markets for the issuance, trading and settlement of various types and features of fixed income securities.

(3) The trading of government securities on the Stock exchanges is currently through ______ using members of BSE/NSE.

(4) _______ are not direct debt instruments. Instead they derive value from various debt instruments.

(5) The _________ 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.

(6) ________ of interest simply means that the rate of interest is variable.

Question C] Select the correct option.

1. _______ is an electronic platform for facilitating dealing in Government Securities & Money Market Instruments.

(*a*) Negotiated Instrument System (NIS)

(*b*) Negotiated Dealing System (NDS)

(*c*) Negotiated System (NS)

(*d*) Negotiated Trading System (NTS)

2. Debt securities are considered to have very ________

(*a*) more risk

(*b*) less risk

(*c*) more risk than equity shares

(*d*) none of the above

3. Who among the following gets priority over the assets of the company in times of liquidation?

(*a*) Equity subscribers and Government

(*b*) Preference share holder

(*c*) Debt subscribers and bond buyers

(*d*) Can't say anything

4. The deposits offered by NBFCs are not insured whereas the deposits accepted by most banks are insured up to a maximum of _______

(*a*) ₹ 10,000

(*b*) ₹ 1,00,000

(*c*) ₹ 10,00,000

(*d*) ₹ 5,00,000

5. A zero coupon bond is issued at a ________, fetches no periodic interest and is redeemed at the face value at maturity.

(*a*) discount to its face value

(*b*) face value to discount

(*c*) premium to its face value

(*d*) none of the above

6. Sardar Sarovar Nigam Ltd. issued a bond at ₹ 3,600 redeemable on face value of ________ after 21 years.

(*a*) ₹ 5,55,000

(*b*) ₹ 1,11,000

(*c*) ₹ 2,22,000

(*d*) ₹ 51,100

7. Who is/are the intermediaries in debt market in India?

(*a*) Primary dealers

(*b*) Brokers

(*c*) Both (a) and (b)

(*d*) Neither (a) nor (b)

8. As per Section 71(5) 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 ______

(*a*) 500

(*b*) 5,000

(*c*) 1,000

(*d*) 2,500

9. As per the Companies Act, 2013, 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 ______ in value of the debentures outstanding, at their meeting.

(*a*) $1/4^{th}$

(*b*) $1/3^{rd}$

(*c*) $2/3^{rd}$

(*d*) $3/4^{th}$

10. SEBI (Issue & Listing of Debt Securities) Regulations, 2008 shall apply to ______

(I) Public issue of debt securities

(II) Listing of debt securities issued through public issue or on private placement basis on a recognized stock exchange

(*a*) (II) only

(*b*) (I) only

(*c*) Both (I) and (II)

(*d*) Neither (I) nor (II)

Answer to Question A:

Abbreviation	Long Form
CD	Certificates of deposit
CP	Commercial paper
ZCB	Zero Coupon Bonds
FRB	Floating Rate Bonds
NDS	Negotiated Dealing System
FD	Fixed Deposit
NBFC	Non Banking Financial Companies
PTS	Pass-through Securities
LIBOR	London Inter Bank Offer Rate
MIBOR	Mumbai Inter Bank Offer Rate
PD	Primary Dealers
FII	Foreign Institutional Investors
MCA	Ministry of Corporate Affair
DEA	Department of Economic Affairs
DRR	Debenture Redemption Reserve

Answer to Question B:

(1) Debt security **(2)** Debt markets **(3)** Negotiated Dealing System **(4)** Derived instruments **(5)** Pass-through securities **(6)** Floating rate

Answer to Question C:

1. (*b*)	**3.** (*c*)	**5.** (*a*)	**7.** (*c*)	**9.** (*d*)
2. (*b*)	**4.** (*b*)	**6.** (*b*)	**8.** (*a*)	**10.** (*c*)

7

CHAPTER

MONEY MARKET

MONEY MARKET – MEANING & FEATURES

Question 1] What do you understand by money market? What are the important features of money market?

The money market is a wholesale market. **CS (Executive) - June 2011 (2 Marks)**

Ans.: Money Market is the market for dealing in **monetary assets** of **short-term nature**. It is a formal financial market that deals with short-term fund management. Funds are available in this market for periods ranging from a **single day up to a year**.

Trading in the money markets involves:

- Government securities
- Money at call & short notice
- Bill rediscounting
- Interbank participation
- Money markets mutual funds
- Call money markets
- Treasury bills
- Certificate of deposit
- Inter corporate deposits
- Commercial bills
- Commercial papers (CP)
- Gilt edged securities

The money market is a **wholesale debt market** for:

- Low-risk
- High liquidity
- Minimum transaction cost
- Short term instruments

Key features of money market :

→ It is **important segment of financial system**.

→ It provides **access for short-term funds** to fulfil borrowings and investment.

→ It deals in the lending and borrowing of **short-term finance** (i.e., for 1 year or less)

→ It performs the **important role** in **monetary policy**.

→ It is **regulated by RBI**.

→ It solves short term liquidity problems.

→ The degree of risk is **small** in the money market.

→ It serves as a **signalling-device** for other segments of the financial system.

→ **Government** & **banking industry** is an **active player** in the money market.

→ Corporates, foreign institutional investors (FIIs) also transact in money market.

Question 2] There are large number of participants in the money market. Comment.

CS (Executive) - Dec 2011 (3 Marks)

Write a short note on: Participants in money market **CS (Executive) - Dec 2015 (3 Marks)**

Ans.: Following are the dealers/participants in money market:

- Government
- Banking industry
- Corporates
- Mutual funds (MFs)
- Foreign institutional investors (FIIs)
- DHFI

Though there are few types of players in money market, the role and the level of participation by each type of player differs largely.

Government is an active player in the money market. It constitutes the biggest borrower in this market. Both, Government securities and Treasury bill is a security issued by RBI on behalf of the Government of India to meet the latter's borrowing for financing fiscal deficit. Apart from functioning as a banker to the government, the RBI also regulates the money market and issues guidelines to govern the money market operations.

Another dominant player in the money market is the banking industry. Banks mobilize deposits of savers in lending to investors of the economy. This process is known as **credit creation**.

Other institutional players like financial institutions, corporates, mutual funds, Foreign institutional investors (FIIs) etc. also transact in money market to fulfil their respective short term finance deficits and short falls.

However, the degree of participation of these players depends largely on the regulations formulated by the regulating authorities in an economy. For instance, the level of participation of the FIIs in the Indian money market is restricted to investment in government securities only.

Question 3] Distinguish between: Money Market & Capital Market

CS (Inter) - Dec 2005 (5 Marks), June 2006 (2 Marks)

CS (Inter) - Dec 2006 (2 Marks)

CS (Executive) - June 2012 (3 Marks)

Distinguish between: Money Market & Security Market

CS (Inter) - Dec 2002 (3 Marks), June 2004 (2 Marks)

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.

Points	Money Market	Securities Market
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 3A] Distinguish between: 'Cash reserve ratio' and 'statutory liquidity ratio'

CS (Executive) - June 2016 (2 Marks)

Ans.: As per Banking Regulation Act, 1949 every bank has to maintain cash reserve ratio and 'statutory liquidity ratio notified by RBI time to time.

Cash reserve ratio is the cash parked by the banks in their specified current account maintained with RBI.

Statutory liquidity ratio is in the form of cash (book value), gold (current market value) and balances in unencumbered approved securities.

Question 4] Explain the term related to money market: Primary dealer

CS (Executive) - June 2010 (2 Marks)

Ans.: Primary dealer in money market are:

- Government
- Banking industry
- Corporate

Question 5] Reserve Bank of India is the main regulator of money market in India. Comment.

CS (Executive) - June 2012 (5 Marks)

Ans.: Money market is a very important segment of a financial system. It is the market for dealing in monetary assets of short-term nature. Money market provides access to providers and users of short-term funds to fulfil their investments and borrowings requirements respectively at an efficient market clearing price. The money market is one of the primary mechanism through which the Central Bank (RBI) influences liquidity and the general level of interest rates in an economy. Apart from functioning as a banker to the government, the central bank (RBI) also regulates the money market and issues guidelines to govern the money market operations.

Question 6] The organization and structure of money market has undergone a sea changes in the last decade in India. Discuss. CS (Inter) - Dec 2004 (4 Marks)

Ans.: Post reforms period in India has witnessed tremendous growth of the Indian money markets. Banks and other financial institutions have been able to meet the high expectations of short term funding of important sectors like the industry, services and agriculture. Functioning under the regulation and control of the RBI, the Indian money markets have also exhibited the required maturity and resilience over the years.

The organization and structure of the money market has undergone a sea change in the last decade in India. This was accompanied by a growth in quantitative terms also.

Up to 1987, the money market consisted of 6 facets:

1. Call Money Market
2. Inter Bank Term Deposit/Loan Market
3. Participation Certificate Market
4. Commercial Bills Market
5. Treasury Bills Market and
6. Inter-corporate Market.

The market had three main deficiencies:

- It had a very narrow base with RBI, Banks, LIC and UTI as the only participants lending funds while the borrowers were large in number.
- There were only few money market instruments.
- The interest rates were not market determined but were controlled either by RBI or by a voluntary agreement between the participants through the Indian Banks Association (IBA).

To set right these deficiencies, the recommendations of Chakravarthy Committee (1985) and the Vaghul Committee (1987) laid foundation for systematic development of the Indian Money Market. The implementation of the suggestions of the respective committees has widened and deepened the market considerably by increasing the number of participants and instruments and introducing market determined rates as against the then existing administered or volunteered interest rates.

Further, an active secondary market for dealings of money market instrument was created which positively impacted the liquidity of these instruments. For this purpose, the Discount and Finance House of India Limited (DFHI) was formed as an autonomous financial intermediary in April, 1988 to embellish the short-term liquidity imbalances and to develop an active secondary market for the trading of instruments of the money market. The DFHI plays the role of a market maker in money market instruments. With the relaxation of the regulatory framework and the arrival of new instruments and participants, DFHI occupies a key role in ushering a more active and de-regulated money market.

Question 7] Name any 8 instruments that are dealt in money market.

Write short note on: Money market instruments **CS (Inter) - June 2003 (5 Marks)**

List at least four money market instruments and explain the essential feature of any two of them.
CS (Inter) - June 2005 (5 Marks)

CS (Executive) - June 2011 (5 Marks)

Ans.: Various money market instruments are as follows:

- Government securities
  - → Dated securities
  - → Zero coupon bonds
  - → Floating rate bonds
  - → Capital indexed bonds
  - → Treasury bills
  - → Gilt edged government securities
- Money at call & short notice

- Bills rediscounting
- Inter Bank Participation Certificate (IBPC)
- Money Market Mutual funds
- Call Money market/short term deposit
- Certificates of deposit
- Commercial papers

MONEY MARKET INSTRUMENTS - GOVERNMENT SECURITIES

Question 8] Discuss the salient features of Government Securities.

Why should an investor prefer to invest in government securities? Discuss the benefits.

CS (Inter) - June 2006 (4 Marks)

Ans.: Government Securities are securities issued by the Government for raising a public loan or as notified in the Official Gazette. They consist of Government Promissory Notes, Bearer Bonds, Stocks or Bonds held in Bond Ledger Account. They may be in the form of Treasury Bills or Dated Government Securities.

Government Securities are mostly interest bearing dated securities issued by RBI on behalf of the Government of India. GOI uses these funds to meet its expenditure commitments. These securities are generally fixed maturity and fixed coupon securities carrying semi-annual coupon. Since the date of maturity is specified in the securities, these are known as dated Government Securities, e.g. 8.24% GOI 2018 is a Central Government Security maturing in 2018, which carries a coupon of 8.24% payable half yearly.

Key Features :

(1) Issued at face value

(2) No default risk as the securities carry sovereign guarantee.

(3) Ample liquidity as the investor can sell the security in the secondary market.

(4) Interest payment on a half yearly basis on face value.

(5) No TDS.

(6) Can be held in demat form.

(7) Rate of interest and tenor of the security is fixed at the time of issuance and is not subject to change (unless intrinsic to the security like FRBs - Floating Rate Bonds).

(8) Redeemed at face value on maturity

(9) Maturity ranges from of 1-10 years.

(10) Securities qualify as Statutory Liquidity Ratio (SLR) investments unless otherwise stated.

Question 9] Explain with reference to money market the term 'Auction'.

CS (Executive) - June 2010 (2 Marks)

Explain briefly : Underwriting in auctions **CS (Executive) - Dec 2012 (3 Marks)**

Ans.: Auctioning is a method of trading whereby merchants bid against one another and where the securities are sold to the highest bidder. Auctions for government securities are either multiple-price auctions or uniform price auction - either yield based or price based.

(1) Yield Based : In this type of auction, RBI announces the issue size or notified amount and the tenor (duration) of the paper to be auctioned. The bidders submit bids in term of the yield at which they are ready to buy the security. If the bid is more than the cut-off yield then its rejected otherwise it is accepted.

(2) Price Based : In this type of auction, RBI announces the issue size or notified amount and the tenor of the paper to be auctioned, as well as the coupon rate. The bidders submit bids in terms of the price. This method of auction is normally used in case of reissue of existing government securities. Bids at price lower than the cut off price are rejected and bids higher than the cut off price are accepted. Price based auction leads to a better price discovery then the yield based auction.

Underwriting in auction : One day prior to the auction, bids are received from the primary dealers indicating the amount they are willing to underwrite and the fee expected. The auction committee of RBI then examines the bid on the basis of the market condition and takes a decision on the amount to be underwritten and the fee to be paid. In case of devolvement, the bids put in by the PD's are set off against the amount underwritten while deciding the amount of devolvement and in case the auction is fully subscribed, the PD need not subscribe to the issue unless they have bid for it.

Question 10] Distinguish between : Cut off yield and Cut off price

CS (Executive) - June 2009 (4 Marks), June 2011 (2 Marks)

Ans.: "Cut off yield" and "cut off price" are the methods of making auctions at the time issuance of government securities.

Following are the main points of difference between cut off yield and cut off price:

Points	**Cut off yield**	**Cut off price**
Meaning	Cut off yield is the rate at which bids are accepted	Cut off price is the minimum price accepted for the security.
Acceptance of bids	Bid lower than cut-off yield is accepted otherwise it is rejected.	Bids higher than the cut-off price are accepted otherwise it is rejected.

Question 11] A client purchases 7.40% GOI 2012 for face value of ₹ 10,00,000 @ ₹ 101.80. The settlement is due on October 3, 2012. Interest payment dates are 3rd May, and 3rd November every year. What is the amount to be paid by the client?

Ans.: The security is 7.40% GOI 2012 for which the interest payment dates are 3rd May, and 3rd November every year. The last interest payment date for the current year is 3rd May, 2012.

The principal amount payable is ₹ 10,00,000 × 101.80% = 10,18,000.

Last interest payment date was 3rd May, 2012 and settlement date is 3rd October, 2012.

Therefore, the interest has to be paid for 150 days counted as follows: (including 3rd May, and excluding October 3, 2012)

Months	Days
May (30 - 2)	28
June	30
July	30
August	30
September	30
October	2
	150

$$\text{Interest payable} = 10{,}00{,}000 \times 7.4\% \times \frac{150}{360} = ₹\ 30{,}833.33$$

Total amount payable by client = 10,18,000 + 30,833.33 = ₹ 10,48,833.33

Note: For government dated securities and state government securities the day count is taken as 360 days for a year and 30 days for every completed month. However for T-bills it is 365 days for a year.

Question 12] Ajay purchases 8.4% Government of India Bond, 2018 of face value of ₹ 20 lakh @ ₹ 102.50 for every unit of security having face value of ₹ 100. The settlement is due on 13th October, 2009. What is the amount to be paid by Ajay? (Assume that interest is payable on 13th May and 13th November every year) **CS (Executive) - June 2009 (5 Marks)**

Ans.: The security is 8.4% GOI 2018 for which the interest payment dates are 13th May and 13th November every year. The last interest payment date for the current year is 13th May, 2009.

The principal amount payable is ₹ 20,00,000 × 102.50% = 20,50,000.

Last interest payment date was 13th May, 2009 and settlement date is 13th October, 2009.

Therefore, the interest has to be paid for 150 days counted as follows (including 13th May, and excluding 13th October, 2009)

Months	Days
May (30 - 12)	18
June	30
July	30
August	30
September	30
October	12
	150

$$\text{Interest payable} = 20{,}00{,}000 \times 8.4\% \times \frac{150}{360} = ₹\,70{,}000$$

Total amount payable by client = 20,50,000 + 70,000 = ₹ 21,20,000

Question 13] What are the different types of issuance techniques of government securities?

Explain the term related to money market: Auction

CS (Executive) - June 2010 (2 Marks)

"It is not ethical for an issuer of a security to charge different prices for same security from different bidders in a competitive bid." Do you agree? In the light of this statement, distinguish between 'Dutch auction' and 'French auction'.

CS (Executive) - Dec 2016 (4 Marks)

Ans.: The most prevalent form of issuance technique for government securities is the auction method. Under auction method, there are other methods - French auction system, Dutch auction system, private placement and on-tap issue.

Auctioning is a method of trading whereby merchants bid against one another and where the securities are sold to the highest bidder. In securities market there are two main types of auctions, Dutch Option & French Auction.

(1) Multiple Price/French Auction : It operates on the principle of highest-bidder-wins. After receiving bids at various levels, a particular level is decided. Auction participants who bid at levels lower than the as cut-off get full allotment at a premium. Applications of bidders who bid at higher levels than the cut-off levels are rejected.

> **Example:** It is decided to issue security at ₹ 97 which is redeemable after 3 month at ₹ 100. At the time of issue various bids are received and those who make bid below ₹ 100 but up to ₹ 97 will be accepted and any bid below ₹ 97 will be rejected. Thus, if particular investor makes a bid for ₹ 97.65 it will be accepted.

(2) Uniform price/Dutch auction price : In this system security is issued at predetermined cut off price. All the bids equal to above the cut off price are accepted at cut off level. But unlike French auction, the bidder obtains the security at the cut off price.

> **Example:** It is decided to issue security at 97 which is redeemable after 3 month at ₹ 100. At the time of issue various bids are received and those who make bid below ₹ 100 but up to ₹ 97 will be accepted but at cut off rate *i.e.* ₹ 97. Thus, if particular investor makes a bid for ₹ 97.65 it will be accepted at ₹ 97.

(3) Private placement : The Central Government may also privately place government securities with RBI. The issue is priced at market related yields. RBI may later offload these securities to the market through Open Market Operations (OMO).

(4) On-tap issue : Under this scheme of arrangements after the initial primary auction of a security, the issue remains open to yet further subscriptions. The period for which the issue remains open may be time specific or volume specific.

(5) Fixed coupon issue : Government Securities may also be issued for a notified amount at a fixed coupon.

Open market operations (OMO) : When a central bank buys or sells government bonds on the open market it is known as open market operation. A central bank uses them as the primary means of implementing monetary policy. The usual aim of open market operations is to control the short term interest rate and the supply of base money in an economy, and thus indirectly control the total money supply. This involves meeting the demand of base money at the target interest rate by buying and selling government securities, or other financial instruments. Monetary targets such as inflation, interest rates or exchange rates are used to guide this implementation.

Question 14] Distinguish between : French Auction & Dutch Auction

CS (Inter) - Dec 2005 (2 Marks)

CS (Executive) - June 2009 (4 Marks), Dec 2014 (3 Marks)

Ans.: Following are the main distinction between French & Dutch Auction:

Point	French Auction	Dutch Auction
Meaning	It operates on the principle of highest-bidder-wins. After receiving bids at various levels, a particular level is decided. Auction participants who bid at levels lower than the as cut-off get full allotment at a premium.	In this system security is issued at predetermined cut off price. All the bids equal to above the cut off price are accepted at cut off level. But unlike French auction, the bidder obtains the security at the cut off price.
Return	Return differs from investor to investors.	Return for all the investor will be the same.
Treasury bill	This method is followed in issue of 364 days treasury bills.	This method is followed in issue of 91 days treasury bills.
Shares	In November 2009, SEBI allowed companies to go for French Auction (Multiple Price Auction) in a follow-on public offer (FPO). It operates on the principle of highest-bidder-wins. The companies making public issues will fix only the floor price. The prospective buyers submit bids that specify a quantity and the price (above the floor price) at which they wish to purchase the desired quantity. Allocation of shares will begin on a top-down basis starting with the highest bidder. However, if the issuer wants to put a cap on allotting shares to a single bidder, it is allowed to do so.	In India, primary issuances of equity shares take place through Dutch Auction, also known as Uniform Price Auction. Under this auction, companies fix a price band and the maximum difference between floor and ceiling prices in the band can be 10%. A bidder has to bid in the given band only. On the basis of demand at various price points, the offer price is fixed and applied uniformly to all investors. So, everyone will pay the same price, irrespective of their actual bid price.

Question 15] Write a short note on: Types of Government Securities

Ans.: Types of Government Securities are as follows:

→ Dated Securities

→ Zero Coupon Bonds

→ Floating Rate Bonds

→ Capital Indexed Bonds

→ Treasury Bills

Question 16] Write a short note on: Dated Securities

Dated securities are fixed maturity and fixed coupon securities.

CS (Executive) - Dec 2010 (2 Marks)

Ans.: Dated securities means a fixed interest security that has a specified date for repayment (redemption date).

Dated Securities are generally carries semi-annual coupon. These are called dated securities because these are identified by their date of maturity and the coupon, *e.g.* 11.03% GOI 2012 is a Central Government security maturing in 2012, which carries a coupon of 11.03% payable half yearly.

Key Features :

(*a*) They are **issued at face value**.

(*b*) Coupon rate is fixed at the time of issuance of security.

(*c*) The tenor (duration) of the security is also fixed.

(*d*) Interest is made on a half yearly basis.

(*e*) The security is redeemed at par at face value on its maturity date.

MONEY MARKET INSTRUMENTS

Question 17] Write a short note on : Money at call and short notice

CS (Inter) - June 2005 (5 Marks)

Distinguish between : Money at call and money at short notice CS (Inter) - Dec 2007 (4 Marks)

Ans.: Money at call is a loan that is repayable on demand. Money at call does not have a set repayment schedule, but is payable immediately and in full upon demand. Money-at-call loans give banks a way to earn interest while retaining liquidity. Investors might use money at call to cover a margin account. The interest rate on such loans is called the call-loan rate.

Money at short notice is repayable within **14 days** of serving a notice. The participants are banks & all other Indian Financial Institutions as permitted by RBI. The market is over the telephone market, non-bank participants act as lender only. Banks borrow for a variety of reasons to maintain their CRR, to meet their heavy payments, to adjust their maturity mismatch etc.

Difference between "money at call" and "money at short notice" : 'At call' money is repayable on demand, whereas 'short notice' money implies that notice of repayment of up to 14 days will be given. After cash, money at call and short notice are the banks' most liquid assets. They are usually interest-earning secured loans but their importance lies in providing the banks with an opportunity to use their surplus funds and to adjust their cash and liquidity requirements.

Question 18] Write a short note on: Bills re-discounting CS (Inter) - June 2004 (2 Marks)

CS (Executive) - Dec 2012 (3 Marks)

Ans.: Generally bill of exchange and other negotiable instruments are discounted with bank. But due such discounting bank may face a problem of liquidity hence banks or financial institutions discounts the bill discounted in other banks or financial institution or with central bank which is called as rediscounting of bill.

Banks can rediscount the bills with the RBI and other approved institutions like LIC, GIC, UTI, ICICI, IFCI, DFHI etc.

As per RBI's guidelines regarding bill discounting by the commercial banks should not rediscount the bill discounted by NBFC as the RBI has provided enough rediscounting facilities to the banks, they can get the bill rediscounted from other banks.

Establishment of **Discount & Finance House of India (DFHI)** is a landmark step in this direction.

DFHI aims to impart liquidity to commercial bills, which have already been discounted by commercial banks or FI. For this purpose, it announces its bid and rediscount rates on a fortnightly basis.

Question 19] Write a short note on: Treasury Bills **CS (Executive) - Dec 2009 (5 Marks)**

Write a short note on: 364 days treasury bill **CS (Inter) - June 2004 (2 Marks)**

"Treasury bill is a powerful instrument in the money market." Comment.

CS (Inter) - Dec 2006 (4 Marks)

CS (Executive) - June 2014 (5 Marks)

Ans.: Treasury bills are money market instruments to finance the short term requirements of the Government of India. These are discounted securities and thus are issued at a discount to face value. The return to the investor is the difference between the face value and issue price.

Key features :

(1) **Objectives :** These are issued to raise funds for meeting expenditure needs and also provide outlet for parking temporary surplus funds by investors.

(2) **Investors :** Treasury bills can be purchased by any one (including individuals) except State Govt. These are issued by RBI and sold through fortnightly or monthly auctions at varying discount rate depending upon the bids.

(3) **Maturity :** 14 days, 91 days, 182 days and 364 days.

(4) **Issue :** Treasury bills are issued by auctions. The auction of treasury bills is done by RBI through Mumbai.

(5) **Rate of interest :** Market determined, based on demand for and supply of funds in the money market.

(6) **Minimum amount of bids :** Bids for treasury bills are to be made for a minimum amount of ₹ 25,000 only and in multiples thereof.

(7) **Day Count :** For treasury bills the day count is taken as 365 days for a year.

(8) **Availability :** All treasury bills are highly liquid instruments available both in the primary and secondary market.

(9) **Benefits of investment in Treasury Bills**

→ No TDS

→ Zero risk

→ Highly liquid instrument

→ Better returns in short term

→ Simplified settlement

→ Active secondary market

(10) **Return/yield calculation :** The return on treasury bill is calculated as follows:

$$\text{YTM} = \frac{(100 - P)}{P} \times \frac{365}{D} \times 100$$

P = Price

D = Days to maturity

(11) **Types of treasury bills :** These are 4 types of treasury bills.

Type	Maturity period	Auction	Notified amount
14 day T-bill	Maturity is in 14 days	Its auction is on every Friday of every week.	₹ 100 crore
91 day T-bill	Maturity is in 91 days	Its auction is on every Friday of every week.	₹ 100 crore
182 day T-bill	Maturity is in 182 days	Its auction is on every alternate Wednesday. (which is not a reporting week)	₹ 100 crore
364 day T-bill	Maturity is in 364 days	Its auction is on every alternate Wednesday. (which is a reporting week)	₹ 500 crore

Question 20] How treasury bills are issued? State the procedure for such issue

Ans.: Treasury bills are issued by auctions. The auction of treasury bills is done by RBI through Mumbai office.

Types of auctions: There are two types of auctions for treasury bills:

(1) **Multiple price/French auction:** Under this method, all bids **equal to or above** the cut-off price are accepted. However, the bidder has to obtain the treasury bills at the price quoted by him. This method is followed in the case of 364 days treasury bills and is valid only for competitive bidders.

(2) **Uniform price/Dutch auction:** Under this system, all the bids equal to or above the cut-off price are accepted at the cut-off level. However, unlike the Multiple Price based method, the bidder obtains the treasury bills at the cut-off price and not the price quoted by him. This method is applicable in the case of 91 days treasury bills only. The system of Dutch auction has been done away with by the RBI w.e.f. 8.12.2002 for the 91 days treasury Bill.

Question 21] A co-operative bank wishes to buy 91 days T-bill maturing on 6th December, 2016 on 12th October, 2016. The rate quoted by seller is ₹ 99.1489 per ₹ 100 face values. Calculate yield to maturity (YTM).

Ans.: The days to maturity of Treasury bill are 55 days as shown below:

Months	Days
October (31 - 11)	20
November	30
December	5
	55

$$\text{YTM} = \frac{100 - 99.1489}{99.1489} \times \frac{365}{55} \times 100 = 5.6966\% \text{ } i.e. \text{ } 5.7\%$$

Note: For government dated securities and State Government securities the day count is taken as 360 days for a year and 30 days for every completed month. ***However, for T-bills it is 365 days for a year.***

Question 22] RBI sold a 91-day T-bill of face value of ₹ 100 at an yield of 6%. What was the issue price? **CA (Final) - May 2005 (2 Marks)**

Ans.:

$$\text{Interest for 91 days} = 6 \times \frac{91}{365} = 1.4959\%$$

Amount received + Interest = Face Value

100 + 1.4959 = 101.4959

In problem amount on maturity is given which will be 101.995%.

For 101.4959 - 100

For 100 - ?

$$\text{Amount to be invested in T-bill} = 100 \times \frac{100}{101.4959} = 98.5261$$

Verification :

Amount received on issue of T-bill	100.0000	98.5261
Add: Interest	1.4959	1.4739
Face value	101.4959	100.0000

Question 23] On 30th October, 2015, Shan Co-operative Bank buys 91-day treasury bill maturing on 24th December, 2015. The rate quoted by the seller is ₹ 99.25 per ₹ 100 face value. Calculate the yield percentage of the treasury bill. **CS (Inter) – June 2006 (5 Marks)**

Ans.: The days to maturity of T bill are 55 days as shown below:

Months	Days
October (31 – 29)	2
November	30
December	23
	55

$$YTM = \frac{100 - 99.25}{99.25} \times \frac{365}{55} \times 100 = 5.0149\%$$

Question 24] On 25th January, 2013, XY Bank purchased a 91-day treasury bill maturing on 16th March, 2013. The rate quoted by the seller is ₹ 99.25 per ₹ 100 face value. Compute the yield percentage of the treasury bill. **CS (Executive) – Dec 2014 (3 Marks)**

Ans.: The days to maturity of T bill are 50 days as shown below:

Months	Days
January (31 – 24)	7
February	28
March	15
	50

$$YTM = \frac{100 - 99.25}{99.25} \times \frac{365}{50} \times 100 = 5.5164\%$$

Question 25] As on 1st April, 2008, Cash Rich Ltd. has surplus cash for 6 months. It has following two options under consideration for investing the surplus cash:

(i) To invest in fixed deposit at the interest rate of 8% p.a. payable quarterly and

(ii) To buy treasury bills of the face value of ₹ 100 at ₹ 98.019 with maturity after 6 months.

Presuming that the risk involved in both the options is identical, state giving reasons which option should be selected by the company for investing its surplus funds.

CS (Inter) – June 2008 (6 Marks)

CS (Executive) – Dec 2016 (4 Marks)

Ans.: Assume surplus cash is ₹ 1,00,000.

Option I: To invest surplus money in fixed deposit.

Effective Interest rate for 6 months for investment in FD 8% × 6/12 = 4%

Amount invested	100	1,00,000
Add: Interest	4	4,000
	104	1,04,000

Thus, amount available after 6 months is ₹ 1,04,000

Option II: To invest surplus money in treasury bills.

Amount Invested + Interest = Face Value

98.019 + 1.981 = 100

Amount to be invested in T-bill	98.019	1,00,000
Add: Interest	1.981	2,021
Face value	100.000	1,02,021

Analysis: From the above calculation it can be seen that investment in FD is better than T-bill.

Question 26] Write a short note on: Certificates of Deposits

CS (Executive) - Dec 2011 (3 Marks)

CS (Inter) - June 2007 (2 Marks)

Ans.: A certificate of deposit is a promissory note issued by a bank or other financial institutions. CDs are money market instruments of a relatively short duration that pay a fixed rate of interest until a given maturity date. Funds placed in such a CD cannot usually be withdrawn or can only be withdrawn with advanced notice and by having a penalty assessed.

CD can be issued to Individuals, Associations, Companies and Trust Funds. CDs are freely transferable by endorsement and delivery after an initial lock-in period of 15 days after which they may be sold to any of the above participants or to the Discount and Finance House of India (DFHI). CD are to be issued at a discount to the face value.

Master Circular on Guidelines for issue of CDs :

The guidelines for issue of CDs incorporating all the amendments issued till date are given below :

(1) **Eligibility :** CDs can be issued by scheduled commercial banks excluding RRBs and Local Area Banks (LABs) and selected all-India Financial Institutions that have been permitted by RBI to raise short-term resources within the umbrella limit fixed by RBI.

(2) **Aggregate Amount :** Banks are free to issue CDs as per their requirements. A Fl may issue CDs within the overall umbrella limit fixed by RBI *i.e.*, issue of CD together with other instruments *viz.*, term money, term deposits, commercial papers and inter corporate deposits should not exceed **100% of its net owned funds**, as per the latest audited balance sheet.

(3) **Minimum size of issue and denominations :** Minimum amount of a CD should be **₹ 1 lakh** and in the multiples of ₹ 1 lakh thereafter. CDs can be issued to individuals, corporations, companies, trusts, funds, associations, etc.

Non-Resident Indians (NRIs) may also subscribe to CDs, but only on non-repatriable basis which should be clearly stated on the certificate. Such CDs cannot be endorsed to another NRI in the secondary market.

(4) **Maturity :**

→ Banks can issue CDs for a period **not less than 7 days & not exceeding more than 1 year.**

→ FIs can issue CDs for a period **not less than 1 year & not exceeding 3 years from the date of issue.**

(5) **Discount/coupon rate :** CDs may be issued at a discount on face value. Banks/FIs are also allowed to issue CDs on **floating rate** basis provided the methodology of compiling the floating rate is objective, transparent and market based. The issuing bank/FI is free to determine the discount/coupon rate. The interest rate on floating rate CDs would have to be reset periodically in accordance with a pre-determined formula that indicates the spread over a transparent benchmark.

(6) **Reserve requirements :** Banks have to maintain the appropriate reserve requirements, *i.e.*, CRR and SLR, on the issue price of the CDs.

(7) **Transferability :** Physical CDs are freely transferable by endorsement and delivery. Demat CDs can be transferred as per the procedure applicable to other demat securities. There is **no lock-in period** for the CDs. Banks/FIs cannot grant loans against CDs. Furthermore, they cannot buy-back their own CDs before maturity.

(8) **Format of CDs :** Banks/FIs should issue CDs only in the dematerialized form. However, according to the Depositories Act, 1996, investors have the option to seek certificate in physical form. If investor

insists on physical certificate, the bank/Fl may inform to Monetary Policy Department, RBI, Central Office, Fort, Mumbai-400001 about such instances separately.

(9) **Stamp duty :** Issuance of CD attracts stamp duty.

(10) **Maturity :** There will be **no grace period** for repayment of CDs. If the maturity date happens to be holiday, the issuing bank should make payment on the immediate preceding working day. Banks/ FIs may, therefore, so fix the period of deposit that the maturity date does not coincide with a holiday to avoid loss of discount/interest rate.

(11) **Security :** Since physical CDs are freely transferable by endorsement and delivery, it will be necessary for banks to see that the certificates are printed on good quality security paper and necessary precautions are taken to guard against tempering with the document. They should be signed by two or more authorized signatories.

(12) **Payment :** Since CDs are transferable, the physical certificate may be presented for payment by the last holder. It is desirable that banks make payment only by a crossed cheque. The holders of dematted CDs will approach their respective depository participants (DPs) and have to give transfer/delivery instructions to transfer the demat security represented by the specific ISIN to the **'CD Redemption Account'** maintained by the issuer. The holder should also communicate to the issuer by a letter/fax enclosing the copy of the delivery instruction it had given to its DP and intimate the place at which the payment is requested to facilitate prompt payment. Upon receipt of the Demat credit of CDs in the "CD Redemption Account", the issuer, on maturity date, would arrange to repay to holder/ transferor by way of Banker's cheque/high value cheque, etc.

(13) **Issue of duplicate certificates :** In case of the loss of physical CD certificates, duplicate certificates can be issued after compliance of the following:

   (a) A notice is required to be given in at least one local newspaper

   (b) Lapse of a reasonable period (say 15 days) from the date of the notice in the newspaper, and

   (c) Execution of an indemnity bond by the investor to the satisfaction of the issuer of CD.

   The duplicate certificate should only be issued in physical form. No fresh stamping is, required as a duplicate certificate is issued against the original lost CD. The duplicate CD should clearly state that the CD is a Duplicate one stating the original value date, due date, and the date of issue as "Duplicate issued on............"

(14) **Accounting :** Banks/FIs may account the issue price under the Head "CDs issued" and show it under deposits. Accounting entries towards discount will be made as in the case of "cash certificates". Banks/FIs should maintain a register of CDs issued with complete particulars.

Question 27] P Co. has to make payment of ₹ 20,00,000 on 16th April, 2015. It has surplus money today i.e. 15th January, 2015 and the company has decided to invest in Certificates of Deposits of a leading nationalized bank at 8% p.a. What money is required to be invested now?

CA (Final) - Nov 1998 (5 Marks)

Ans.: The days to maturity of CD are 91 days. (17 + 28 + 31 + 15 = 91 days)

Interest for 91 days = 8 × 91/365 = 1.9945%

Amount Received + Interest = Face Value

100 + 1.9945 = 101.9945

In problem amount on maturity is given which will be 101.995%.

For 101.9945 - 20,00,000

For 100 - ?

$$\text{Amount to be invested in CD} = \frac{20,00,000}{101.9945} \times 100 = 19,60,890$$

Verification:

Amount received on issue of CD	100	19,60,890
Add: Interest	1.9945	39,110
Face value	101.995	20,00,000

Question 28] Write a short note on: Inter-Corporate Deposits **CS (Inter) - June 2007 (2 Marks)**

Ans.: An Inter-Corporate Deposit (ICD) is an unsecured borrowing by corporate and FIs from other corporate entities registered under the Companies Act, 2013. The corporate having surplus funds would lend to another corporate in need of funds. This lending would be an uncollateralized basis and hence a higher rate of interest would be demanded by the lender. The short term credit rating of the corporate would determine the rate at which the corporate would be able to borrow funds.

Primary Dealers are only permitted to borrow in the ICD market. The borrowing under ICD is restricted to **50% of the Net Owned Funds** and the minimum tenor of borrowing is for **7 days**.

Provisions of Companies Act, 2013 : As per **Companies (Acceptance of Deposits) Rules, 2014,** any amount received by a Company from any other Company is not deposit. Thus, said rule is not applicable for inter corporate deposit.

Eligibility : Corporate & FIs from other corporate entities registered under the Companies Act, 2013 are eligible for inter corporate deposit.

Period : The tenor of ICD may range from **7 days to 1 year,** but the most common tenor of borrowing is for 90 days.

Interest Rate : Interest depending on market conditions.

Question 29] Distinguish between: Certificate of Deposit and Inter Corporate Deposit
CS (Executive) - Dec 2014 (3 Marks)

Ans.: Following are the main distinctions between certificate of deposit and inter corporate deposit:

Points	Certificate of Deposit	Inter Corporate Deposit
Meaning	A certificate of deposit is a promissory note issued by a bank or other financial institutions.	An Inter-Corporate Deposit (ICD) is an unsecured borrowing by corporate and FIs from other corporate entities registered under the Companies Act, 2013.
Issuer	CDs can be issued by scheduled commercial banks excluding RRBs and Local Area Banks (LABs) and selected all-India Financial Institutions that have been permitted by RBI to raise short-term resources within the umbrella limit fixed by RBI.	Inter-Corporate Deposit can be given by one corporate to other corporate.
Minimum amount	Minimum amount of a CD should be ₹ 1 lakh and in the multiples of ₹ 1 lakh thereafter.	There is no minimum amount as such.
Eligibility	CDs can be issued to individuals, corporations, companies, trusts, funds, associations, etc.	Corporate & FIs from other corporate entities registered under the Companies Act, 2013 are eligible for inter corporate deposit.
Market	The CDs market is an organized market.	The ICD market is not organized.

Question 30] Write a short note on: Commercial Bills

Ans.: Commercial Bills of Exchange arise out of genuine trade transactions and are drawn by the seller of the goods on the buyers (*i.e.* debtors), where goods are sold on credit. They are also known as **'Trade Bills'**. Person who draws the bill (seller) is known as drawer and person on whom bill is drawn is known as drawee. By accepting the bills, the drawee gives his consent to make payment of the bills on the due date. Thus, payment of the bills is assured on the dates of maturity.

The drawer generally discounts the bill with a commercial bank. Thus, the drawer gets payment of the bill immediately. The discounting banker, however, recovers the money from the acceptor of the bill on the due date of the bill.

Commercial Bill of Exchange is a negotiable instrument *i.e.* it may be negotiated (or endorsed or transferred) any number of times till its maturity.

The RBI introduced a Re-discounting Scheme in 1970. Under this scheme bills are re-discounted by RBI or other financial institution. But important pre-conditions are that the bill should arise out of a genuine trade transaction, must be accepted by the buyer's banker either singly or jointly with him and the period of maturity should not exceed 90 days.

Question 31] What do you understand by 'Commercial Papers'? What are its key features? Also state the guidelines applicable for Commercial Papers.

Briefly discuss the guidelines for issue of commercial paper.

CS (Executive) - June 2009 (4 Marks)

Explain the term: Commercial Paper **CS (Executive) - June 2012 (2 Marks)**

Ans.: Commercial Paper (CP) is an **unsecured** money market instrument issued in the form of a promissory note. It was introduced in India in **1990**. It was introduced with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors. Subsequently, primary dealers and all-India financial institutions were also permitted to issue CP to enable them to meet their short-term funding requirements for their operations.

Key features :

(1) **Issue of CP:** Corporate, primary dealers and FIs are eligible to issue CP. The total amount of CP proposed to be issued should be raised within a period of **2 weeks** from the date on which the issuer opens the issue for subscription. CP may be issued on a single date or in parts on different dates provided that in the latter case, each CP shall have the same maturity date. Further, every issue of CP, including renewal, shall be treated as a fresh issue.

CP will be issued at a discount to face value as may be determined by the issuer.

(2) **Eligibility :** All the corporates are eligible to issue CP provided:
   (*a*) Tangible **net worth** of the company, as per the latest audited balance sheet, is not less than ₹ **4 Crore**.
   (*b*) Company has been sanctioned working capital limit by bank or all-India financial institution and
   (*c*) The **borrowal account** of the company is classified as a **Standard Asset** by the financing banks/institutions.

(3) **Credit rating :** All eligible participants shall obtain the credit rating for issuance of CP either from CRISIL or ICRA or CARE or other credit rating agency as may be specified by the RBI. The minimum credit rating shall be **A3**. The issuers shall ensure at the time of issuance of CP that the rating so obtained is current and has not fallen due for review.

(4) **Maturity :** CP can be issued for maturities between **7 days to 1 year** from the date of issue.

(5) **Limit :** The aggregate amount of CP from an issuer shall be within the limit as approved by its Board of Directors or the quantum indicated by the Credit Rating Agency for the specified rating, whichever is lower. As regards FIs, they can issue CP within the overall umbrella limit prescribed in the Master Circular on Resource Raising Norms for FIs, issued by DBOD and updated from time-to-time.

(6) **Denominations :** CP can be issued in denominations of ₹ **5 lakh or multiples** thereof.

(7) **Issuing and paying agent (IPA) :** Only a scheduled bank can act as an IPA for issuance of CP.

(8) **Who can invest in CP :** Individuals, banking companies, other corporate bodies (registered or incorporated in India) and unincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs) etc. can invest in CPs. However, investment by FIIs would be within the limits set for them by SEBI from time-to-time.

(9) **Dematerialised form :** CP can be issued either in the form of a promissory note or in a dematerialised form through any of the depositories approved by and registered with SEBI. Banks, FIs and PDs can hold CP only in dematerialised form.

(10) **Trading in secondary market :** CPs are actively traded in the OTC market. Such minutes transactions, however, are to be reported on the *FIMMDA reporting platform within 15 minutes of the trade for dissemination of trade information to market participation thereby ensuring market transparency.

*Fixed Income Money Market & Derivatives Association of India (FIMMDA)

(11) **Standby facility by the bankers/FIs for CP issue :** It would not be obligatory on the part of banks and FIs to provide stand-by facility to the issuers of CP. However, Banks and FIs have the flexibility to provide for a CP issue, stand-by assistance/credit backstop facility, etc., based on their commercial judgment and as per terms prescribed by them.

(12) **Procedure for issuance :** Every issuer must appoint an IPA for issuance of CP. The issuer should disclose to the potential investors its financial position as per the standard market practice. After the exchange of deal confirmation between the investor and the issuer, issuing company shall issue physical certificates to the investor or arrange for crediting the CP to the investor's account with a depository. Investors shall be given a copy of IPA certificate to the effect that the issuer has a valid agreement with the IPA and documents are in order.

(13) **Role and responsibilities :** The role and responsibilities of issuer, IPA and CRA are set out below:

(*a*) **Issuer :** With the simplification in the procedures for CP issuance, issuers would now have more flexibility. Issuers would, however, have to ensure that the guidelines and procedures laid down for CP issuance are strictly adhered to.

(*b*) Issuing and Paying Agent (IPA):

(*i*) IPA would ensure that issuer has the minimum credit rating as stipulated by the RBI and amount mobilised through issuance of CP is within the quantum indicated by CRA for the specified rating.

(*ii*) IPA has to verify all the documents submitted by the issuer *viz.*, copy of board resolution, signatures of authorised executants (when CP in physical form) and issue a certificate that documents are in order. It should also certify that it has a valid agreement with the issuer (Schedule III).

(*iii*) Original documents verified by the IPA should be held in the custody of IPA.

(*c*) Credit Rating Agency (CRA)

(*i*) Code of Conduct prescribed by the SEBI for CRAs for undertaking rating of capital market instruments shall be applicable to them (CRAs) for rating CP.

(*ii*) Further, the credit rating agency would henceforth have the discretion to determine the validity period of the rating depending upon its perception about the strength of the issuer. Accordingly, CRA shall at the time of rating, clearly indicate the date when the rating is due for review.

(*iii*) While the CRAs can decide the validity period of credit rating, CRAs would have to closely monitor the rating assigned to issuers *vis-a-vis* their track record at regular intervals and would be required to make its revision in the ratings public through its publications and website.

(14) **Documentation procedure :** FIMMDA may prescribe standardized procedure and documentation that are to be followed by the participants. Till such time, the procedures/documentations prescribed by IBA should be followed.

Violation of these guidelines will attract penalties prescribed in the Act by the RBI and may also include debarring from the CP market.

Question 32] ABC Ltd. wanted to issue commercial papers (CPs) worth ₹ 100 crore during March, 2014. For this, it obtained rating from three rating agencies and in the month of February, 2014, all the rating agencies gave A2 rating. But on 4th March, 2014, one of the agencies revised its rating to A3 before the issue of CPs. As a Company Secretary, advise whether the company can issue CPs to raise money for a short period **CS (Executive) - Dec 2010 (2 Marks)**

Ans.: Credit rating is mandatory for issue of commercial papers. All issuer of CPs shall obtain the credit rating for issuance of CP either from CRISIL or ICRA or CARE or other credit rating agency. The minimum credit rating shall be **A3**. The issuers shall ensure at the time of issuance of CP that the rating so obtained is current and has not fallen due for review.

In the given case one of the rating agency has degraded the earlier rating for A2 to A3 before issue of CP. However, still its rating is not below the prescribed rating and hence ABC Ltd. can issue commercial paper.

Question 33] Distinguish between: Commercial bill & Commercial paper

CS (Inter) - Dec 2006 (2 Marks), June 2008 (4 Marks)

CS (Executive) - June 2010 (3 Marks), Dec 2012 (3 Marks)

Ans.: Following are the main distinctions between Commercial bill & Commercial paper:

Points	Commercial bill	Commercial paper
Meaning	Commercial Bills of Exchange arise out of genuine trade transactions and are drawn by the seller of the goods on the buyers (*i.e.* debtors), where goods are sold on credit. They are also known as **'Trade Bills'**.	Commercial Paper (CP) is an **unsecured** money market instrument issued in the form of a promissory note.
Who issue	Seller of goods or service issues bill of exchange on purchaser.	Corporate, primary dealers and FIs are eligible to issue CP.
Trading in secondary market	Commercial Bills are endorsed or can be discounted with banks.	Commercial Paper are actively traded in secondary market.
Credit rating	No credit rating required for Commercial Bills.	All eligible participants shall obtain the credit rating for issuance of CP either from CRISIL or ICRA or CARE or other credit rating agency
Issue amount	Commercial Bills can be issued for any amount.	CP can be issued in denominations of **₹ 5 lakh or multiples** thereof.

Question 34] Z Ltd. issued CP as per the following details

Date of issue - 17th January, 2010

Date of maturity - 17th April, 2010

Interest rate - 11.25% p.a.

Amount received is - 9.73 crore

At what amount this CP will be redeemed? **CA (Final) - May 1998 (5 Marks)**

Ans.: The days to maturity of CP are 90 as shown below:

Months	Days
January (31 - 16)	15
February	28
March	31
April	16
	90

Interest for 90 days = 11.25 × 90/365 = 2.774%

CP are redeemed at face value.

Hence,

Amount Received + Interest = Face Value

100 + 2.774 = 102.774

9.73 crore + 0.27 crore = 10 crore

Question 35] From the following particulars, calculate the effective interest p.a. as well as the total cost of funds to ABC Ltd., which is planning a CP issue:

Issue price of CP - ₹ 97,350

Face value - ₹ 1,00,000

Maturity period - 3 months.

Issue expenses:

Brokerage: 0.125% for 3 months.

Rating charges: 0.5% p.a.

Stamp duty: 0.125% for 3 months

CA (Final) - May 2006 (6 Marks)

Ans.: CP are redeemed at face value.

Hence,

Amount Received + Interest = Face Value

97,350 + x = 1,00,000

x = Interest = 2,650

$$\text{Interest rate} = \frac{\text{Interest}}{\text{Amount Received}} \times 100$$

$$\text{Interest rate} = \frac{2{,}650}{97{,}350} \times 100 = 2.7221\%$$

$$\text{Interest rate for the year} = 2.7221 \times \frac{12}{3} = 10.89\%$$

Calculation of total cost of funds :

Interest rate for the year	10.89%
(+) Brokerage (0.125 × 4)	0.50%
(+) Rating charges	0.50%
(+) Stamp duty (0.125 × 4)	0.505
	12.39%

Question 36] Kastro Ltd. issued commercial paper as per following details :

Date of issue 19th October, 2006

Date of maturity 17th January, 2007

Interest rate 7.25% p.a.

Face value of commercial paper ₹ 10 crore

What was the net amount received by the company on issue of commercial paper?

CS (Final) - June 2007 (5 Marks)

Ans.: The days to maturity of CP are 90 as shown below :

Months	Days
October (31 - 18)	13
November	30
December	31
January	16
	90

$$\text{Interest for 90 days} = 7.25 \times \frac{90}{365} = 1.7877\%$$

CP are redeemed at face value.

Hence,

Amount Received + Interest = Face Value

100 + 1.787671232 = 101. 787671232

In problem face value has been given which will be 101.7877%.

For 101.787671232 - 10,00,00,000

For 100 - ?

$$\text{Amount received on issue of CP} = \frac{10{,}00{,}00{,}000}{101.\ 787671232} \times 100 = 9{,}82{,}43{,}725$$

Verification:

Amount received on issue of CP	100	9,82,43,725
Add: Interest	1. 787671232	17,56,275
Face value	101. 787671232	10,00,00,000

Question 37] A company issues 90 days commercial papers of the face value of ₹ 1,000 at ₹ 980. The credit rating expenses are 0.6% of the size of issue, issuing and paying agent charges are 0.25% and stamp duty is to be paid @ 0.20%.

You are required to calculate : Cost of issuing commercial papers.

CS (Inter) - June 2009 (4 Marks)

Ans.: CP are redeemed at face value.

Hence,

Amount received + Interest = Face Value

980 + 20 = 1,000

$$\text{Interest rate} = \frac{\text{Interest}}{\text{Amount received}} \times 100$$

$$\text{Interest rate for 90 days} = \frac{20}{980} \times 100 = 2.0408\%$$

$$\text{Interest rate for the year} = 2.0408 \times \frac{365}{90} = 8.28\%$$

Calculation of total cost of funds:

Interest rate for the year	8.28%
Add: Credit rating expenses (0.6 × 365/90)	2.43%
Add: Issuing & paying agent charges (0.25 × 365/90)	1.01%
Add: Stamp duty (0.20 × 365/90)	0.81%
	12.53%

Question 38] Write a short note on: Gilt-edged Securities

CS (Inter) - June 2003 (5 Marks), June 2007 (2 Marks)

Describe the issue process of guilt edged securities **CS (Inter) - Dec 2005 (8 Marks)**

Ans.: Gilts are securities issued by certain national governments. The term is of British origin, and originally referred to the debt securities issued by the Bank of England, which had a gilt (or gilded) edge. Hence, they are called gilt-edged securities, or gilts for short. These securities are normally referred to, as "gilt-edged" as repayments of principal as well as interest are totally secured by sovereign guarantee. Thus securities issued by Central or State Government or semi government authorities are called as gilt-edged securities.

Key Features :

(1) **Who can issue G-Sec. :** These securities are issued by:
   - Central & State Governments
   - Semi-Government Authorities
   - City Corporations, Municipalities
   - Port Trust
   - State Electricity Boards
   - Metropolitan Authorities
   - Housing Boards, and
   - Large Financial Institutions.

(2) **Security :** These securities are issued by the government, hence they are most secured financial instruments which guarantees both safety of the capital and the income.

(3) **Rate of interest :** The rate of interest is low but it is payable half-yearly.

(4) **Issue :** These securities are issued by the **Public Debt Office** (PDO) of the RBI. They are not auctioned, their issues are notified a few days before opening for subscription and offer is kept open for **2 to 3 days**.

DEVELOPMENT, GROWTH & DRAWBACKS OF MONEY MARKET

Question 39] "The board objective of the money market are to provide a balancing mechanism for short surpluses and deficiencies". Discuss. **CS (Inter) - Dec 2003 (4 Marks)**

Ans.: Money Market is the market for dealing in **monetary assets** of **short-term nature**. It is a formal financial market that deals with short-term fund management. Funds are available in this market for periods ranging from a **single day up to a year**.

It helps in meeting the short-term requirements of banks, financial institutions, firms, companies and also the Government. On the other hand, the surplus funds for short periods, with individuals and other savers, are mobilized through the market and made available to the banking system and money market entities for utilization by them. Thus, the money market provides a mechanism for evening out short-term liquidity imbalances within an economy. The development of the money market is, thus, a prerequisite for the growth and development of the economy of a country.

Major features or characteristics money market :

(1) **Structure:** It is a significant aspect of the Indian money market. It has a simultaneous existence of both the organized money market as well as unorganized money markets. The organized money market consists of RBI, all scheduled commercial banks and other recognized financial institutions. However, the unorganized part of the money market comprises domestic money lenders, indigenous bankers, trader, etc. The organized money market is in full control of the RBI. However, unorganized

money market remains outside the RBI control. Thus both the organized and unorganized money market exists simultaneously.

(2) **Seasonality :** The demand for money in Indian money market is of a seasonal nature. India being an agriculture predominant economy, the demand for money is generated from the agricultural operations.

(3) **Multiplicity of interest rates :** Interest rates differ from bank to bank from period to period and even from borrower to borrower. Again in both organized and unorganized segment the interest rate differs.

Question 40] The money market are to provide a balancing mechanism for short surpluses and deficiencies but still has some arguments against it. Discuss this statement pointing out the various drawbacks of money market.

Ans.: Money Market is the market for dealing in **monetary assets** of **short-term nature**. It is a formal financial market that deals with short-term fund management. Funds are available in this market for periods ranging from a **single day up to a year**.

Money markets are particularly low risk and therefore are not suitable for an investor looking for high returns. The money markets are used for short-term loans only and are not designed to achieve long-term growth of assets. Despite the apparent low risk of the money markets, all transactions in them must be properly assessed in the context of the global market. When the global financial markets go through one of their periodic cycles of turmoil and instability, one should always err on the side of caution with any investment.

Drawbacks of Indian money market are :

(1) **Absence of integration :** The Indian money market is broadly divided into the Organized and Unorganized Sectors. The former comprises the legal financial institutions backed by the RBI. The unorganized statement of it includes various institutions such as indigenous bankers, village money lenders, traders, etc. There is lack of proper integration between these two segments.

(2) **Multiple rate of interest :** In the Indian money market, especially the banks, there exists too many rates of interests. These rates vary for lending, borrowing, government activities, etc. Many rates of interests create confusion among the investors.

(3) **Insufficient funds or resources :** The Indian economy with its seasonal structure faces frequent shortage of financial recourse. Lower income, lower savings, and lack of banking habits among people are some of the reasons for it.

(4) **Shortage of investment instruments :** In the Indian money market, various investment instruments such as T-Bills, Commercial Bills, CDs, CP, etc. are used. But taking into account the size of the population and market these instruments are inadequate.

(5) **Shortage of commercial bill :** In India, as many banks keep large funds for liquidity purpose, the use of the commercial bills is very limited. Similarly since a large number of transactions are preferred in the cash from the scope for commercial bills are limited.

(6) **Lack of organized banking system :** In India even though we have a big network of commercial banks, still the banking system suffers from major weaknesses such as the NPA, huge losses, poor efficiency. The absence of the organized banking system is major problem for Indian money market.

(7) **Less number of dealers :** There are poor number of dealers in the short-term assets who can act as mediators between the government and the banking system. The less number of dealers leads to the slow contact between the end lender and end borrowers.

FACTORING

Question 41] What do you understand by the term 'factoring'?

Ans.: Factoring is an arrangement to have debts collected by a third party entity for a fee. A large business house has two options, namely either to manage its own receivables or to entrust the task of such management to a third party for a fee. In factoring arrangement the debts as and when fall due are collected by the factor.

Parties in Factoring: The factoring transaction involves three parties:

- The Seller, who has produced the goods/services and raised the invoice.
- The Buyer, the consumer of goods/services and the party to pay.
- The Factor, the financial institution that advances the portion of funds to the seller and recovers the amount from buyer.

Factoring Arrangement:

1. The factor enters into an agreement with the seller for rendering factor services *i.e.* collection of receivables/debts.
2. The factor pays 80% or more of the amount of receivables copies of sale documents.
3. The factor receives payments from the buyer on due dates and pays the balance money to the seller after deducting the service charges.

Functions of a Factor: The purchase of book debts or receivables is central to the function of factoring permitting the factor to provide basic services such as:

- ◆ Administration of sellers' sales ledger.
- ◆ Collection of receivables purchased.
- ◆ Provision of finance.
- ◆ Protection against risk of bad debts/credit control and credit protection.
- ◆ Rendering advisory services by virtue of their experience in financial dealings with customers.

Question 42] Discuss the steps involved in the process of factoring.

CS (Executive) - Dec 2013 (5 Marks)

Ans.: The steps involved in factoring operations are:

1. Customer (buyer) places the order to the client (seller)
2. Client (seller) fixes the limit.
3. Client delivers the goods and instructs the customer to make payment to the factor.
4. Factor sends the invoice copy to the client.
5. Factor makes the pre-payment of invoice to the client.
6. Factor follows up with the customer
7. Customer makes the payment to the factor
8. Factor after deducting its fees and other charges pays the balance amount to the client.

Question 43] Write a note on: Advantages of Factoring

Factoring is a financial option for the management of receivables. In the light of this statement, explain the meaning and advantage of factoring.

CS (Executive) - June 2015 (3 Marks)

Ans.: Factoring is an arrangement to have debts collected by a third party entity for a fee.

Advantages of Factoring: Factoring is becoming popular all over the world on account of various services offered by the institutions engaged in it. Factors render services ranging from bill discounting facilities offered by the commercial banks to total takeover of administration of credit sales including maintenance of sales ledger, collection of accounts receivables, credit control, protection from bad debts, provision of finance and rendering of advisory services to their clients. Thus, factoring is a tool of receivables management employed to release the funds tied up in credit extended to customers and to solve problems relating to collection, delays and defaults of the receivables.

A firm that enters into factoring agreement is benefited in a number of ways, some of the important benefits are outlined below:

- The factor provides specialised services with regard to sales ledger administration and credit control and relieves the client from botheration of debt collection. He can concentrate on the other major areas of his business and improve his efficiency.
- The advance payments made by the factor to the client in respect of the bills purchased increase his liquid resources. He is able to meet his liabilities as and when they arise thus improving his credit standing position before suppliers, lenders and bankers. The factor's assumption of credit risk relieves him from the tension of bad debt losses. The client can take steps to reduce his reserve for bad debts.
- It provides flexibility to the company to decide about extending better terms to their customers.
- The company itself is in a better position to meet its commitments more promptly due to improved cash flows.
- Enables the company to meet seasonal demands for cash whenever required.
- Better purchase planning is possible. Availability of cash helps the company to avail cash discounts on its purchases.
- As it is an off balance sheet finance, thus it does not affect the financial structure. This would help in boosting the efficiency ratios such as return on asset etc.
- Saves the management time and effort in collecting the receivables and in sales ledger management.
- Where credit information is also provided by the factor, it helps the company to avoid bad debts.
- It ensures better management of receivables as factor firm is specialised agency for the same.

Question 44] Write a note on: Types of Factoring

Ans.: Various types of factoring are as follows:

(1) **Non-Recourse or Full Factoring :** Under this type of factoring the bank takes all the risk and bear all the loss in case of debts becoming bad debts.

(2) **Recourse Factoring :** Under this type of factoring the bank purchases the receivables on the condition that any loss arising out or bad debts will be borne by the company which has taken factoring.

(3) **Maturity Factoring :** Under this type of factoring bank does not give any advance to the company rather bank collects it from customers and pays to the company either on the date of collection from the customers or on a guaranteed payment date.

(4) **Advance Factoring :** Under advance factoring arrangement the factor provides an advance against the uncollected and non-due receivables to the firm.

(5) **Undisclosed Factoring :** Under this type of factoring, the customer is not informed of the factoring arrangement. The firm may collect dues from the customer on its own or instruct to make remit once at some other address.

(6) **Invoice Discounting :** Under this type of factoring the bank provide an advance to the company against the account receivables and in turn charges interest rate from the company for the payment which bank has given to the company.

OBJECTIVE QUESTIONS

Question A] Expand the following abbreviations (with reference to money market):

(1)	FII	(6)	SLR	(11)	DFHI	(16)	RRB	(21)	FIMMDA
(2)	MF	(7)	FRBs	(12)	MMMF	(17)	LAB	(22)	IPA
(3)	DII	(8)	OMO	(13)	T-bills	(18)	CRR	(23)	CRA
(4)	IPBC	(9)	FPO	(14)	YTM	(19)	ICD		
(5)	GOI	(10)	WIP	(15)	CD	(20)	CP		

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

(1) .... is the market for dealing in monetary assets of short-term nature.

(2) Money Market is a formal financial market that deals with ....

(3) Money market is a .... debt market.

(4) Money market is regulated by..........

(5) .... are securities issued by the Government for raising a public loan or as notified in the official Gazette.

(6) Government Securities are mostly interest bearing dated securities issued by .... on behalf of the Government of India.

(7) The most prevalent form of issuance technique for government security is the .... method.

(8) In securities market there are two main types of auctions, ... & .... auction.

(9) .... is followed in issue of 364 days treasury bills.

(10) .... means a fixed interest security that has a specified date for repayment (redemption date).

(11) Dated securities are issued at a ....

(12) .... bonds are bonds with variable interest rate with a fixed percentage over a benchmark rate, which may be treasury bill rate, bank rate etc.

(13) Floating rate bonds are issued at ....

(14) .... are bonds where interest rate is a fixed percentage over the wholesale price index (WIP).

(15) Capital Indexed Bonds are bonds where interest rate is a fixed percentage over the.....................

(16) Capital Indexed Bonds are issued at ....

(17) .... is a loan that is repayable on demand, and money at short notice is repayable within 14 days of serving a notice.

(18) Money at call is a loan that is repayable on demand, and money at short notice is repayable within .... of serving a notice.

(19) .... aims to impart liquidity to commercial bills, which have already been discounted by commercial banks or FI.

(20) .... is a mutual fund that invests in money market instruments.

(21) The call money market refers to the market for short period loans; say ....

(22) .... is basically over-the-telephone market.

(23) .... are money market instruments to finance the short term requirements of the Government of India.

(24) Treasury bills are discounted securities and thus are issued at a ....

(25) Treasury bills can be purchased by any one (including individuals) except ....

(26) Treasury bills are issued by .... method.

(27) Bids for treasury bills are to be made for a minimum amount of ₹ .... only and in multiples thereof.

(28) For treasury bills the day count is taken as .... for a year.

(29) 14 day T-bills auction is on every .... of every week.

(30) The auction of treasury bills is done by RBI through ....

(31) .... is a promissory note issued by a bank or other financial institutions.

(32) CDs are freely transferable by endorsement and delivery after an initial lock-in period of .... after which they may be sold to any of the above participants or to the Discount and Finance House of India (DFHI).

(33) Minimum amount of a CD should be ₹ ...... and in the multiples of ₹ .... thereafter.

(34) There will be no .... period for repayment of CDs.

(35) CDs are freely transferable by ....

(36) An .... is an unsecured borrowing by corporate and FIs from other corporate entities registered under the Companies Act, 2013.

(37) Commercial Paper was introduced in India in the year ....

(38) All the corporate are eligible to issue CP provided tangible net worth of the company, as per the latest audited balance sheet, is not less than ₹ ....

(39) The minimum credit rating shall be .... for issue of CP.

(40) CP can be issued for maturities between .... from the date of issue.

(41) CP can be issued in denominations of .... or multiples thereof.

(42) Only a .... bank can act as an IPA for issuance of CP.

(43) Securities are normally referred to, as .... as repayments of principal as well as interest are totally secured by sovereign guarantee.

(44) Gilt-edged securities are issued by the .... of the RBI.

(45) Capital market regulated by ....

Question C] Select the correct option.

1. Which of the following is formal financial market for dealing in monetary assets of short-term nature?

(a) Capital Market

(b) Money Market

(c) Commodity market

(d) None of above

2. Money Market deals with the instruments that generally have maturity period less than ....

(a) 5 years

(b) 4 years

(c) 2 years

(d) 1 year

3. Which of the following involves trading in money market?

(a) Government securities

(b) Money at call & short notice

(c) Interbank participation

(d) All of above

4. Which of the following involves trading in money market?

(a) Treasury bills

(b) Certificate of deposit

(c) Commercial papers (CP)

(d) All of above

5. Which of the following involves trading in money market?

(a) Gilt edged securities
(b) Inter corporate deposits
(c) Both (a) & (b)
(d) Neither (a) nor (b)

6. Which of the following do not involves trading in money market?

(a) Interbank participation
(b) Call money markets
(c) Shares & debenture of companies
(d) Commercial papers

7. Which of the following(s) feature of money market?

(a) Low-risk
(b) High liquidity
(c) Minimum transaction cost
(d) All of above

8. Which of the following is dealer in money market?

(a) Banking industry
(b) Government
(c) DHFI
(d) All of above

9. Which of the following is not primary dealer in money market?

(a) Corporate
(b) HUF
(c) Individual
(d) (b) & (c) of above

10. Which of the following is not feature of money market?

(a) Money market is important segment of financial system.
(b) It provides access for short-term funds to fulfil borrowings and investment.
(c) It is regulated by SEBI.
(d) Government & banking industry is an active player in the money market.

11. Money market is regulated by ....

(a) State Bank of India
(b) Reserve Bank of India
(c) Central & State Government
(d) Foreign institutional investors

12. Money market deals in the lending and borrowing of ....

(a) Short-term finance (*i.e.* for 1 year or less)
(b) Long-term finance (*i.e.* for more than 1 year)
(c) Commodities
(d) None of above

13. Which of following is government security?

(a) Dated securities
(b) Capital indexed bonds
(c) Treasury bills
(d) All of above

14. Which of following is NOT government security?

(a) Dated securities
(b) Gilt edged securities
(c) Secured Premium Notes
(d) All of the above

15. Which of the following is/are key feature of government security?

(I) No default risk
(II) No TDS

(a) (II) only
(b) Both (I) and (III)
(c) (I) only
(d) Neither (I) nor (II)

16. Zero Coupon bonds are bonds issued at ______

(a) Discount value
(b) Face value
(c) Par value
(d) Premium

17. In India, ... have taken the initiative to issue Zero Coupon bonds.

(a) Reliance Industries Ltd.
(b) Mahindra & Mahindra Ltd.
(c) Foseco Ltd.
(d) Bata Ltd.

18. Floating rate bonds are bonds with _____

(a) Fixed interest rate
(b) Variable interest rate

(c) Semi fixed interest rate
(d) None of above

19. A bond that allows the issuer of the bond to redeem the bond before the date of maturity is called as ________

(a) Callable bond
(b) Put bond
(c) Floating rate bonds
(d) Fixed rate bond

20. A bond which has a provision that allows the holder of the bond the right to force the issuer to pay back the principal on the bond is called as ....

(a) Callable bond
(b) Put bond
(c) Floating rate bonds
(d) Fixed rate bond

21. Capital Indexed Bonds are bonds where interest rate is a fixed percentage over the ....

(a) Inflation index
(b) Retail price index
(c) Wholesale price index
(d) SENSEX

22. Money at call is a loan that is repayable on demand, and money at short notice is repayable ....of serving a notice.

(a) Within 7 days
(b) Within 21 days
(c) Within 14 days
(d) Within 15 days

23. Inter-Bank Participation Certificates (IBPCs) means a certificate of fixed duration issued by issuer bank to participating bank against their priority sector advance on ....

(a) Risk sharing
(b) Without risk sharing basis
(c) Risk sharing or without risk sharing basis
(d) None of above

24. A money market fund is a mutual fund that invests in ....

(a) Shares
(b) Debentures
(c) Money market instruments
(d) Partly in shares and partly in debentures

25. A money market fund is a mutual fund that invests in short term securities in ...

(a) Treasury bills
(b) Certificate deposits
(c) Commercial papers
(d) Any of above

26. The call money market refers to the market for short period loans; say..........

(a) 5 to 30 days
(b) 1 to 14 days
(c) 14 to 45 days
(d) 3 months to 6 months

27. In call money market loans are repayable

(a) After fixed duration
(b) On demand
(c) Before maturity at the option of issuer
(d) None of above

28. Treasury bills are money market instruments to finance the short term requirements of the ....

(a) Reserve Bank of India
(b) State Bank of India
(c) Government of India
(d) Companies registered under Companies Act, 2013

29. Which of the following can be maturity period for Treasury bills?

(a) 91 days
(b) 182 days
(c) 364 days
(d) Any of above

30. Bids for treasury bills are to be made for a minimum amount of ₹ .... only and in multiples thereof.

(a) 50,000
(b) 25,000
(c) 1,00,000
(d) 5,00,000

31. Under which of the following auction method, bids are accepted at or above the cut-off price?

(a) French auction system

(b) Dutch auction system

(c) English auction system

(d) Indian auction system

32. Under which of the following auction method, bids are accepted at cut-off price?

(a) French auction system

(b) Dutch auction system

(c) English auction system

(d) Indian auction system

33. Minimum amount of a CD should be .... and in multiples.

(a) ₹ 1 lakh

(b) ₹ 5 lakh

(c) ₹ 10 lakh

(d) ₹ 20 lakh

34. CDs can be issued to ....

(a) Individuals

(b) Corporations

(c) Companies

(d) Any of the above

35. There will be .... for repayment of CDs.

(a) 3 days grace period

(b) No grace period

(c) 5 days grace period

(d) 4 days grace period

36. Commercial Paper (CP) is an .... money market instrument issued in the form of a promissory note.

(a) Unsecured

(b) Secured

(c) Partly unsecured partly secured

(d) None of above

37. CP can be issued in denominations of ....

(a) ₹ 1 lakh or multiples

(b) ₹ 5 lakh or multiples

(c) ₹ 10 lakh or multiples

(d) ₹ 20 lakh or multiples

38. Gilts securities are generally issued by ________

(a) Government

(b) RBI

(c) SEBI

(d) SBI

39. Which of the following can issue Gilts securities?

(a) Central & State Governments

(b) Semi-Government Authorities

(c) City Corporations, Municipalities

(d) Any of above

Answer to Question A :

Abbreviation	Long Form
FII	Foreign Institutional Investors
MF	Mutual Fund
DII	Domestic Institutional Investor
IPBC	Inter Bank Participation Certificate
GOI	Government of India
SLR	Statutory Liquidity Ratio
FRB	Floating Rate Bonds
OMO	Open market operations
FPO	Follow-on public offer
WIP	Wholesale price index
DFHI	Discount & Finance House of India
MMMF	Money Market Mutual Funds
T-bills	Treasury Bills
YTM	Yield to Maturity
CD	Certificate of Deposit

Abbreviation	Long Form
RRB	Regional Rural Bank
LAB	Local Area Banks
CRR	Cash Reserve Ratio
ICD	Inter-Corporate Deposit
CP	Commercial Paper
FIMMDA	Fixed Income Money Market & Derivatives Association of India
IPA	Issuing and Paying Agent
CRA	Credit Rating Agency

Answer to Question B:

(1) Money Market **(2)** short-term fund **(3)** wholesale **(4)** RBI **(5)** Government Securities **(6)** RBI **(7)** Auction **(8)** Dutch, French **(9)** French Auction (Multiple Price Auction) **(10)** Dated securities **(11)** discount to the face value **(12)** Floating rate **(13)** face value **(14)** Capital Indexed Bonds **(15)** wholesale price index **(16)** face value **(17)** Money at call **(18)** 14 days **(19)** DFHI **(20)** A money market fund **(21)** 1 to 14 days **(22)** call money market **(23)** Treasury bills **(24)** discount to face value **(25)** State govt. **(26)** Auctions **(27)** 25,000 **(28)** 365 days **(29)** Friday **(30)** Mumbai office **(31)** A certificate of deposit **(32)** 15 days **(33)** 1 lakh, 1 lakh **(34)** Grace **(35)** endorsement and delivery **(36)** Inter-Corporate Deposit (ICD) **(37)** 1990 **(38)** 4 Crore **(39)** A3 **(40)** 7 days to 1 year **(41)** ₹ 5 lakh **(42)** Scheduled **(43)** gilt-edged **(44)** Public Debt Office **(45)** SEBI

Answer to Question C:

1. (b)	**8.** (d)	**15.** (b)	**22.** (c)	**29.** (d)	**36.** (a)
2. (d)	**9.** (d)	**16.** (a)	**23.** (c)	**30.** (b)	**37.** (b)
3. (d)	**10.** (d)	**17.** (b)	**24.** (c)	**31.** (a)	**38.** (a)
4. (d)	**11.** (b)	**18.** (b)	**25.** (d)	**32.** (b)	**39.** (d)
5. (c)	**12.** (a)	**19.** (a)	**26.** (b)	**33.** (a)	
6. (c)	**13.** (d)	**20.** (b)	**27.** (b)	**34.** (d)	
7. (d)	**14.** (c)	**21.** (c)	**28.** (c)	**35.** (b)	

CHAPTER 8

MUTUAL FUNDS

MUTUAL FUNDS

Question 1] What is 'mutual fund'? How mutual funds operate in India?

Ans.: A mutual fund is a trust that pools the resources of like-minded investors for investment in the capital market. By investing in the units of mutual funds, the investor becomes a part owner of the assets of the mutual funds.

A mutual fund is constituted in the form of a trust. The sponsor sets up the business, the assets management company invests the money and the trustee oversees the operation.

The five principle constituents are :

(1) **Sponsor :** A company established under the Companies Act establishes a mutual fund. Thus, for instance, Reliance Capital Ltd., set up the Reliance Mutual Fund, then Reliance Capital Ltd. is the sponsor company.

(2) **Trustee :** The trust is headed by a Board of Trustees. The trustee entity holds the property of the mutual fund in trust for the benefit the unit holders and ensures that all legal requirements in connection with the operation and functioning of the mutual fund are met.

(3) **Mutual Fund :** A mutual fund is established under the Indian Trust Act, 1882 to raise moneys through the sale of units to the public for investment in the capital markets. The funds so raised are handed over to the asset management company for investment. The mutual fund is required to be registered with SEBI.

(4) **Asset Management Company (AMC) :** This entity is registered under the Companies Act, to manage the money invested in the mutual fund and to operate the schemes of the mutual fund in accordance with the governing regulations. The AMC is thus charged with the responsibility of investing and managing the investor's resources.

(5) **Unit holder :** Any person or entity holding a undivided share in the assets of a mutual fund scheme is called as unit holder.

How does a mutual fund operate : A mutual fund collects money from several investors, and invests it in various options like stocks, bonds, etc. This fund is managed by professionals who understand the market well, and try to accomplish growth by making strategic investments. Investors get units of the mutual fund according to the amount they have invested. The AMC is responsible for managing the investments for the various schemes operated by the mutual fund. It also undertakes activities such like advisory services, financial consulting, customer services, accounting, marketing and sales functions for the schemes of the mutual fund.

Question 2] Write a short note on: Asset Management Company (AMC)

CS (Inter) - June 2006 (5 Marks)

Ans.: Asset Management Company is an entity registered under the Companies Act, to manage the money invested in the mutual fund and to operate the schemes of the mutual fund in accordance with the governing regulations.

Important points relating to Asset Management Company:

- AMC is company incorporated under the Companies Act, 2013
- Every mutual fund is required to have an AMC
- AMC should be approved by the SEBI.
- AMC operates the schemes of the mutual fund.
- AMC is charged with the responsibility of investing and managing the investor's resources.
- The application for the approval of the AMC shall be made in Form D.
- The appointment of an AMC can be terminated by majority of the trustees or by 75% of the unit holders of the scheme.
- The AMC should have a net worth of not less than ₹ 50 crore.

Question 3] Write a short note on: Advantages of Mutual Funds

Ans.: Following are the advantages of investing in mutual funds:

(1) **Professional Management :** The small investor does not have the time or expertise to manage his own money. Mutual funds are run by professionals who are experts in the field of investment management. Thus, money of small investors is in safe hands.

(2) **Diversification :** The key to stock market investment is diversification. Diversification has advantage of risk reduction. A well-diversified portfolio normally contains in it about 10 to 15 stocks. If an individual investor has to buy, say 100 shares of each of the selected stocks, it could cost him about ₹ 2 to 3 lakhs. However, when he invests in a mutual fund a small sum say ₹ 5,000, he gets instant diversification at a fraction of the cost. This is because, as a unit holder he becomes a part owner of the stock that the mutual fund holds. In short, mutual funds help him buy diversification off the shelf.

(3) **Economies of scale :** Unlike small investor mutual funds makes large scale purchase and sale of shares. For example, if an investor invests in 500 shares of Reliance, a mutual fund would be investing 50,000 shares. Since they deal in large volumes, the funds are able to bargain for finer rates form the stock brokers. Thus, if an individual investor is charged 1%, the mutual fund could be charged as low as 0.05%. As both purchase and sales takes place on the stock, that means there is net saving of 1.9%. A low brokerage means a higher returns and if we assume return of 1.9% for a month, it means 23% p.a. (1.9% × 12)

(4) **Liquidity :** Mutual funds are easy to buy and sell and hence provide great liquidity. Any person holding in open ended scheme can sell the units of his mutual fund and get his money back.

(5) **Transparency :** Mutual funds are regulated by the SEBI and hence as per SEBI regulations mutual funds have to provide various types of information periodically to the investors. Thus, there is much more transparency and chance of investor being cheated are negligible.

(6) **Low Costs :** Mutual funds are a relatively less expensive way to invest compared to directly investing in the capital markets because the benefits of scale in brokerage, custodial and other fees translate into lower costs for investors.

(7) **Return Potential :** Over a medium to long term, Mutual funds have the potential to provide a higher return as they invest in a diversified basket of selected securities.

Question 4] Discuss briefly risk involved in Mutual Funds.

CS (Inter) - Dec 2007 (4 Marks), June 2008 (2 Marks),

CS (Executive) - Dec 2009 (4 Marks)

Ans.: The level of risk in a mutual fund depends on what it invests in. Usually, the higher the potential returns, the higher the risk will be. For example, stocks are generally riskier than bonds, so an equity fund tends to be riskier than a fixed income fund.

Some specialty mutual funds focus on certain kinds of investments, such as emerging markets, to try to earn a higher return. These kinds of funds also tend to have a greater risk of a larger drop in value.

Mutual funds may face the following risks leading to non-satisfactory performance:

1. Excessive diversification of portfolio, losing focus on the securities of the key segments.
2. Too much concentration on blue-chip securities which are high priced and which do not offer more than average return.
3. Necessity to effect high turnover through liquidation of portfolio resulting in large payments of brokerage and commission.
4. Poor planning of investment with minimum returns.
5. Un-researched forecast on income, profits and Government policies.
6. Fund managers being unaccountable for poor results.
7. Failure to identify clearly the risk of the scheme as distinct from risk of the market.

Question 5] "Put not your trust in money, put your money in trust". Comment.

CS (Inter) - Dec 2007 (3 Marks)

"The mutual funds have emerged as one of the important class of financial intermediaries which cater to the needs of retail investors." Discuss. CS (Executive) - Dec 2014 (6 Marks)

Ans.: The small investors who generally lack expertise to invest on their own in the securities market have reinforced the saying *"put not your trust in money, put your money in trust"*. They prefer some kind of collective investment vehicle like, mutual funds, which pool their marginal resources, invest in securities and distribute the returns therefrom among them on cooperative principles. The investors benefit in terms of reduced risk and higher returns arising from professional expertise of fund managers employed by the mutual funds.

Question 6] Write a short note on: Open-ended mutual funds

Ans.: Open-ended mutual funds buy and sell units on a continuous basis and allow investors to enter and exit as per their convenience. The units can be purchased and sold even after the initial offering period (in case of new funds). The units are bought and sold at the Net Asset Value (NAV) declared by the fund.

The number of outstanding units goes up or down every time the fund house sells or repurchases the existing units. This is the reason that the unit capital of an open-ended mutual fund keeps varying. The fund expands in size when the fund house sells more units than it repurchases as more money is flowing in. On the other hand, the fund's size reduces when the fund house repurchases more units than it sells. An open-ended fund is not obliged to keep selling new units all the time. For instance, if the management thinks that it cannot manage a large-sized fund optimally, it can stop accepting new subscription requests from investors. However, it has to repurchase the units at all times.

Question 7] Write a short note on: Close ended mutual funds

Ans.: A closed-ended fund is a collective investment model based on issuing a fixed number of shares which are not redeemable from the fund.

The unit capital of closed-ended funds is fixed and they sell a specific number of units. Unlike in open-ended funds, investors cannot buy the units of a closed-ended fund after its initial offering period is over. This means that new investors cannot enter, nor can existing investors exit till the term of the scheme ends. However, to provide a platform for investors to exit before the term, the fund houses list their closed-ended schemes on a stock exchange.

Trading on a stock exchange enables investors to buy and sell units through a broker in the same manner as transacting the shares of a company. The units may trade at a premium or discount to the NAV depending on the investors' expectations of the fund's future performance and prospects. The demand and supply of fund units and other market factors also affect their price.

The number of outstanding units of a closed-ended fund does not change as a result of trading on the stock exchange. Apart from listing on an exchange, these funds sometimes offer to buy back the units, thus offering another avenue for liquidity.

Question 8] Distinguish between: Open-ended mutual funds & Close-ended mutual funds

CS (Inter) - June 2006 (2 Marks)

CS (Executive) - Dec 2008 (3 Marks), June 2012 (3 Marks)

CS (Executive) - Dec 2016 (4 Marks)

Ans.: Following are the main points of difference between Open-ended mutual funds & Close-ended mutual funds:

Points	Open-Ended Mutual Funds	Close-Ended Mutual Funds
Meaning	Open-ended mutual funds buy and sell units on a continuous basis and allow investors to enter and exit as per their convenience.	A closed-ended-fund is a collective investment model based on issuing a fixed number of shares which are not redeemable from the fund.
Corpus	Variable corpus due to ongoing purchase and redemption.	Fixed corpus: no new units can be offered beyond the limit.
Listing	No listing on exchange; transactions done directly with the fund.	Listed on the stock exchange for buying and selling.
Values	Only one price available namely NAV.	Two values available namely NAV and the Market Trading Price.
Liquidity	Highly liquid	Mostly liquid

Question 9] Discuss briefly the various investment schemes of mutual funds.

Ans.: There are different investors having different expectations form their investments. Some investors may desire regular and study income on their investment while some investors may desire have capital appreciation, some investor may like to get benefit of trading in real estate and thus, various mutual funds offers various schemes keeping view the requirements of these investors.

Various investment schemes of mutual funds are as follows:

(a) **Income Oriented Schemes :** The aim of income funds is to provide regular and steady income to investors. Such schemes generally invest in fixed income securities such as bonds, corporate debentures, Government securities and money market instruments. Such funds are less risky compared to equity schemes. These funds are not affected because of fluctuations in equity markets. However, opportunities of capital appreciation are also limited in such funds.

(b) **Growth Oriented Schemes :** The aim of growth funds is to provide capital appreciation over the medium to long-term. Such schemes normally invest a major part of their corpus in equities. Such funds have comparatively high risks. These schemes provide different options to the investors like dividend option, capital appreciation, etc. and the investors may choose an option depending on their preferences. The investors must indicate the option in the application form. The mutual funds also allow the investors to change the options at a later date. Growth schemes are good for investors having a long-term outlook seeking appreciation over a period of time.

(c) **Hybrid Schemes :** Such schemes 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**".

(d) **High Growth Schemes :** In stock market, high risk gives high returns. So these funds primarily invest in high risk and high return volatile securities in the market and induce the investors with a high degree of capital appreciation. Aggressive investors willing to take excessive risks are the normal target group of such funds.

(e) **Capital Protection Oriented Schemes :** The investment objective of such scheme is to seek capital protection by investing a portion of the portfolio in highest rated debt securities and money market instruments and also to provide capital appreciation by investing the balance in equity and equity related securities.

(f) **Tax Saving Schemes :** These schemes offer tax rebates to the investors under specific provisions of the Income-tax Act, 1961 as the Government offers tax incentives for investment in specified avenues. For example, Equity Linked Savings Schemes (ELSS). Pension schemes launched by the mutual funds also offer tax benefits. These schemes are growth oriented and invest predominantly in equities. Their growth opportunities and risks associated are like any equity-oriented scheme.

(g) **Sector Specific Schemes :** These are the funds which invest in the securities of only those sectors or industries as specified in the offer documents. For example, Pharmaceuticals, Software, Fast Moving Consumer Goods (FMCG), Petroleum stocks, etc. The returns in these funds are dependent on the performance of the respective sectors. While these funds may give higher returns, they are more risky compared to diversified funds. Investors need to keep a watch on the performance of those sectors and must exit at an appropriate time. They may also seek advice of an expert.

(h) **Real Estate Funds :** A real estate fund is a type of mutual fund that primarily focuses on investing in securities offered by public real estate companies.

(i) **Offshore Funds :** Such funds invest in securities of foreign companies with RBI permission.

(j) **Leverage Funds :** 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. Leveraged funds use a variety of financial instruments from equity swaps to derivatives, such as futures contracts, to achieve their returns. Leveraged funds try to achieve returns that are more sensitive, by a specific magnitude, to market movements than non-leveraged fund. The returns for leveraged funds usually vary between two times and three times the movement in a given index or market sector.

(k) **Index Funds :** Index funds replicate the portfolio of a particular index such as the BSE Sensex, Nifty etc. These schemes invest in the securities in the same weightage comprising of an index. NAVs of such schemes would rise or fall in accordance with the rise or fall in the index, though not exactly by the same percentage due to some factors known as "tracking error" in technical terms. Necessary disclosures in this regard are made in the offer document of the mutual fund scheme. There are also exchange traded index funds launched by the mutual funds which are traded on the stock exchanges.

(l) **New Direction Funds :** They invest in companies engaged in scientific and technological research such as birth control, anti-pollution, oceanography etc.

(m) **Money Market Mutual Funds :** *Discussed separately.*

(n) **Infrastructure Debt Fund :** They invest primarily in the debt securities or securitized debt investment of infrastructure companies.

Question 10] Distinguish between: Income Oriented Schemes & Growth Oriented Schemes

CS (Inter) - June 2007 (4 Marks)

Ans.: Following are the main points of difference between Income oriented schemes & Growth oriented schemes:

Points	Income Oriented Schemes	Growth Oriented Schemes
Meaning	Income Oriented Schemes are the scheme of mutual funds which provides regular and steady income to the investors.	Growth Oriented Schemes are the scheme of mutual funds which provides capital appreciation to the investors.
Mode of investment	Under Income Oriented Schemes funds are invested in fixed income securities such as bonds, corporate debentures, Government securities and money market instruments.	Under Growth Oriented Schemes funds are invested in equity shares and related instruments.
Form of return	Income Oriented Schemes offers fixed income to investors.	Growth Oriented Schemes offers capital appreciation to the investors. When sells his units in mutual funds difference between purchase price and sale price is capital gain.
Suitability	Income Oriented Schemes are suitable to investors seeking capital stability and regular income.	Growth Oriented Schemes are suitable for investors, having a long term outlook seeking growth over period of time.

Question 11] Write a short note on: Money Market Mutual Funds

CS (Inter) - Dec 2007 (4 Marks)

CS (Executive) - Dec 2010 (3 Marks)

Ans.: A money market fund is a mutual fund that invests in money market instruments. Since the operations in the money market are dominated by institutional players, the retail investor involvement in the money market is limited. For such retail investors who want to invest in the money market, money market mutual funds provide a possibility to retail investor to invest their money into the money market.

Money market instruments are forms of debt that mature in less than one year and are very liquid. The monies are invested in safer short term securities like treasury bills, certificate deposits, commercial papers, interbank call money etc. the returns from these schemes fluctuate according to the interest rate that is prevalent at the market at that point of time. These funds must have high liquidity and should be of the highest quality.

Money-market mutual fund is akin to a high-yield bank account but is not entirely risk free. When investing in a money-market fund, attention should be paid to the interest rate that is being offered.

Types of Money MMMF : Money market funds are of two types:

(1) **Institutional MMMF :** These are the funds where money is parked in big profiled instruments of governments, corporations, financial institution where huge sum of investment is needed. These funds give standard return which are quiet lesser but they are risk free investments.

(2) **Retail MMMF :** These are funds where money is invested temporarily for a short period of time. Money is invested in treasury bills, tax saving bonds, short term debts etc. Thus if you are looking for some safer investments or otherwise risk free investments money market mutual funds are the best.

Special features of MMMF :

- **Safety :** Money market mutual funds are one of the safest instruments of investment for the retail low income investor. The assets in a money market fund are invested in safe and stable instruments of investment issued by governments, banks and corporations etc.

- **Investment by retail investor :** Generally, money market instruments require huge amount of investments and it is beyond the capacity of an ordinary retail investor to invest such large sums. Money market funds allow retail investors the opportunity of investing in money market instrument and benefit from the price advantage.
- **Rating :** Money market mutual funds are usually rated by the rating agencies. So, check for the fund ratings before investing.

Benefits of investing in MMMF :

(1) Investors who keep their money in saving accounts of bank, because the return from money market mutual fund is higher than that of bank saving deposit.

(2) It is highly liquid and hence investor can take his money whenever he requires.

(3) It is safe to invest in money market mutual funds because investment of such mutual funds is in high quality securities of government or high rated corporate bonds.

(4) Costs of such mutual funds are also low than other type of mutual funds and hence it is an added advantage for the investor.

Hence, from the above one can see that money market mutual fund is a low risk and high return source of investment for those investors who want to invest in money market.

Question 12] Write a short note on: Mutual Fund Costs

Ans.: There are two broad categories of mutual fund costs:

(a) Operating Expenses : Costs incurred in operating mutual funds are known operating expenses. It includes advisory fees paid to investment managers, custodial fees, audit fees, transfer agent fees, trustee fees, agents commission etc. The break-up of these expenses is required to be reported in the schemes offer document.

When the operating expenses are divided by the average net asset, the **expense ratio** is arrived at. Based on the type of the scheme and the net assets, operating expenses are determined within the limits indicated by SEBI Mutual Fund Regulations, 1996. Expenditure which is in excess over the specified limits shall be borne by the Asset Management Company, the Trustees or the Sponsors. Operating expenses are calculated on an annualised basis but are accrued on a daily basis. Therefore, an investor face expenses prorated for the time he has invested in the fund.

(b) Sales Charges : These are called as sales loads and are charged directly to the investors. Mutual funds use the sales loads for payment of agent's commission and expenses for distribution and marketing.

Question 13] Explain the various factors for judging efficiency of mutual funds.

CS (Executive) - June 2011 (3 Marks)

Ans.: Judging efficiency of mutual funds is done with reference to various factors such as -

- Whether the fund is stable
- Whether it is liquid (listed on exchanges)
- Whether it offers increase in NAV, consistent growth in dividend and capital appreciation
- Whether the investment objectives are clearly laid and implemented
- Whether the issuer has a proven track record and offers assured returns or returns not less than a percentage
- Whether it observes investment norms to balance risks and profits

Question 14] Write a short note on: Roll-over of a scheme in mutual fund

Ans.: A mutual fund can roll over a close ended scheme on or before the redemption of the scheme after giving an option to investors to redeem their units at NAV based price. The roll over scheme may include a fresh extension of period or continue under the same terms of the original scheme with or without modifications.

Question 15] Can investor of mutual fund switch over from one scheme to another scheme?

Ans.: A mutual fund may use its discretion to permit switching over of the investment in units from one to another of its schemes, to help the investor shift, from a high risk scheme to a low risk one or *vice versa.*

Question 16] Discuss the accounting policies and standards which are to be mandatorily followed by the asset management companies. **CS (Executive) - June 2012 (5 Marks)**

Ans.: The AMC shall follow the accounting policies and standards as specified in mutual fund regulation to provide appropriate details of the scheme wise disposition of the assets of the fund at the relevant accounting date and the performance during that period together with information regarding distribution or accumulation of income accruing to the unit holder in a fair and true manner. The relevant Accounting Standards are: **AS 9** Revenue Recognition; **AS 10** Accounting for Fixed Assets; **AS 19** Lease; **AS 29** Provisions, Contingent Liabilities Assets.

Question 16A] Write a short note on: Restriction on redemption in mutual funds

Ans.: The facility of restriction on redemption under any scheme of the mutual fund can be made only after the approval from the board of directors of the Asset Management Company (AMC) and the trustees.

Restriction on redemption should apply during excess redemption requests that could arise in overall market crisis situations rather than exceptional circumstances of entity specific situations.

Therefore, in order to bring more clarity and to protect the interest of the investors, the following requirement shall be observed before imposing restriction on redemptions:

- Restriction may be imposed when there are circumstances leading to a systemic crisis or event that severely constricts market liquidity or the efficient functioning of markets such as:
  - (*a*) **Liquidity issues:** When market at large, becomes illiquid affecting almost all securities instead of any issuer specific security. AMCs should have in place, a sound internal liquidity management tools for schemes. Restriction on redemption cannot be used as an ordinary tool in order to manage the liquidity of a scheme.
  - (*b*) **Market failures, exchange closures:** When markets are affected by unexpected events which impact the functioning of exchanges or the regular course of transactions. Such unexpected events could also be related to political, economic, military, monetary or other emergencies.
  - (*c*) **Operational issues:** When exceptional circumstances are caused by *force majeure*, unpredictable operational problems and technical failures (e.g. a black out). Such cases can only be considered if they are reasonably unpredictable and occur in spite of appropriate diligence of third parties, adequate and effective disaster recovery procedures and systems.
- Restriction on redemption may be imposed for a specified period of time which is not more than 10 working days in any 90 days period.
- Any imposition of restriction would require specific approval of board of AMCs and trustees and the same should be informed to SEBI immediately.
- When restriction on redemption is imposed, the following procedure shall be applied:
  - No redemption requests up to ₹ **2 lakh** shall be subject to such restriction.
  - Where redemption requests are above ₹ 2 lakh, AMCs shall redeem the first ₹ 2 lakh without such restriction and remaining part over and above ₹ 2 lakh shall be subject to such restriction.
- The above information to investors shall be disclosed prominently and extensively in the scheme related documents regarding the possibility that their right to redeem may be restricted in such exceptional circumstances and the time limit for which it can be restricted.

SEBI (MUTUAL FUNDS) REGULATIONS, 1996

Question 17] State the provisions relating to 'registration of mutual fund' under the SEBI (Mutual Funds) Regulations, 1996.

Ans.: Application for registration [Regulation 3] : An application for registration of a mutual fund shall be made to the SEBI in **Form A** by the sponsor.

Application fee to accompany the application [Regulation 4] : Every application for registration shall be accompanied by non-refundable application fee as specified in the **Second Schedule**.

Application to conform to the requirements [Regulation 5] : An application shall be liable to be rejected if it is not complete in all respect. However, before rejecting any such application, the applicant shall be given an opportunity to complete such formalities within such time as may be specified by the SEBI.

Furnishing information [Regulation 6] : SEBI may require the sponsor to furnish such further information or clarification as may be required by it.

Eligibility criteria [Regulation 7] : The applicant has to fulfil the following:

(*i*) The sponsor should have a sound track record and general reputation of fairness and integrity in all his business transactions.

> "Sound track record" shall mean the sponsor should -
>
> (*i*) be carrying on business in financial services for a period of not less than 5 years; and
>
> (*ii*) the net worth is positive in all the immediately preceding 5 years; and
>
> (*iii*) the net worth in the immediately preceding year is more than the capital contribution of the sponsor in the AMC; and
>
> (*iv*) the sponsor has profits after providing for depreciation, interest and tax in 3 out of the immediately preceding 5 years, including the 5th year; and
>
> (*v*) the applicant is a fit and proper person;

(*ii*) In the case of an existing mutual fund, such fund is in the form of a trust and the trust deed has been approved by the SEBI.

(*iii*) The sponsor has contributed or contributes at least 40% to the net worth of the AMC. However, any person who holds 40% or more of the net worth of an AMC shall be deemed to be a sponsor and will be required to fulfil the eligibility criteria specified in these regulations.

(*iv*) The sponsor or any of its directors or the principal officer to be employed by the mutual fund should not have been guilty of fraud or has not been convicted of an offence involving moral turpitude or has not been found guilty of any economic offence.

(*v*) Trustees for the mutual fund are appointed in accordance with the regulations.

(*vi*) Appointment of AMC to manage the mutual fund and operate the scheme of such funds in accordance with the provisions of these regulations.

(*vii*) Appointment of custodian in order to keep custody of the securities or gold and gold related instrument or other assets of the mutual fund held in terms of these regulations, and provide such other custodial services as may be authorised by the trustees.

Criteria for fit and proper person [Regulation 7A] : For the purpose of determining whether an applicant or the mutual funds is fit and proper person the Board may take into account the criteria specified in **Schedule II** of the **SEBI (Intermediaries) Regulations, 2008**.

Consideration of application [Regulation 8] : SEBI may on receipt of all information decide the application.

Grant of Certificate of Registration [Regulation 9] : SEBI may register the mutual fund and grant a certificate in **Form B** on the applicant paying the registration fee as specified in **Second Schedule**.

Terms and conditions of registration [Regulation 10] : The registration granted to a mutual fund shall be subject to the following terms and conditions -

(*a*) The trustees, the sponsor, the AMC and the custodian shall comply with the provisions of these regulations.

(*b*) The mutual fund shall forthwith inform the SEBI, if any information or particulars previously submitted to the SEBI was misleading or false in any material respect.

(*c*) The mutual fund shall forthwith inform the SEBI, of any material change in the information or particulars previously furnished, which have a bearing on the registration granted by it.

Rejection of application [Regulation 11] : Where the sponsor does not satisfy the eligibility criteria mentioned in Regulation 7, the SEBI may reject the application and inform the applicant of the same.

Payment of annual service fee [Regulation 12] : A mutual fund shall pay before the 15th April each year a service fee as specified in the Second Schedule for every financial year. However, delay up to 2 months may be allowed by the SEBI.

Failure to pay annual service fee [Regulation 13] : SEBI may not permit a mutual fund that has not paid service fee to launch any scheme.

Question 18] A mutual fund shall be constituted in the form of a trust. Comment.

Ans.: Trust deed to be registered under the Registration Act [Regulation 14] : A mutual fund shall be constituted in the form of a trust and the instrument of trust shall be in the form of a deed, duly registered under the provisions of the Indian Registration Act, 1908, executed by the sponsor in favour of the trustees named in such an instrument.

Question 19] What are the contents of trust deed of mutual fund

Ans.: Contents of trust deed [Regulation 15] : The trust deed shall contain clauses mentioned in the **Third Schedule** and such other clauses which are necessary for safeguarding the interests of the unit holders.

No trust deed shall contain a clause which has the effect of -

(*a*) limiting or extinguishing the obligations and liabilities of the trust in relation to any mutual fund or the unit holders; or

(*b*) indemnifying the trustees or the asset management company for loss or damage caused to the unit holders by their acts of negligence or acts of commission or omission.

Question 20] Who cannot be appointed as trustee of a mutual fund as per the SEBI (Mutual Funds) Regulations, 1996?

Ans.: Disqualification from being appointed as trustees [Regulation 16]: A mutual fund shall appoint trustees in accordance with these regulations.

No person shall be eligible to be appointed as a trustee unless -

(*a*) he is a person of ability, integrity and standing; and

(*b*) has not been found guilty of moral turpitude; and

(*c*) has not been convicted of any economic offence or violation of any securities laws; and

(*d*) has furnished particulars as specified in **Form C**.

No asset management company and no director including independent director, officer or employee of an asset management company shall be eligible to be appointed as a trustee of any mutual fund.

No person who is appointed as a trustee of a mutual fund shall be eligible to be appointed as a trustee of any other mutual fund.

Two-thirds of the trustees shall be independent persons and shall not be associated with the sponsors or be associated with them in any manner whatsoever.

In case a company is appointed as a trustee then its directors can act as trustees of any other trust provided that the object of the trust is not in conflict with the object of the mutual fund.

Approval of the Board for appointment of trustee [Regulation 17]: No trustee shall be appointed without prior approval of the SEBI.

The existing trustees of any mutual fund may form a trustee company to act as a trustee with the prior approval of the SEBI.

Question 21] Discuss briefly the rights and obligations of the trustees of the mutual fund.

Ans.: Rights and obligations of the trustees [Regulation 18]:

(1) The trustees and the AMC shall with the prior approval of the SEBI enter into an Investment Management Agreement (IMA).

(2) The IMA shall contain clauses as are mentioned in the **Fourth Schedule** and other clauses as are necessary for the purpose of making investments.

(3) The trustees shall have a right to obtain from the AMC such information as is considered necessary by the trustees.

(4) The trustees shall ensure before the launch of any scheme that the AMC has -

(*a*) systems in place for its back office, dealing room and accounting;

(*b*) appointed all key personnel including fund manager(s) for the scheme(s) and submitted their bio-data which shall contain the educational qualifications, past experience in the securities market with the trustees, within 15 days of their appointment;

(*c*) appointed auditors to audit its accounts;

(*d*) appointed a Compliance Officer who shall be responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines, instructions, etc., issued by the SEBI or the Central Government and for redressal of investors grievances;

(*e*) appointed registrars and laid down parameters for their supervision;

(*f*) prepared a compliance manual and designed internal control mechanisms including internal audit systems;

(*g*) specified norms for empanelment of brokers and marketing agents;

(*h*) obtained, wherever required under these regulations, prior in principle approval from the recognised stock exchange where units are proposed to be listed.

(5) The compliance officer shall immediately and independently report to the SEBI any non-compliance observed by him.

(6) The trustees shall ensure that an AMC has been diligent in empanelling the brokers, in monitoring securities transactions with brokers and avoiding undue concentration of business with any broker.

(7) The trustees shall ensure that the AMC has not given any undue or unfair advantage to any associates or dealt with any of the associates of the AMC in any manner detrimental to interest of the unit holders.

(8) The trustees shall ensure that the transactions entered into by the AMC are in accordance with these regulations and the scheme.

(9) The trustees shall ensure that the AMC has been managing the mutual fund schemes independently of other activities and have taken adequate steps to ensure that the interest of investors of one scheme are not being compromised with those of any other scheme or of other activities of the AMC.

(10) The trustees shall ensure that all the activities of the AMC are in accordance with the provisions of these regulations.

(11) Where the trustees have reason to believe that the conduct of business of the mutual fund is not in accordance with these regulations and the scheme they shall forthwith take such remedial steps as are necessary by them and shall immediately inform the SEBI of the violation and the action taken by them.

(12) Each trustee shall file the details of his transactions of dealing in securities with the Mutual Fund on a quarterly basis.

(13) The trustees shall be accountable for, and be the custodian of, the funds and property of the respective schemes and shall hold the same in trust for the benefit of the unit holders in accordance with these regulations and the provisions of trust deed.

(14) The trustees shall take steps to ensure that the transactions of the mutual fund are in accordance with the provisions of the trust deed.

(15) The trustees shall be responsible for the calculation of any income due to be paid to the mutual fund and also of any income received in the mutual fund for the holders of the units of any scheme in accordance with these regulations and the trust deed.

(16) The trustees shall obtain the consent of unit holders –

(*a*) whenever required to do so by the SEBI in the interest of the unit holders; or

(*b*) whenever required to do so on the requisition made by three-fourths of the unit holders of any scheme; or

(*c*) when the majority of the trustees decide to wind up or prematurely redeem the units.

(17) The trustees shall ensure that no change in the fundamental attributes of any scheme or the trust or fees and expenses payable or any other change which would modify the scheme and affects the interest of unit holders, shall be carried out unless, –

(*a*) a written communication about the proposed change is sent to each unit holder and an advertisement is given in one English daily newspaper having nationwide circulation as well as in a newspaper published in the language of region where the Head Office of the mutual fund is situated; and

(*b*) the unit holders are given an option to exit at the prevailing NAV without any exit load.

(18) The trustees shall call for the details of transactions in securities by the key personnel of the AMC in his own name or on behalf of the AMC and shall report to the SEBI, as and when required.

(19) The trustees shall quarterly review all transactions carried out between the mutual funds, AMC and its associates.

(20) The trustees shall quarterly review the net worth of the AMC and in case of any shortfall, ensure that the AMC make up for the shortfall.

(21) The trustees shall periodically review all service contracts such as custody arrangements, transfer agency of the securities and satisfy itself that such contracts are executed in the interest of the unit holders.

(22) The trustees shall ensure that there is no conflict of interest between the manner of deployment of its net worth by the AMC and the interest of the unit holders.

(23) The trustees shall periodically review the investor complaints received and the redressal of the same by the AMC.

(24) The trustees shall abide by the Code of Conduct as specified in the **Fifth Schedule**.

(25) The trustees shall furnish to the SEBI on a half-yearly basis –

(*a*) a report on the activities of the mutual fund;

(*b*) a certificate stating that the trustees have satisfied themselves that there have been no instances of self-dealing or front running by any of the trustees, directors and key personnel of the AMC;

(c) a certificate to the effect that the AMC has been managing the schemes independently of any other activities.

(26) The independent trustees shall give their comments on the report received from the AMC regarding the investments by the mutual fund in the securities of group companies of the sponsor.

(27) Trustees shall exercise due diligence as under:

A. General Due Diligence :

(*i*) The Trustees shall be discerning in the appointment of the directors on the SEBI of the AMC.

(*ii*) Trustees shall review the desirability or continuance of the AMC if substantial irregularities are observed in any of the schemes and shall not allow the AMC to float new schemes.

(*iii*) The Trustee shall ensure that the trust property is properly protected, held and administered by proper persons and by a proper number of such persons.

(*iv*) The Trustee shall ensure that all service providers are holding appropriate registrations from the SEBI or concerned regulatory authority.

(*v*) The Trustees shall arrange for test checks of service contracts.

(*vi*) Trustees shall immediately report to the SEBI of any special developments in the mutual fund.

B. Specific due diligence :

The Trustees shall:

(*i*) obtain internal audit reports at regular intervals from independent auditors appointed by the Trustees,

(*ii*) obtain compliance certificates at regular intervals from the AMC,

(*iii*) hold meeting of trustees more frequently,

(*iv*) consider the reports of the independent auditor and compliance reports of AMC at the meetings of trustees for appropriate action,

(*v*) maintain records of the decisions of the Trustees at their meetings and of the minutes of the meetings,

(*vi*) prescribe and adhere to a code of ethics by the Trustees, AMC and its personnel,

(*vii*) communicate in writing to the AMC of the deficiencies and checking on the rectification of deficiencies.

(28) The trustees shall not be held liable for acts done in good faith if they have exercised adequate due diligence honestly.

(29) The independent directors of the trustees or AMC shall pay specific attention to the following, as may be applicable, namely:

(*i*) the IMA and the compensation paid under the agreement,

(*ii*) service contracts with affiliates - whether the AMC has charged higher fees than outside contractors for the same services,

(*iii*) selections of the AMC's independent directors,

(*iv*) securities transactions involving affiliates to the extent such transactions are permitted,

(*v*) selecting and nominating individuals to fill independent directors vacancies,

(*vi*) code of ethics must be designed to prevent fraudulent, deceptive or manipulative practices by insiders in connection with personal securities transactions,

(*vii*) the reasonableness of fees paid to sponsors, AMC and any others for services provided,

(*viii*) principal underwriting contracts and their renewals,

(*ix*) any service contract with the associates of the AMC.

Question 22] Is there any advertisement code for mutual funds?

CS (Executive) - Dec 2007 (6 Marks), Dec 2015 (6 Marks)

Briefly explain the advertisement code prescribed for mutual funds under the SEBI (Mutual Funds) Regulations, 1996. **CS (Executive) - June 2016 (9 Marks)**

Ans.: Advertisement Material [Regulation 30] : Advertisements shall be in conformity with the Advertisement Code as specified in the **Sixth Schedule** and shall be submitted to the SEBI within **7 days** from the date of issue.

(*a*) Advertisements shall be accurate, true, fair, clear, complete, unambiguous and concise.

(*b*) Advertisements shall not contain statements which are false, misleading, biased or deceptive, based on assumption/projections and shall not contain any testimonials or any ranking based on any criteria.

(*c*) Advertisements shall not be so designed as likely to be misunderstood or likely to disguise the significance of any statement. Advertisements shall not contain statements which directly or by implication or by omission may mislead the investor.

(*d*) Advertisements shall not carry any slogan that is exaggerated or unwarranted or slogan that is inconsistent with or unrelated to the nature and risk and return profile of the product.

(*e*) **No celebrities** shall form part of the advertisement.

(*f*) Advertisements shall not be so framed as to exploit the lack of experience or knowledge of the investors. Extensive use of technical or legal terminology or complex language and the inclusion of excessive details which may detract the investors should be avoided.

(*g*) Advertisements shall contain information which is timely and consistent with the disclosures made in the Scheme Information Document (SID), Statement of Additional Information and the Key Information Memorandum (KIM).

(*h*) No advertisement shall directly or indirectly discredit other advertisements or make unfair comparisons.

(*i*) Advertisements shall be accompanied by a standard warning in legible fonts which states 'Mutual Fund investments are subject to market risks, read all scheme related documents carefully.' No addition or deletion of words shall be made to the standard warning.

(*j*) In audio-visual media based advertisements, the standard warning in visual and accompanying voice over reiteration shall be audible in a clear and understandable manner. For example, in standard warning both the visual and the voice over reiteration containing **14 words** running for at least **5 seconds** may be considered as clear and understandable.

Misleading Statements [Regulation 31] : The offer document and advertisement materials shall not be misleading or contain any statement or opinion, which are incorrect or false.

Question 23] Write a short note on: Listing of close ended schemes

Ans.: Listing of close ended schemes [Regulation 32] : Every close ended scheme, other than an equity linked savings scheme, shall be listed on a recognised stock exchange within such time period and subject to such conditions as specified by the SEBI. However, listing of close ended scheme launched prior to the commencement of the SEBI (Mutual Funds) (Amendment) Regulations, 2009 shall not be mandatory –

(*a*) if the said scheme provides for periodic repurchase facility to all the unit holders with restriction, if any, on the extent of such repurchase; or

(*b*) if the said scheme provides for monthly income or caters to special classes of persons like senior citizens, women, children, widows or physically handicapped or any special class of persons providing for repurchase of units at regular intervals; or

(c) if the details of such repurchase facility are clearly disclosed in the offer document; or

(d) if the said scheme opens for repurchase within a period of six months from the closure of subscription; or

(e) if the said scheme is a capital protection oriented scheme.

Question 24] Can mutual fund provide guarantee of return to an investor. Comment.

Ans. : Guaranteed Returns [Regulation 38]: No guaranteed return shall be provided in a scheme -

(a) unless such returns are fully guaranteed by the sponsor or the AMC;

(b) unless a statement indicating the name of the person who will guarantee the return, is made in the offer document;

(c) the manner in which the guarantee is to be met has been stated in the offer document.

Thus, mutual fund can provide guarantee of return to an investor provided that above conditions are fulfilled.

Question 25] What conditions are required to be fulfilled by mutual fund in order to launch capital protection oriented scheme under the SEBI (Mutual Funds) Regulations, 1996?

Ans.: Capital Protection Oriented Schemes [Regulation 38A] : A capital protection oriented scheme may be launched, subject to the following:

(a) the units of the scheme are rated by a registered credit rating agency from the viewpoint of the ability of its portfolio structure to attain protection of the capital invested therein;

(b) the scheme is close ended; and

(c) there is compliance with other requirements specified by the SEBI in this behalf.

Question 26] State the provisions relating to winding-up of close-ended scheme of mutual fund under the SEBI (Mutual Funds) Regulations, 1996.

Ans.: Winding-up [Regulation 39] : A close-ended scheme shall be wound up on the expiry of duration fixed in the scheme on the redemption of the units unless it is rolled over for a further period.

A scheme of a mutual fund may be wound up, after repaying the amount due to the unit holders,—

(a) on the happening of any event which, in the opinion of the trustees, requires the scheme to be wound-up; or

(b) if 75% of the unit holders of a scheme pass a resolution that the scheme be wound-up; or

(c) if the SEBI so directs in the interest of the unit holders.

Where a scheme is to be wound-up, the trustees shall give notice disclosing the circumstances leading to the winding-up of the scheme to the SEBI and in 2 daily newspapers having circulation all over India, a vernacular newspaper circulating at the place where the mutual fund is formed.

Effect of winding up [Regulation 40] : On and from the date of the publication of notice, the trustee or the AMC as the case may be, shall—

(a) cease to carry on any business activities in respect of the scheme so wound-up;

(b) cease to create or cancel units in the scheme;

(c) cease to issue or redeem units in the scheme.

Winding-up of the scheme [Regulation 42] : After the receipt of the report, if the SEBI is satisfied that all measures for winding-up of the scheme have been complied with, the scheme shall cease to exist.

Delisting of units [Regulation 42A] : The units of a mutual fund scheme shall be delisted from a recognised stock exchange in accordance with the guidelines specified by the SEBI.

Question 27] In which way a mutual fund may invest moneys collected by it?

Ans.: Investment Objective [Regulation 43] : A mutual fund may invest moneys collected under any of its schemes only in –

(*i*) securities

(*ii*) money market instruments

(*iii*) privately placed debentures

(*iv*) securitised debt instruments, which are either Asset Backed or Mortgage Backed Securities (MBS)

(*v*) gold or gold related instruments;

(*vi*) real estate assets

(*vii*) infrastructure debt instrument

Moneys collected under any money market scheme of a mutual fund shall be invested only in money market instruments.

Moneys collected under any gold exchange traded fund scheme shall be invested only in gold or gold related instruments.

Moneys collected under a real estate mutual fund scheme shall be invested in real estate.

Question 28] What are the restrictions on investment and borrowing on mutual funds?

Ans.: Investment, borrowing, restriction, etc. [Regulation 44] :

(1) Any investment to be made under Regulation 43 shall be invested subject to the investment restriction specified in the **Seventh Schedule**. However, these restrictions shall not apply to a gold exchange traded fund scheme.

(2) The mutual fund having an aggregate of securities which are worth ₹ **10 crores** or more, as on the latest balance-sheet date, shall settle their transactions only through dematerialised securities.

(3) The mutual fund shall not borrow except to meet temporary liquidity needs of the mutual funds for the purpose of repurchase, redemption of units or payment of interest or dividend to the unit holders. However, the mutual fund shall not borrow more than **20%** of the net asset of the scheme and the duration of such a borrowing shall not exceed a period of **6 months**.

(4) The mutual fund shall not advance any loans for any purpose.

(5) A mutual fund may lend and borrow securities in accordance with the framework relating to short selling and securities lending and borrowing specified by the SEBI.

(6) A gold exchange traded fund scheme shall be subject to the following investment restrictions:

   (a) The funds of any such scheme shall be invested only in gold or gold related instruments except to the extent necessary to meet the liquidity requirements for honouring repurchases or redemptions, as disclosed in the offer document; and

   (b) Pending deployment of funds, the mutual fund may invest such funds in short-term deposits of scheduled commercial banks.

Seventh Schedule

Restrictions on Investments [Regulation 44(1)]

1. A mutual fund scheme shall not invest more than 10% of its NAV in debt instruments comprising money market instruments and non-money market instruments issued by a single issuer which are rated not below investment grade by a credit rating agency authorized to carry out such activity. Such investment limit may be extended to 12% of the NAV of the scheme with the prior approval of the Board of Trustees and Board of Directors of the Asset Management Company (AMC). However, such limit shall not be applicable for investments in Government Securities, Treasury Bills and collateralized borrowing and lending obligations. Investments within such limit can be made in Mortgaged Backed Securitized Debts which are rated not below

investment grade by a credit rating agency registered with the SEBI. The schemes already in existence shall with an appropriate time and in the manner, as may be specified by the SEBI, conform to such limits.

2. A mutual fund scheme shall not invest more than 10% of its NAV in unrated debt instruments issued by a single issuer and the total investment in such instruments shall not exceed 25% of the NAV of the scheme. All such investments shall be made with the prior approval of the Board of Trustees and the Board of AMC.
3. No mutual fund under all its schemes should own more than 10% of any company's paid up capital carrying voting rights.
4. Transfers of investments from one scheme to another scheme in the same mutual fund shall be allowed only if -
   (*a*) Such transfers are done at the prevailing market price for quoted instruments on spot basis.
   (*b*) The securities so transferred shall be in conformity with the investment objective of the scheme to which such transfer has been made.
5. A scheme may invest in another scheme under the same AMC or any other mutual fund without charging any fees, provided that aggregate inter-scheme investment made by all schemes under the same management or in schemes under the management of any other AMC shall not exceed 5% of the net asset value of the mutual fund. However, this clause shall not apply to any fund of funds scheme.
6. Every mutual fund shall buy and sell securities on the basis of deliveries and shall in all cases of purchases, take delivery of relevant securities and in all cases of sale, deliver the securities. However, a mutual fund may engage in short selling of securities in accordance with the framework relating to short selling and securities lending and borrowing specified by the SEBI. A mutual fund may enter into derivatives transactions in a recognized stock exchange, subject to the framework specified by the SEBI. Sale of government security already contracted for purchase shall be permitted in accordance with the guidelines issued by the RBI in this regard.
7. Every mutual fund shall get the securities purchased or transferred in the name of the mutual fund on account of the concerned scheme, wherever investments are intended to be of long-term nature.
8. Pending deployment of funds of a scheme in terms of investment objectives of the scheme, a mutual fund may invest them in short term deposits of schedule commercial banks, subject to such Guidelines as may be specified by the SEBI.
9. No mutual fund scheme shall make any investment in -
   (*a*) any unlisted security of an associate or group company of the sponsor; or
   (*b*) any security issued by way of private placement by an associate or group company of the sponsor; or
   (*c*) the listed securities of group companies of the sponsor which is in excess of 25% of the net assets.
10. No scheme of a mutual fund shall make any investment in any fund of funds scheme.
11. No mutual fund scheme shall invest more than 10% of its NAV in the equity shares or equity related instruments of any company. The limit of 10% shall not be applicable for investments in case of index fund or sector or industry specific scheme.
12. A mutual fund scheme shall not invest more than 5% of its NAV in the unlisted equity shares or equity related instruments in case of open ended scheme and 10% of its NAV in case of close ended scheme.
13. A fund of funds scheme shall be subject to the following investment restrictions:
   (*a*) A fund of funds scheme shall not invest in any other fund of funds scheme.
   (*b*) A fund of funds scheme shall not invest its assets other than in schemes of mutual funds, except to the extent of funds required for meeting the liquidity requirements for the purpose of repurchases or redemptions, as disclosed in the offer document of fund of funds scheme.

Question 29] Write a short note on: Overseas investment by mutual funds

Ans.: Mutual Funds are permitted to make investment in:

(*a*) ADRs/GDRs issued by Indian or foreign companies

(*b*) Equity of overseas companies listed on recognized stock exchanges overseas

(*c*) Initial and follow on public offerings for listing at recognized stock exchanges overseas (*d*) Foreign debt securities in the countries with fully convertible currencies, short term as well as long term debt instruments with rating not below investment grade by accredited/registered credit rating agencies

(*e*) Money market instruments rated not below investment grade

(*f*) Repos in the form of investment, where the counterparty is rated not below investment grade; repos should not however, involve any borrowing of funds by mutual funds

(*g*) Government securities where the countries are rated not below investment grade

(*h*) Derivatives traded on recognized stock exchanges overseas only for hedging and portfolio balancing with underlying as securities

(*i*) Short term deposits with banks overseas where the issuer is rated not below investment grade

(*j*) Units/securities issued by overseas mutual funds or unit trusts registered with overseas regulators and investing in (*a*) aforesaid securities, (*b*) Real Estate Investment Trusts (REITs) listed in recognized stock exchanges overseas or (*c*) unlisted overseas securities (not exceeding 10% of their net assets).

Question 30] The SEBI in its guidelines related to restrictions on investments by mutual funds prescribes that the investment in equity shares or equity related securities of a single company must not exceed 10% of the net assets of the scheme. A particular mutual fund had repeatedly exceeded this permissible limit through its associate broker. The Adjudicating Officer (AO) concerned imposed a penalty. The mutual fund approached the Court and pleaded that the limit was not exceeded intentionally and hence, it should not be penalised for such unintentional deed. As per the provisions of the Securities and Exchange Board of India Act, 1992 and decided case laws, suggest whether the Court should set aside AO's order *inter alia* on the ground that the limit was not exceeded intentionally. CS (Inter) - June 2007 (8 Marks), CS (Executive) - Dec 2013 (6 Marks)

Ans.: The facts of the given case are similar to *SEBI* v. *Shriram Mutual Fund & Others - Appeal Nos. 9523-24 of 2003*, wherein a penalty of ₹ 2 lakh was imposed by Adjudicating Officer on Shriram Mutual Fund (SMF) as it had repeatedly exceeded the permissible limits of transactions through its associate broker.

On an appeal by SMF, SAT set aside Adjudicating Officer's order *inter alia* on the ground that the limit was not exceeded intentionally.

SEBI filed an appeal to Supreme Court. The Supreme Court set aside the judgment of SAT and settled the issues, as under:

- *Mens rea* is not an essential ingredient for contravention of the provisions of a Civil Act.
- Penalty is attracted as soon as contravention of the statutory obligation as contemplated by the Act is established, and therefore the intention of the parties committing such violation becomes immaterial.
- Unless the language of the statute indicated the need to establish the element of *mens rea*, it is generally sufficient to prove that a default in complying with the statute has occurred.
- Once the contravention is established, the penalty has to follow and only the quantum of penalty is discretionary.

Thus, SEBI will succeed in its appeal to Supreme Court.

Question 31] Can a mutual fund enter into derivatives or short selling transactions?

Ans.: Carry forward transactions, derivatives transactions and short selling transactions [Regulation 45] : The funds of a scheme shall not in any manner be used in carry forward transactions. However, a mutual fund may enter into derivatives transactions on a recognized stock exchange, subject to the framework specified by the SEBI.

A mutual fund may enter into short selling transactions on a recognized stock exchange, subject to the framework relating to short selling and securities lending and borrowing specified by the SEBI.

Question 32] An enquiry officer appointed by SEBI found evidence that a particular mutual fund was indulging in short-selling and buying-selling of derivative products for speculative purposes.

You are required to answer -

(i) Can the mutual fund be held liable for violation of any provision/rule laid down by the SEBI in this regard?

(ii) If yes, then what kind of penalties can be imposed by the enquiry officer on the mutual fund?

CS (Executive) - Dec 2014 (5 Marks)

Ans.: As per **Regulation 45** of the **SEBI (Mutual Funds) Regulations, 1996**, a mutual fund may enter into short-selling transactions on a recognized stock exchange, subject to the framework relating to short-selling and securities lending and borrowing specified by the SEBI.

In given case, mutual fund was indulging in short-selling and buying-selling of derivative products for speculative purposes which is clear violation of Regulation 45 of the SEBI (Mutual Funds) Regulations, 1996.

Liability for action in case of default [Regulation 68] : A mutual fund who contravenes any of the provisions of the Act, Rules or Regulations framed thereunder shall be liable for one or more actions specified therein including the action under **Chapter V** of the **SEBI (Intermediaries) Regulations, 2008.**

Question 33] Can a mutual fund enter into underwriting agreement? If yes, what is the limit of such underwriting obligation?

Ans.: Underwriting of securities [Regulation 46] : Mutual funds may enter into underwriting agreement after obtaining a certificate of registration in terms of the SEBI (Underwriters) Rules and SEBI (Underwriters) Regulations, 1993 authorising it to carry on activities as underwriters.

The capital adequacy norms for the purpose of underwriting shall be the net asset of the scheme. However, the underwriting obligation of a mutual fund shall not at any time exceed the total net asset value of the scheme.

Question 34] Write a short note on: Valuation of investments of mutual fund

Ans.: Valuation of Investments [Regulation 47] : Every mutual fund shall ensure that the asset management company computes and carries out valuation of investments made by its scheme(s) in accordance with the investment valuation norms specified in **Eighth Schedule**, and publishes the same.

Computation of Net Asset Value [Regulation 48] : Every mutual fund shall compute the NAV of each scheme by dividing the net assets of the scheme by the number of units outstanding on the valuation date. The NAV of the scheme shall be calculated on **daily basis** and published in at least **two daily newspapers** having circulation all over India.

Question 35] State the provisions of the SEBI (Mutual Funds) Regulations, 1996 relating to "pricing of units" of a mutual fund.

Ans.: Pricing of Units [Regulation 49] :

(1) The price at which the units may be subscribed or sold and repurchase price shall be made available to the investors by the mutual fund.

(2) In case of open-ended scheme, the mutual fund shall publish in a **daily newspaper** of all India circulation, the sale and repurchase price of units at least **once a week**.

(3) While determining the prices of the units, the mutual fund shall ensure that the repurchase price is not lower than **93% of the NAV** and the sale price is not higher than **107% the NAV**. However, the difference between the repurchase price and the sale price of the unit shall not exceed **7% of sale price**.

Question 36] What are Real Estate Mutual Funds (REMF)? Discuss their features.

CS (Executive) - Dec 2009 (4 Marks)

Ans.: Some of the salient features of REMFs are as under:

1. Existing mutual funds are eligible to launch real estate mutual funds if they have adequate number of experienced **key personnel/directors**.
2. Sponsors seeking to set up new mutual funds, for launching only real estate mutual fund schemes, shall be carrying on business in real estate for a period not less than **5 years**. They shall also fulfil all other eligibility criteria applicable for sponsoring a mutual fund.
3. Every real estate mutual fund scheme shall be **close-ended** and its units shall be listed on a recognized stock exchange.
4. **NAV** of the scheme shall be declared **daily**.
5. At least **35%** of the net assets of the scheme shall be invested directly in real estate assets. Balance may be invested in mortgage backed securities, securities of companies engaged in dealing in real estate assets or in undertaking real estate development projects and other securities. Taken together, investments in real estate assets, real estate related securities (including mortgage backed securities) shall not be less than **75%** of the net assets of the scheme.
6. Each asset shall be valued by two valuers, who are accredited by a credit rating agency, every **90 days** from the date of purchase. Lower of the two values shall be taken for the computation of NAV.
7. Caps will be imposed on investments in a single city, single project, securities issued by sponsor/ associate companies etc.
8. Unless otherwise stated, the investment restrictions specified in the Seventh Scheme shall apply.
9. No mutual fund shall transfer real estate assets amongst its schemes.
10. No mutual fund shall invest in any real estate asset which was owned by the sponsor or the AMC or any of its associates during the period of last 5 years or in which the sponsor or the AMC or any of its associates hold tenancy or lease rights.
11. A real estate mutual fund scheme shall not undertake lending or housing finance activities.
12. Accounting and valuation norms pertaining to Real Estate Mutual Fund schemes have also been specified.

Question 37] What do you understand by Infrastructure Debt Fund Schemes (IDFS)? Discuss the eligibility criteria required to be fulfilled by a mutual fund for launching such a scheme.

CS (Executive) - Dec 2013 (5 Marks)

Explain briefly: Infrastructure debt fund **CS (Executive) - June 2015 (3 Marks)**

Ans.: "Infrastructure debt fund scheme" means a mutual fund scheme that invests primarily (minimum 90% of scheme assets) in the debt securities or securitized debt instrument of -

- infrastructure companies or
- infrastructure capital companies or
- infrastructure projects or
- special purpose vehicles created for the purpose of facilitating or promoting investment in infrastructure
- other permissible assets or
- revenue generating projects of infrastructure companies or projects or special purpose vehicles.

Eligibility criteria for launching infrastructure debt fund scheme [Regulation 49N] :

(1) An existing mutual fund may launch an infrastructure debt fund schemes if it has an adequate number of key personnel having adequate experience in infrastructure sector.

(2) A certificate of registration may be granted to an applicant proposing to launch only infrastructure debt fund schemes if the sponsor or the parent company of the sponsor -

(*a*) has been carrying on activities or business in infrastructure financing sector for a period of not less than 5 years;

(*b*) fulfils the eligibility criteria as provided in Mutual Fund Regulation.

Question 38] Discuss briefly salient features of Infrastructure Debt Fund Schemes.

Ans.: Some of the salient features of IDFS are as under:

1. No scheme of an infrastructure debt fund, in the case of a public offer, shall be open for subscription for more than **45 days**.
2. An infrastructure debt fund scheme shall be launched either as close-ended scheme maturing after more than **5 years** or interval scheme with lock-in of 5 years and specified transaction period of not more than **45 days** as may be specified in the scheme information document.
3. Units of infrastructure debt fund schemes shall be listed on a recognized stock exchange, provided that such units shall be listed only after being fully paid up.
4. An infrastructure debt fund scheme shall have **minimum 5 investors** and no single investor shall hold more than **50% of net assets** of the scheme.
5. No infrastructure debt fund scheme shall accept any investment from any investor which is less than **₹ 1 crore**.
6. The minimum size of the unit shall be **₹ 10 lakhs**.
7. Each scheme launched as infrastructure debt fund scheme shall have firm commitment from the strategic investors for contribution of an amount of at least **₹ 25 Crore** before the allotment of units of the scheme are marketed to other potential investors.
8. The units of an infrastructure debt fund scheme may be offered through private placement to less than **50 persons**, subject to approval by the trustees and the board of the AMC.
9. Every infrastructure debt fund scheme shall invest at least **90% of the net assets** of the scheme in the debt securities or securitized debt instruments of infrastructure companies or projects or special purpose vehicles related to infrastructure.
10. No mutual fund shall, under all its infrastructure debt fund schemes, invest more than **30% of its net assets** in the debt securities or assets of any single infrastructure company or project or special purpose vehicles related to infrastructure.

Question 39] Discuss briefly salient features of Gold Exchange Traded Fund Scheme (GETFS).

Ans.: "Gold exchange traded fund scheme" shall mean a mutual fund scheme that invests primarily in gold or gold related instruments.

Some of the salient features of gold exchange traded fund scheme are as under:

1. **Permissible investment :** Moneys collected under any gold exchange traded fund scheme shall be invested only in gold or gold related instruments.
2. **Investment restriction :** A gold exchange traded fund scheme shall be subject to the following investment restrictions:

   (*a*) The funds of gold exchange traded fund scheme shall be invested only in gold or gold related instruments in accordance with its investment objective, except to the extent necessary to meet the liquidity requirements for honouring repurchases or redemptions, as disclosed in the offer document.

(*b*) Pending deployment of funds, the mutual fund may invest such funds in short-term deposits of scheduled commercial banks.

3. **Valuation :** Since physical gold and other permitted instruments linked to gold are denominated in gold tonnage, it will be valued based on the market price of gold in the domestic market and will be marked to market on a daily basis. The market price of gold in the domestic market on any business day would be arrived at as under:

   Domestic price of gold = (London Bullion Market Association AM fixing in US$/ounce × conversion factor for converting ounce into kg. for 0.995 fineness × rate for US$ into INR) + custom duty for import of gold + sales tax/octroi and other levies applicable.

   The Trustees reserve the right to change the source (centre) for determining the exchange rate. The AMC should record in writing the reason for change in the source for determining the exchange rate.

4. **Determination of NAV :** NAV of units under the gold exchange traded fund scheme would be calculated as shown below:

$$\text{NAV} = \frac{\text{MV} + \text{CA} - \text{CL}}{\text{N}}$$

   Where,

   MV = Market or Fair Value of investments

   CA = Current Assets

   CL = Current Liabilities and Provisions

   The NAV shall be calculated up to 4 decimals.

5. **Recurring expenses :** For a gold exchange traded fund scheme, the limits applicable to equity schemes as specified in SEBI Regulations shall be applicable.

6. **Benchmark :** As there are no indices catering to the gold sector/securities linked to gold, currently gold exchange traded fund scheme shall be benchmarked against the price of gold.

7. **Half yearly report by trustees :** Physical verification of gold underlying the Gold ETF Units shall be carried out by statutory auditors of mutual fund schemes and reported to trustees on half yearly basis. The confirmation on physical verification of gold shall form part of half yearly report by trustees to SEBI.

MISCELLANEOUS

Question 40] Explain briefly : Mezzanine Financing **CS (Executive) - Dec 2013 (3 Marks)**

Ans.: Mezzanine financing is basically **debt capital** that gives the lender the rights to convert to an ownership or **equity interest** in the company if the loan is not paid back in time and in full. It is generally subordinated to debt provided by senior lenders such as banks and venture capital companies.

Thus, mezzanine financing is a hybrid of debt and equity financing that is typically used to finance the expansion of existing companies.

Question 41] How Net Assets Value is calculated in mutual fund?

Ans.: The NAV of a mutual fund is the amount which a unit holder would receive if the mutual fund were wound-up today. An investor in a MF is a part owner of all its assets and liabilities.

NAV is calculated as follows:

Market value of assets of the fund *minus* Liabilities attributable to those assets

Example: If the total assets of a scheme are ₹ 500 lakhs and its outside liabilities are ₹ 50 lakhs, the NAV ₹ 450 lakhs.

Question 42] How return is calculated for investor holding units of mutual funds?

Ans.:

$$\text{Return} = \frac{D_1 + CG_1 + (NAV_1 - NAV_0)}{NAV_0} \times 100$$

Where,

D_1 = Dividend

CG_1 = Realized capital gain

$NAV_1 - NAV_0$ = Unrealized capital gain

NAV_0 = Base net asset value

NAV_1 = Net asset value at the end of period one

Question 43] Distinguish between: Front End Load & Back End Load

CS (Inter) - Dec 2005 (2 Marks)

Ans.: Following are the main points of difference between Front End Load & Back End Load:

Points	Front End Load	Back End Load
Meaning	Front End Load means **'entry load'** which is paid by investors while investing in mutual funds.	Back End Load means **'exit load'** which is afforded by the investors while selling units of mutual funds.
Time of payment	Entry load is paid when investor **buys** units of mutual funds.	Exit load is paid when investor **sells** units of mutual funds.
Formula	NAV = Public Offer Price (1 – Front End Load)	NAV = Redemption Price (1 + Back End Load)

There shall be no entry load for all mutual fund schemes. [SEBI/IMD/MC No.2/836/2011, January 7, 2011]

PRACTICAL PROBLEMS ON MUTUAL FUNDS

Question 44] Based on the following data, determine the NAV of a regular income scheme.

Particulars	*₹ in Lakhs*
Listed shares at cost (ex-dividend)	**20.00**
Cash in hand	**1.23**
Bonds & debenture at cost *(of these, bonds not listed and quoted ₹ 1 lakh)*	**4.30**
Other fixed interest securities at cost	**4.50**
Dividend accrued	**0.80**
Amounts payable on shares	**6.32**
Expenditure accrued	**0.75**

Number of units (₹ 10 face value) = 2,40,000 units

Current realizable value of fixed income securities of face value of ₹ 100 = ₹ 106.50.

All listed shares are purchased at a time when index was 1200. On NAV date, the index is ruling at 2120. Listed bonds and debentures carry a market value of ₹ 5 lakhs on NAV date.

CS (Inter) - Dec 2007 (8 Marks)

Ans.:

Particulars	*Computation*	*₹ in Lakhs*
Assets		
Listed shares	$\left[20 \times \frac{2120}{1200}\right]$	35.33
Cash in hand	Book value	1.23
Bonds & debenture (listed)	Market value	5.00
Bonds & debenture (unlisted)	Book value	1.00
Other fixed interest securities	$\left[4.50 \times \frac{106.5}{100}\right]$	4.79
Dividend accrued		0.80
Liabilities		
Amounts payable on shares		(6.32)
Expenditure accrued		(0.75)
NAV		41.08

$$\text{NAV per unit} = \frac{41.08}{2.40} = 17.12 \text{ per unit}$$

Question 45] A mutual fund that had a net asset value of ₹ 10 at the beginning of month made income and capital gain distribution of ₹ 0.05 and ₹ 0.04 per share respectively during the month, and then ended the month with a net asset value of ₹ 10.03. Calculate return.

Ans.:

$$\text{Return} = \frac{D_1 + CG_1 + (NAV_1 - NAV_0)}{NAV_0} \times 100$$

$$= \frac{0.05 + 0.04 + (10.03 - 10)}{10} \times 100$$

$= 1.2\%$ (for a month)

Annualized Return = 1.2 × 12 = 14.4%

Question 46] A mutual fund that had a net asset value of ₹ 20 at the beginning of month made income and capital gain distribution of Re. 0.0375 and Re. 0.03 per share respectively during the month, and then ended the month with a net asset value of ₹ 20.06. Calculate monthly return.

CA (Final) - May 2003 (4 Marks)

Ans.:

$$\text{Return} = \frac{D_1 + CG_1 + (NAV_1 - NAV_0)}{NAV_0} \times 100$$

$$= \frac{0.0375 + 0.03 + (20.06 - 20)}{20} \times 100$$

$= 0.6375\%$ (for a month)

Annualized Return = 0.6375 × 12 = 7.65%

Question 47] A mutual fund that had a net asset value of ₹ 16 at the beginning of a month, made income and capital gain distribution of ₹ 0.04 & ₹ 0.03 respectively per unit during the month, and then ended the month with a net asset value of ₹ 16.08. Calculate monthly and annual rate of return.

CA (Final) - June 2009 (4 Marks)

Ans.:

$$\text{Return} = \frac{D_1 + CG_1 + (NAV_1 - NAV_0)}{NAV_0} \times 100$$

$$= \frac{0.04 + 0.03 + (16.08 - 16)}{16} \times 100$$

$$= 0.9375\% \text{ (for a month)}$$

Annualized Return = 0.9375 × 12 = 11.25%

Question 48] A mutual fund having 300 units has shown its NAV of ₹ 8.75 and ₹ 9.45 at the beginning and at the end of the year respectively. The mutual fund has given two options:

(i) Pay ₹ 0.75 per unit as dividend and ₹ 0.60 per unit as a capital gain, or

(ii) These distributions are to be reinvested at an average NAV of ₹ 8.65 per unit.

What difference it would make in terms of return available and which option is preferable?

CA (Final) - May 2006 (6 Marks)

Ans.:

Option 1:

$$\text{Return} = \frac{D_1 + CG_1 + (NAV_1 - NAV_0)}{NAV_0} \times 100$$

$$= \frac{0.75 + 0.60 + (9.45 - 8.75)}{8.75} \times 100$$

$$= 23.4286\%$$

Option 2:

Amount to be reinvested = (0.75 + 0.60) × 300 = 405

$$\text{Fresh units} = \frac{405}{8.65} = 46.82$$

Total units = 300 + 46.82 = 346.82

Total value at the year end = 346.82 × 9.45 = 3,277.45

Purchase cost = 300 × 8.75 = 2,625

$$\text{Return} = \frac{3{,}277.45 - 2{,}625}{2{,}625} \times 100$$

$$= 24.8552\%$$

Analysis: Option 2 gives a higher return and should be preferred.

Question 49] A has invested in three Mutual Fund Schemes as per details below:

	MF A	*MF B*	*MF C*
Date of investment	**1.12.2015**	**1.1.2016**	**1.3.2016**
Amount of investment	**₹ 50,000**	**₹ 1,00,000**	**₹ 50,000**
Net Asset Value (NAV) at entry date	**₹ 10.50**	**₹ 10**	**₹ 10**
Dividend received up to 31.3.2016	**₹ 950**	**₹ 1,500**	**Nil**
NAV as at 31.3.2016	**₹ 10.40**	**₹ 10.10**	**₹ 9.80**

What is the effective yield on per annum basis on respect of each of the three schemes to Mr. A up to 31.3.2016? **CA (Final) - Nov 2004 (6 Marks)**

Ans.: *MF A*

$$\text{No. of units} = \frac{50{,}000}{10.50} = 4{,}761.9 \text{ say } 4{,}762$$

$$\text{Dividend per unit} = \frac{950}{4{,}762} = 0.1995$$

$$\text{Return} = \frac{D_1 + CG_1 + (NAV_1 - NAV_0)}{NAV_0} \times 100$$

$$= \frac{0.1995 + 0 + (10.40 - 10.50)}{10.50} \times 100$$

$$= 0.9476\%$$

Period of holding = 1.12.2015 to 31.3.2016 = 122 days

$$\text{Annualized Return} = 0.9476 \times \frac{365}{122} = 2.835\%$$

MF B

$$\text{No. of units} = \frac{1{,}00{,}000}{10} = 10{,}000$$

$$\text{Dividend per unit} = \frac{1{,}500}{10{,}000} = 0.15$$

$$\text{Return} = \frac{D_1 + CG_1 + (NAV_1 - NAV_0)}{NAV_0} \times 100$$

$$= \frac{0.15 + 0 + (10.10 - 10)}{10} \times 100$$

$$= 2.5\%$$

Period of holding = 1.1.2016 to 31.3.2016 = 91 days

$$\text{Annualized Return} = 2.5 \times \frac{365}{91} = 10.0275\%$$

MF C

$$\text{No. of units} = \frac{50{,}000}{10} = 5{,}000$$

$$\text{Return} = \frac{D_1 + CG_1 + (NAV_1 - NAV_0)}{NAV_0} \times 100$$

$$= \frac{0 + 0 + (9.8 - 10)}{10} \times 100$$

$$= -2\%$$

Period of holding = 1.3.2016 to 31.3.2016 = 31 days

$$\text{Annualized Return} = -2 \times \frac{365}{31} = -23.5484\%$$

Question 50] Safal Mutual Fund provides the following information related to one of its schemes :

Size of the scheme	**: ₹ 2,000 Crore**
Face value of the units	**: ₹ 10 per unit**
Number of outstanding units	**: ₹ 200 Crore**
Market value of funds-portfolio	**: ₹ 4,200 Crore**
Receivables	**: ₹ 100 Crore**
Accrued income	**: ₹ 100 Crore**
Liabilities	**: ₹ 150 Crore**
Accrued expenses	**: ₹ 275 Crore**

You are required to calculate Net Asset Value (NAV) of the scheme and rate of return if a unit holder has purchased units at the NAV of ₹ 15 per unit and received a dividend of ₹ 2 per unit during the period. **CS (Inter) - Dec 2006 (6 Marks)**

Ans.:

Particulars	*₹ in Crores*
Market value of funds-portfolio	4,200
Receivables	100
Accrued income	100
Liabilities	(150)
Accrued expenses	(275)
NAV	3,975

$$\text{NAV per unit} = \frac{3,975}{200} = 19.875 \text{ per unit}$$

$$\text{Return} = \frac{D_1 + CG_1 + (NAV_1 - NAV_0)}{NAV_0} \times 100$$

$$= \frac{2 + 0 + (19.875 - 15)}{15} \times 100$$

$$= 45.832\%$$

Question 51] If Rahul invests ₹ 10,000 in a scheme that charges 2% front-end load at an NAV of ₹ 10 per unit, what shall be the public offer price? **CS (Executive) - Dec 2008 (5 Marks)**

Ans.: NAV = Public Offer Price (1 – Front-End Load)

Let the Public Offer Price be 'x'

$10 = x\,(1 - 0.02)$

$10 = x - 0.02x$

$10 = 0.98x$

$$x = \frac{10}{0.98}$$

x = Public Offer Price = 10.20

Question 52] The redemption price of a mutual fund unit is ₹ 48 while the front-end load and back-end load charges are 2% and 3% respectively. You are required to calculate:

(i) Net asset value per unit and

(ii) Public offer price of the unit **CS (Executive) - June 2010 (7 Marks), June 2014 (5 Marks)**

Ans.:

NAV = Redemption Price (1 + Back End Load)

Let the NAV be 'x'

$x = 48\,(1 + 0.03)$

$x = 48 + 1.44$

x = NAV = 49.44

Let the Public Offer Price be 'x'

NAV = Public Offer Price (1 - Front End Load)

$49.44 = x\,(1 - 0.02)$

$49.44 = x - 0.02x$

$49.44 = 0.98x$

$$x = \frac{49.44}{0.98}$$

x = Public Offer Price = 50.45

Question 53] Super mutual fund has launched a scheme named 'Super Bonanza'. The Net Asset Value (NAV) of the scheme is ₹ 12.00 per unit. The redemption price is ₹ 11.65 per unit and offer price is ₹ 12.50 per unit.

You are required to calculate:

(i) Front-end load

(ii) Back-end load **CS (Executive) - June 2015 (6 Marks)**

Ans.:

NAV = Redemption Price (1 + Back-End Load)

Let the Back-End Load be 'x'

$12 = 11.65\,(1 + x)$

$12 = 11.65 + 11.65x$

$0.35 = 11.65x$

$$x = \frac{0.35}{11.65}$$

x = Back End-Load = 0.03 i.e. 3%

Let the Front-End Load be 'x'

NAV = Public Offer Price (1 - Front-End Load)

$12 = 12.50\,(1 - x)$

$12 = 12.50 - 12.50x$

$0.50 = 12.50x$

$$x = \frac{0.50}{12.50}$$

x = Front-End Load = 0.04 i.e. 4%

Question 54] A unit of Evergrow Equity Fund is redeemed at ₹ 15, the exit load being 2.25%. Calculate the NAV. **CS (Inter) - June 2008 (4 Marks)**

Ans.: Let the NAV be 'x'

NAV = Redemption Price (1 + Back-End Load)

$x = 15\ (1 + 0.0225)$

$x = 15 + 0.3375$

$x = \text{NAV} = 15.3375$

Question 55] Calculate the value of right, if

Number of right shares offered	**7,500**
Number of shares held	**2,500**
Ex-right price	**₹ 20**
Right offer price	**₹ 12**
Face value of shares	**₹ 10**

CS (Inter) - Dec 2005 (6 Marks)

Ans.: In case of mutual fund value of right shares is calculated by the following formula:

$$\text{Value of right} = \frac{\text{Right shares offered}}{\text{Number of shares held}} \times (\text{Ex-right price} - \text{Right offer price})$$

$$= \frac{7{,}500}{2{,}500} \times (20 - 12)$$

$$= 24$$

Question 56] Somnath Ltd. has a share capital of 50,000 equity shares of ₹ 100 each. Market value is ₹ 250 per share. The company decides to make a rights issue to the existing shareholders in proportion of one new rights share of ₹ 100 at a premium of ₹ 30 per share for every 5 shares held. Calculate the value of rights. **CS (Executive) - Dec 2015 (6 Marks)**

Ans.:

$$\text{Value of right} = \frac{\text{Right shares offered}}{\text{Number of shares held}} \times (\text{Ex-right price - Right offer price})$$

$$= \frac{1}{5} \times (250 - 130)$$

$$= 24$$

Question 57] Compute NAV and rate of return for a unit holder who bought a unit at ₹ 17.60 and received a dividend of ₹ 2 per unit during the period. Face value of the unit is ₹ 10. Other details are as under:

	(₹ in Crore)
Market value of funds portfolio	**4,200**
Size of the scheme	**2,000**
Accrued income	**100**
Receivables	**100**
Accrued expenses	**275**
Liabilities	**150**

Number of outstanding units : 200 crore **CS (Executive) - Dec 2016 (4 Marks)**

Ans.:

Particulars	*₹ in Crores*
Assets	
Market value of funds-portfolio	4,200
Accrued income	100
Receivables	100
Accrued expenses	(275)
Liabilities	(150)
NAV	3,975

NAV per unit = $\frac{3,975}{200}$ = 19.875 per unit

$$\text{Return} = \frac{D_1 + CG_1 + (NAV_1 - NAV_0)}{NAV_0} \times 100$$

$$= \frac{2 + 0 + (19.875 - 17.60)}{15} \times 100$$

= 28.5%

Where,

D_1 = Dividend

CG_1 = Capital Gain

NAV_1 = Net Asset Value at the end

NAV_0 = Net Asset Value at the beginning

OBJECTIVE QUESTIONS

Question A] Expand the following abbreviations:

(1) AMC
(2) NAV
(3) ELSS
(4) FMC
(5) MMMF
(6) IMA
(7) MBS
(8) ASB
(9) IDFS
(10) GETFS
(11) SID
(12) KIM

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

(1) A mutual fund is constituted in the form of a quasi-partnership.

(2) Mutual funds provide great liquidity.

(3) Mutual funds are a relatively more expensive way to invest.

(4) Open ended fund is based on issuing a fixed number of shares which are not redeemable from the fund.

(5) The aim of growth oriented schemes is to provide regular and steady income to investors.

(6) Celebrities can act in the advertisement of mutual funds.

(7) A scheme of a mutual fund may be wound-up after repaying the amount due to the unit holders.

(8) A mutual fund may enter into short selling transactions.

(9) Mutual funds cannot enter into underwriting agreement.

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

(1) ________ mutual funds buy and sell units on a continuous basis and allow investors to enter and exit as per their convenience.

(2) A ________ is a mutual fund that invests in money market instruments.

(3) In case of mutual fund, when the operating expenses are divided by the average net asset, the ________ is arrived at.

(4) As per the SEBI (Mutual Funds) Regulations, 1996, "sound track record" shall mean the sponsor should be carrying on business in financial services for a period of not less than _______

(5) As per the SEBI (Mutual Funds) Regulations, 1996, the ________ shall contain clauses as are mentioned in the Fourth Schedule and other clauses as are necessary for the purpose of making investments.

(6) An infrastructure debt fund scheme shall have minimum _____ and no single investor shall hold more than ________ of the scheme.

(7) As per the SEBI (Mutual Funds) Regulations, 1996, the sponsor has contributed or contributes at least _______ to the net worth of the AMC.

(8) While determining the prices of the units, the mutual fund shall ensure that the repurchase price is not lower than ______ of the NAV and the sale price is not higher than ________ the NAV.

(9) No scheme of an infrastructure debt fund, in the case of a public offer, shall be open for subscription for more than ________

(10) No infrastructure debt fund scheme shall accept any investment from any investor which is less than ________

Question D] Select the correct option.

1. A mutual fund is established under the ________ to raise moneys through the sale of units to the public for investment in the capital markets.

(a) Indian Contract Act, 1872

(b) Indian Trust Act, 1882

(c) Companies Act, 2013

(d) Mutual Fund Act, 1992

2. Which of the following responsibility is charged on AMC?

(I) investing the investor's resources

(II) managing the investor's resources

(a) (II) only

(b) Neither (I) nor (II)

(c) (I) only

(d) Both (I) and (II)

3. _____ is a collective investment model based on issuing a fixed number of shares which are not redeemable from the fund.

(a) Open-ended fund

(b) Close-ended fund

(c) Open cum Close-ended fund

(d) Mixed end fund

4. Which of the following scheme of mutual fund is to cover both needs of an investor i.e. provide regular income as well as provide capital appreciation?

(a) High Growth Schemes

(b) Hybrid Schemes

(c) Income Oriented Schemes

(d) Growth Oriented Schemes

5. Under the SEBI (Mutual Funds) Regulations, 1996, an application for registration of a mutual fund shall be made to the SEBI in _______ by the sponsor.

(a) Form II

(b) Form A

(c) Form B

(d) Form I

6. Mutual fund shall pay before the __________ each year a service fee as specified in the Second Schedule for every financial year.

(a) 15th April

(b) 15th May

(c) 15th October

(d) 15th November

7. A mutual fund shall be constituted in the form of a trust and the instrument of trust shall be in the form of a deed, duly registered under the provisions of the _________, executed by the sponsor in favour of the trustees named in such an instrument.

(a) Indian Trust Act, 1882

(b) Companies Act, 2013

(c) Indian Registration Act, 1908

(d) Mutual Fund Act, 1992

8. As per the SEBI (Mutual Funds) Regulations, 1996, the trust deed of mutual fund shall contain clauses mentioned in the ______

(a) Second Schedule

(b) Third Schedule

(c) Fourth Schedule

(d) Fifth Schedule

9. As per the SEBI (Mutual Funds) Regulations, 1996, every application for registration shall be accompanied by non-refundable application fee as specified in the ________

(a) Fourth Schedule

(b) Second Schedule

(c) First Schedule

(d) Third Schedule

10. As per the SEBI (Mutual Funds) Regulations, 1996, the Investment Management Agreement (IMA) shall contain clauses as are mentioned in the ________ and other clauses as are necessary for the purpose of making investments.

(a) Fifth Schedule

(b) Second Schedule

(c) Fourth Schedule

(d) Third Schedule

11. The mutual fund having an aggregate of securities which are worth _____ or more, as on the latest balance-sheet date, shall settle their transactions only through dematerialized securities.

(a) ₹ 10 Crore

(b) ₹ 5 Crore

(c) ₹ 50 Crore

(d) ₹ 100 Crore

12. As per the SEBI (Mutual Funds) Regulations, 1996, SEBI may register the mutual fund and grant a certificate in ______ on the applicant paying the registration fee as specified in Second Schedule.

(a) Form C

(b) Form E

(c) Form B

(d) Form D

13. As per the SEBI (Mutual Funds) Regulations, 1996, the trustees of mutual funds shall abide by the Code of Conduct as specified in the _______

(a) Second Schedule

(b) Fifth Schedule

(c) Third Schedule

(d) Fourth Schedule

14. As per Regulation 30 of the SEBI (Mutual Funds) Regulations, 1996 advertisements shall be in conformity with the Advertisement Code as specified in the _______ and shall be submitted to the SEBI within _____ from the date of issue.

(a) Seventh Schedule; 7 days

(b) Fifth Schedule; 10 days

(c) Sixth Schedule; 7 days

(d) Eighth Schedule; 10 days

15. The mutual fund shall not borrow more than ________ of the net asset of the scheme and the duration of such a borrowing shall not exceed a period of ______

(a) 10%; 2 years

(b) 20%; 6 months

(c) 40%; 1 year

(d) 10%; 6 months

16. As per the SEBI (Mutual Funds) Regulations, 1996, every mutual fund shall ensure that the asset management company computes and carries out valuation of investments made by its scheme(s) in accordance with the investment valuation norms specified in _______, and publishes the same.

(a) Eighth Schedule

(b) Seventh Schedule

(c) Ninth Schedule

(d) Tenth Schedule

17. As per Regulation 49 of the SEBI (Mutual Funds) Regulations, 1996, the difference between the repurchase price and the sale price of the unit shall not exceed ______

(a) 7% of sale price

(b) 10% of NAV

(c) 5% of purchase price

(d) 8% of average price of sale and purchase

18. In case of Real Estate Mutual Fund, at least ______ of the net assets of the scheme shall be invested directly in real estate assets.

(a) 49%

(b) 35%

(c) 24%

(d) 53%

19. Which of the following formula is correct for calculation of return in case of mutual funds?

(a) $\text{Return} = \frac{D_1 - CG_1 + (NAV_0 + NAV_1)}{NAV_0} \times 100$

(b) $\text{Return} = \frac{D_1 + CG_1 + (NAV_1 - NAV_0)}{NAV_1} \times 100$

(c) $\text{Return} = \frac{D_1 + CG_1 + (NAV_1 - NAV_0)}{NAV_0} \times 100$

(d) $\text{Return} = \frac{D_1 \times CG_1 \times (NAV_1 - NAV_0)}{NAV_0} \times 100$

20. A mutual fund that had a net asset value of ₹ 25.00 at the beginning of month made income and capital gain distribution of ₹ 0.125 and ₹ 0.10 per share respectively during the month, and then ended the month with a net asset value of ₹ 25.075. Calculate annualized return.

(a) 12.20%

(b) 1.20%

(c) 14.40%

(d) 10.40%

21. A mutual fund that had a net asset value of ₹ 50 at the beginning of month made income and capital gain distribution of ₹ 0.09375 and ₹ 0.075 per share respectively during the month, and then ended the month with a net asset value of ₹ 50.15. Calculate monthly return.

(a) 0.6375%

(b) 0.6356%

(c) 0.6667%

(d) 0.6573%

22. Details of investment in Reliance Mutual Funds of Mr. Pratik is as follows:

Amount of investment (1.12.2015)	₹ 45,000
Net Asset Value (NAV) at entry date	₹ 9.45
Dividend received up to 31.3.2016	₹ 855
NAV as at 31.3.2016	₹ 9.36

What is the effective yield on per annum basis to Mr. Pratik up to 31.3.2016?

(a) 0.948%

(b) 5.538%

(c) 4.453%

(d) 2.835%

23. If Rahul invests ₹ 5,75,750 in a scheme that charges 4% front-end load at an NAV of ₹ 20 per unit, what shall be the public offer price?

(a) ₹ 20.40

(b) ₹ 19.23

(c) ₹ 22.50

(d) ₹ 21.33

24. The redemption price of a mutual fund unit is ₹ 38.40 while the front-end load and back-end load charges are 1.6%. Calculate net asset value per unit.

(a) 50.45

(b) 44.49

(c) 39.55

(d) 54.45

25. Calculate the value of right for XYZ Mutual Fund, if

Number of right shares offered	22,500
Number of shares held	7,500
Ex-right price	₹ 60
Right offer price	₹ 36
Face value of shares	₹ 30

(a) ₹ 82

(b) ₹ 72

(c) ₹ 92

(d) ₹ 88

Answer to Question A:

Abbreviation	Long Form
AMC	Asset Management Company
NAV	Net Asset Value

Abbreviation	Long Form
ELSS	Equity Linked Savings Schemes
FMC	Fast Moving Consumer Goods
MMMF	Money Market Mutual Funds
IMA	Investment Management Agreement
MBS	Mortgage Backed Securities
ASB	Asset Backed Securities
IDFS	Infrastructure Debt Fund Schemes
GETFS	Gold Exchange Traded Fund Scheme
REMF	Real Estate Mutual Fund
SID	Scheme Information Document
KIM	Key Information Memorandum

Answer to Question B:

(1) **Incorrect.** A mutual fund is constituted in the form of a trust.

(2) **Correct.** Mutual funds are easy to buy and sell and hence provide great liquidity.

(3) **Incorrect.** Mutual funds are a relatively less expensive way to invest compared to directly investing in the capital markets because the benefits of scale in brokerage, custodial and other fees translate into lower costs for investors.

(4) **Incorrect.** A closed-end fund is a collective investment model based on issuing a fixed number of shares which are not redeemable from the fund.

(5) **Incorrect.** The aim of income oriented schemes is to provide regular and steady income to investors. The aim of growth funds is to provide capital appreciation over the medium to long-term.

(6) **Incorrect.** As per Regulation 30 of the SEBI (Mutual Funds) Regulations, 1996, no celebrities shall form part of the advertisement.

(7) **Correct.** A scheme of a mutual fund may be wound-up, after repaying the amount due to the unit holders if 75% of the unit holders of a scheme pass a resolution that the scheme be wound-up.

(8) **Correct.** A mutual fund may enter into short selling transactions on a recognized stock exchange, subject to the framework relating to short selling and securities lending and borrowing specified by the SEBI.

(9) **Incorrect.** Mutual funds may enter into underwriting agreement after obtaining a certificate of registration in terms of the SEBI (Underwriters) Rules and SEBI (Underwriters) Regulations, 1993 authorising it to carry on activities as underwriters.

Answer to Question C:

(1) Open ended **(2)** money market mutual fund **(3)** expense ratio **(4)** 5 years **(5)** Investment Management Agreement (IMA) **(6)** 5 investors; 50% of net assets **(7)** 40% **(8)** 93%; 107% **(9)** 45 days **(10)** ₹ 1 crore

Answer to Question D:

1.	(b)	**6.**	(a)	**10.**	(c)	**14.**	(c)	**18.**	(b)	**22.**	(d)
2.	(d)	**7.**	(c)	**11.**	(a)	**15.**	(b)	**19.**	(c)	**23.**	(a)
3.	(b)	**8.**	(b)	**12.**	(c)	**16.**	(a)	**20.**	(c)	**24.**	(c)
4.	(b)	**9.**	(b)	**13.**	(b)	**17.**	(a)	**21.**	(a)	**25.**	(b)
5.	(b)										

9 CHAPTER ALTERNATIVE INVESTMENT FUND

Question 1] What do you understand by 'venture capital'?

Write a short note on: Venture Capital **CS (Executive) - June 2011 (2 Marks)**

Ans.: Venture Capital is money provided by professionals who invest alongside investment, in young, rapidly growing companies that have the potential to develop into economic power houses.

A firm engaged in providing venture capital and related service is referred to a venture capitalist. Venture Capital firms are generally private partnership, or closely held private companies, funded by private pension funds. Venture Capital is also referred as **Risk Capital**.

Venture Capitalists :

- Finance new and rapidly growing companies.
- Purchases equity shares
- Assist in the development of new products or services
- Add value to the enterprise through active participation in management.

Venture Capitalists invest in :

- First generation businesses promoted by first generation entrepreneurs.
- Untried products and untested products and technology.
- High risk projects that have high risk but if successful have enormous rewards.

SEBI (ALTERNATIVE INVESTMENT FUNDS) REGULATIONS, 2012

Note: SEBI had earlier framed the SEBI (Venture Capital Funds) Regulations, 1996 ("VCF Regulations") to encourage investments into start-ups and mid-size companies. Since the introduction of the VCF Regulations, it was observed by SEBI that the venture capital route was being used by several other categories of funds such as private equity funds, real estate funds etc. Further since registration as a venture capital fund was not mandatory under the VCF Regulations, not all private equity or other categories of funds were registering with the SEBI.

While these funds did not enjoy certain exemptions that were available to VCFs, they were not subjected to any investment restrictions either. Currently, while retail investors such as mutual funds and collective investment schemes are well regulated, SEBI noted the need for comprehensive regulations to deal with investments that are sourced from diverse parts of the private pool of capital. Accordingly, SEBI notified the Alternative Investment Fund (AIF) Regulations to govern unregulated entities and create a level playing ground for existing venture capital investors.

Question 2] What do you understand by 'Alternative Investment Fund'?

Write a short note on: Alternative Investment Fund **CS (Executive) - June 2013 (4 Marks)**

Ans.: Alternative Investment Fund (AIF) [Regulation 2(b)] : Alternative Investment Fund means any fund established in the form of a trust or a company or a LLP or a body corporate.

It is a privately pooled investment vehicle that collects funds from investors for investing it in accordance with a defined investment policy for the benefit of its investors.

Following shall not be considered as AIF:

(*a*) Mutual funds

(*b*) Collective Investment Schemes

(*c*) Family trusts set up for the benefit of 'relatives'.

(*d*) ESOP Trusts.

(*e*) Employee welfare trusts or gratuity trusts.

(*f*) Holding companies

(*g*) Other special purpose vehicles including securitization trusts

(*h*) Funds managed by securitisation company or reconstruction company which is registered with the RBI under section 3 of the **Securitisation & Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002** and

(*i*) Any funds which are directly regulated by other regulator in India.

Question 3] Distinguish between: Alternative Investment Fund & Mutual Fund

What do you understand by Alternative Investment Funds? How they differ from mutual funds?

CS (Executive) - Dec 2015 (3 Marks)

Ans.: Alternative Investment Funds are very similar in structure compared to Mutual Funds. However, the AIF regulations ensure that AIF remain within reach of only the sophisticated and knowledgable investors, while Mutual Funds are targeted at mainly retail investors.

Thus, AIF have freedom to structure the fees, can undertake leverage and have no capital requirements as they can only be brought by knowledgable investors. Following are the key areas of differences between AIF and MF:

Points	**Alternative Investment Fund**	**Mutual Fund**
Meaning	Alternative Investment Fund means any fund which is established by privately pooled investment vehicle that collects funds from investors for investing it in accordance with a defined investment policy for the benefit of its investors.	A mutual fund is a trust that pools the resources of like-minded investors for investment in the capital market. By investing in the units of mutual funds, the investor becomes a part owner of the assets of the mutual funds.
Legal Structure	An AIF can be a Trust/Company/LLP/Body Corporate which is established in India	A mutual fund is set up as a trust, which has sponsor, trustees, AMC and custodian.
Registration	An AIF can seek registration under any three categories specified in the SEBI (Alternative Investment Funds) Regulations, 2012.	Three-way structure of Trustees, Sponsor, AMC, has to be registered as per the SEBI (Mutual Fund) Regulations, 1996.
Fund type	Category I & II AIFs should be Closed Ended; Category III AIF can be both Closed Ended and Open Ended.	A Mutual Fund can be both Closed Ended and Open Ended funds.
Minimum Tenure	No scheme of an AIF can have a tenure shorter than 3 years	No minimum tenure for mutual funds.
Number of Investors	An AIF cannot have more than 1000 investors in any scheme.	There is no such ceiling in case of mutual funds.
Minimum Investment Required from Investor	Minimum investment size for an AIF is ₹ 1 crore. However, if investors are employees/directors of the AIF or employees/directors of the Manager, then minimum investment value is reduced to ₹ 25 lakh.	No minimum investment amount specified for mutual funds.

Question 4] Define the following terms as per the SEBI (Alternative Investment Funds) Regulations, 2012:

(a) Debt Fund

(b) Hedge Fund

(c) Infrastructure Fund

(d) Investible Funds **CS (Executive) - Dec 2014 (3 Marks)**

(e) Private Equity Fund

(f) SME Fund

(g) Social Venture Fund **CS (Executive) - Dec 2013 (3 Marks)**

(h) Venture Capital Fund

(i) Venture Capital Undertaking

Ans.:

(a) **Debt Fund [Regulation 2(b)] :** Debt fund means an Alternative Investment Fund which invests primarily in debt or debt securities of listed or unlisted investee companies according to the stated objectives of the Fund.

(b) **Hedge Fund [Regulation 2(k)] :** Hedge fund means an Alternative Investment Fund which employs diverse or complex trading strategies and invests and trades in securities having diverse risks or complex products including listed and unlisted derivatives.

(c) **Infrastructure Fund [Regulation 2(m)] :** Infrastructure fund means an Alternative Investment Fund which invests primarily in unlisted securities or partnership interest or listed debt or securitized debt instruments of investee companies or special purpose vehicles engaged in or formed for the purpose of operating, developing or holding infrastructure projects.

(d) **Investible Funds [Regulation 2(p)] :** Investible funds means corpus of the Alternative Investment Fund net of estimated expenditure for administration and management of the fund.

(e) **Private Equity Fund [Regulation 2(r)] :** Private equity fund means an Alternative Investment Fund which invests primarily in equity or equity linked instruments or partnership interests of investee companies according to the stated objective of the fund.

(f) **SME Fund [Regulation 2(t)] :** SME fund means an Alternative Investment Fund which invests primarily in unlisted securities of investee companies which are SMEs or securities of those SMEs which are listed or proposed to be listed on a SME exchange or SME segment of an exchange.

(g) **Social Venture Fund [Regulation 2(v)] :** Social venture fund means an Alternative Investment Fund which invests primarily in securities or units of social ventures and which satisfies social performance norms laid down by the fund and whose investors may agree to receive restricted or muted returns.

(h) **Venture Capital Fund [Regulation 2(z)] :** Venture capital fund means an Alternative Investment Fund which invests primarily in unlisted securities of **start-ups, emerging** or **early-stage** venture capital undertakings mainly involved in new products, new services, technology or intellectual property right based activities or a new business model and shall include an angel fund.

(i) **Venture Capital Undertaking [Regulation 2(aa)] :** Venture capital undertaking means a domestic company:

(*i*) which is not listed on a recognised stock exchange in India at the time of making investment; and

(*ii*) which is engaged in the business for providing services, production or manufacture of article or things and does not include following activities or sectors:

- non-banking financial companies
- gold financing
- activities not permitted under industrial policy of Government of India
- any other activity which may be specified by the Board in consultation with Government of India from time to time.

Question 4A] Distinguish between: 'Venture capital fund' and 'social venture fund'

CS (Executive) - Dec 2016 (3 Marks)

Ans.: Following are the main points of difference between venture capital fund and social venture fund:

Points	Venture Capital Fund	Social Venture Fund
Meaning	Venture capital fund means an Alternative Investment Fund which invests primarily in unlisted securities of start-ups, emerging or early-stage venture capital undertakings.	Social venture fund means an Alternative Investment Fund which invests primarily in securities or units of social ventures.
Returns	Returns are high in for venture capital fund	Investors generally receive restricted or muted returns.
Investment	Venture capital fund invest in venture capital undertakings which are mainly involved in new products, new services, technology or intellectual property right based activities or a new business model and shall include an angel fund.	Social venture fund invest in social ventures units which satisfies social performance norms.

Question 5] Discuss briefly the various categories of alternative investment funds.

CS (Executive) - Dec 2013 (5 Marks)

Ans.: Registration of Alternative Investment Funds [Regulation 3] : No entity or person shall act as an Alternative Investment Fund unless it has obtained a certificate of registration from the SEBI.

Alternative Investment Funds shall seek registration in one of the categories mentioned below:

(a) **Category I AIF :** It invests in start-up or early stage ventures or social ventures or SMEs or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable and shall include venture capital funds, SME funds, social venture funds, infrastructure funds and such other AIF as may be specified.

(b) **Category II AIF :** It does not fall in Category I and III and which does not undertake leverage or borrowing other than to meet day-to-day operational requirements.

(c) **Category III AIF :** It employs diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives.

An application for grant of certificate shall be made in **Form A** as specified in the **First Schedule** and shall be accompanied by a non-refundable application fee as specified in **Part A** of the **Second Schedule** to be paid in the manner specified in **Part B** thereof.

Question 6] Discuss the provisions relating to registration of AIF/VCF.

Explain the procedure for grant of certificate of registration to venture capital fund by SEBI and effect of refusal to grant certificate. **CS (Executive) - June 2009 (4 Marks)**

Ans.:

Important Note : New venture capital funds will be registered and regulated by the SEBI (Alternative Investment Funds) Regulation, 2012. However, existing venture capital funds will be permitted to continue and shall be governed by the SEBI (Venture Capital Funds) Regulations, 1996 till such fund or scheme managed by the fund is wound up. Thus, SEBI (Venture Capital Funds) Regulations, 1996 is applicable to those venture capital funds that came into existence prior to SEBI (Alternative Investment Funds) Regulations, 2012. Venture Capital Funds will not be permitted to raise any fresh funds after commencement of SEBI (Alternative Investment Funds) Regulations, 2012.

As new venture capital fund are treated as alternative investment funds, provisions applicable to registration of alternative investment funds are also applicable to new venture capital funds. Accordingly answer to above question is given.

Registration of Alternative Investment Funds [Regulation 3] : No entity or person shall act as an Alternative Investment Fund unless it has obtained a certificate of registration from the SEBI.

Alternative Investment Funds shall seek registration in Category I, Category II or Category III.

An application for grant of certificate shall be made in **Form A** as per **First Schedule** and shall be accompanied by a non-refundable application fee as per **Second Schedule**.

The certificate of registration shall be valid till the AIF is wound up.

Furnishing of Information [Regulation 5] : SEBI may require the applicant to furnish further information or clarification to consider the application for grant of a certificate or after registration thereon.

If required by the SEBI, the applicant or Sponsor or Manager shall appear before the Board for personal representation.

Procedure for grant of Certificate [Regulation 6] : The SEBI may grant certificate in Form B, if it is satisfied that the applicant fulfils the specified requirements.

Conditions of certificate [Regulation 7] : The certificate granted shall be subject to the following conditions:

(*a*) AIF shall abide by the provisions of the SEBI Act, 1992 and these regulations.

(*b*) AIF shall not carry on any other activity other than permitted activities.

(*c*) AIF shall forthwith inform the SEBI in writing, if any information or particulars previously submitted to the SEBI are found to be false or misleading in any material particular or if there is any material change in the information already submitted.

An AIF which has been granted registration under a particular category cannot change its category subsequent to registration, except with the approval of the SEBI.

Procedure where registration is refused [Regulation 8] : After considering an application, if 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.

The decision of the SEBI to reject the application shall be communicated to the applicant within 30 days.

Where an application for a certificate is rejected by the SEBI, the applicant shall cease to carry on any activity as an AIF.

Question 7] "An individual cannot start a venture capital fund but a trust or a company can." In the light of this statement, list down the eligibility criteria for getting registered with SEBI as venture capital fund. CS (Executive) - Dec 2014 (5 Marks)

Ans.: *As new VCF are treated as AIF, answer to above question is given as per SEBI (Alternative Investment Funds) Regulations, 2012.*

Eligibility Criteria [Regulation 4] : For the purpose of the grant of certificate to an applicant, the SEBI shall consider the following conditions for eligibility –

(*a*) The MOA in case of a company; or the Trust Deed in case of a Trust; or the Partnership deed in case of a LLP permits it to carry on the activity of an AIF.

(*b*) The applicant is prohibited by its MOA and AOA or trust deed or partnership deed from making an invitation to the public to subscribe to its securities.

(*c*) If the applicant is a Trust, the instrument of trust is in the form of a deed and has been duly registered under the provisions of the Registration Act, 1908.

(*d*) If the applicant is a LLP, the partnership is duly incorporated and the partnership deed has been duly filed with the Registrar under the provisions of the LLP Act, 2008.

(*e*) If the applicant is a body corporate, it is set up or established under the laws of the Central or State Legislature and is permitted to carry on the activities of AIF.

(*f*) The applicant, Sponsor and Manager are fit and proper persons based on the criteria specified in Schedule II of the SEBI (Intermediaries) Regulations, 2008.

(*g*) The key investment team of the Manager of AIF has adequate experience, with at least one key personnel having not less than 5 years experience in advising or managing pools of capital or in fund or asset or wealth or portfolio management or in the business of buying, selling and dealing of securities or other financial assets and has relevant professional qualification.

(*h*) The Manager or Sponsor has the necessary infrastructure and manpower to effectively discharge its activities.

(*i*) The applicant has clearly described at the time of registration the investment objective, the targeted investors, proposed corpus, investment style or strategy and proposed tenure of the fund or scheme.

(*j*) Whether the applicant or any entity established by the Sponsor or Manager has earlier been refused registration by the SEBI.

Thus, as per provisions of Regulation 4, an individual cannot start a VCF/AIF but a trust, company or LLP can start VCF/AIF.

Question 8] Is there any investment strategy specified for Alternative Investment Funds? Also state the conditions for investments.

Ans.: Investment Strategy [Regulation 9] : All Alternative Investment Funds shall state investment strategy, investment purpose and its investment methodology in its placement memorandum to the investors.

Any material alteration to the fund strategy shall be made with the consent of at least **2/3**rd of unit holders by value of their investment in the Alternative Investment Fund.

Investment in AIF [Regulation 10] : Investment in all categories of Alternative Investment Funds shall be subject to the following conditions:

(*a*) AIF may raise funds from any investor whether Indian, foreign or non-resident Indians by way of issue of units.

(*b*) Each scheme of the AIF shall have corpus of at least ₹ **20 Crore**.

(*c*) AIF shall not accept from an investor, an investment of value less than ₹ **1 crore**. However, in case of investors who are employees or directors of the Alternative Investment Fund or employees or directors of the Manager, the minimum value of investment shall be ₹ **25 lakh**.

(*d*) The Manager or Sponsor shall have a continuing interest in the AIF of not less than **2.5% of corpus** or ₹ **5 crore**, whichever is lower, in the form of investment in the AIF and such interest shall not be through the waiver of management fees. However, for Category III AIF, the continuing interest shall be not less than **5% of corpus** or ₹ **10 crore**, whichever is lower.

(*e*) The Manager or Sponsor shall disclose their investment in the AIF to the investors of the AIF.

(*f*) No scheme of the AIF shall have more than **1,000 investors**.

(*g*) The fund shall not solicit or collect funds except by way of private placement.

General Investment Conditions [Regulation 15] : Investments by all categories of AIF shall be subject to the following conditions:

(*i*) AIF may invest in securities of foreign companies subject to conditions or guidelines stipulated by the RBI and the SEBI.

(*ii*) Co-investment in an investee company by a Manager or Sponsor shall not be on terms more favourable than those offered to the AIF.

(*iii*) Category I and II AIF shall invest not more than 25% of the investible funds in one Investee Company.

(*iv*) Category III AIF shall invest not more than 10% of the investible funds in one Investee Company.

(*v*) AIF shall not invest in associates except with the approval of 75% of investors by value of their investment in the AIF.

(*vi*) Un-invested portion of the investible funds may be invested in liquid mutual funds or bank deposits or other liquid assets of higher quality such as Treasury bills, CBLOs, Commercial Papers, Certificates of Deposits, etc. till deployment of funds as per the investment objective.

(*vii*) AIF may act as Nominated Investor.

Question 8A] What are the restrictions for making investment outside India by Alternative Investment Funds?

Ans.: Under Regulation 15(1)(*a*) of SEBI (Alternative Investment Funds) Regulations, 2012, Alternative Investment Fund may invest in securities of companies incorporated outside India subject to such conditions or guidelines that may be stipulated or issued by the RBI and SEBI from time to time.

In this regard, RBI vide its Circular has permitted Alternative Investment Funds registered with SEBI, to invest overseas subject to certain conditions.

In accordance with the aforesaid RBI circular, it is stated as under:

- AIFs may invest in equity and equity linked instruments only of offshore venture capital undertakings, subject to overall limit of **USD 500 million** (combined limit for AIFs and Venture Capital Funds registered under the SEBI (Venture Capital Funds) Regulations, 1996).
- AIFs desirous of making investments in offshore venture capital undertakings shall submit their proposal for investment to SEBI for prior approval. No separate permission from RBI is necessary in this regard.
- Investments would be made only in those companies which have an **Indian connection** (e.g. company which has a front office overseas, while back office operations are in India).
- Such investments shall not exceed **25% of the investible funds** of the scheme of the AIF.
- The allocation of investment limits would be done on **'first come first serve'** basis, depending on the availability in the overall limit of USD 500 million.
- In case an AIF who is allocated certain investment limit, wishes to apply for allocation of further investment limit, the fresh application shall be dealt with on the basis of the date of its receipt and no preference shall be granted to it in fresh allocation of investment limit.
- The AIF shall have a **time limit** of **6 months** from the date of approval from SEBI for making allocated investments in offshore venture capital undertakings. In case the applicant does not utilize the limits allocated within the stipulated period, SEBI may allocate such unutilized limit to other applicants.
- These investments would be subject to provisions of the **Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004** including amendments thereof and related directions issued by RBI from time to time.
- AIFs shall **not invest in JV/WOS** while making overseas investments.
- AIFs shall **adhere to FEMA Regulations** and **RBI guidelines**.
- AIFs shall comply with all requirements under RBI guidelines on opening of branches/subsidiaries/JV/undertaking investment abroad by NBFCs, where more than 50% of the funds of the AIF has been contributed by a single NBFC.

Question 9] Which document is required to be issued by Alternative Investment Fund to raise funds? What kind of information is required to be given in such document?

Ans.: Placement Memorandum [Regulation 11] : AIF shall raise funds through private placement by issue of information memorandum or placement memorandum, by whatever name called.

Such placement memorandum shall contain:

- All material information about the AIF and the Manager
- Background of key investment team of the Manager
- Targeted investors
- Fees and all other expenses proposed to be charged
- Tenure of the AIF or scheme
- Conditions or limits on redemption
- Investment strategy
- Risk management tools and parameters employed
- Key service providers
- Conflict of interest and procedures to identify and address them
- Disciplinary history
- The terms and conditions on which the Manager offers investment services
- Its affiliations with other intermediaries
- Manner of winding up of the AIF or the scheme
- Such other information as may be necessary for the investor to take an informed decision on whether to invest in the AIF.

Question 10] What is tenure of various category of Alternative Investment Fund?

Ans.: Tenure [Regulation 13] : Category I AIF and Category II AIF shall be **close ended** and the tenure of fund or scheme shall be determined at the time of application.

Category I and II AIF or schemes launched by such funds shall have a minimum tenure of **3 years**.

Category III Alternative Investment Fund may be **open ended** or **close ended**.

Extension of the tenure of the close ended AIF may be permitted up to **2 years** subject to approval of **2/3rd** of the unit holders by value of their investment in the AIF.

In the absence of consent of unit holders, the AIF shall fully liquidate within 1 year after expiration of the fund tenure or extended tenure.

Question 11] Write a short note on : Listing of Alternative Investment Fund

Ans.: Listing [Regulation 14] : Units of close ended AIF *may be* listed on stock exchange subject to a minimum tradable lot of ₹ **1 crore**.

Listing of AIF units shall be permitted only after final close of the fund or scheme.

Question 12] What are the general obligations of the Alternative Investment Funds?

Ans.: General Obligations [Regulation 20]:

(1) All AIF shall review policies and procedures, and their implementation, on a regular basis, or as a result of business developments, to ensure their continued appropriateness.

(2) The Sponsor or Manager of AIF shall appoint a custodian registered with the SEBI for safekeeping of securities if the corpus of the AIF is more than ₹ **500 crore**. However, the Sponsor or Manager of a Category III AIF shall appoint such custodian irrespective of the size of corpus of the AIF.

(3) All AIF shall inform the SEBI in case of any change in the Sponsor, Manager or designated partners or any other material change from the information provided by the AIF at the time of application for registration.

(4) In case of change in control of the AIF, Sponsor or Manager, prior approval from the Board shall be taken by the AIF.

(5) The books of account of the AIF shall be audited annually by a qualified auditor.

Question 13] Alternative Investment Funds shall ensure transparency by disclosing various type of information to investors. Comment.

Ans.: Transparency [Regulation 22] : All AIF shall ensure transparency and disclosure of information to investors on the following:

(*a*) Financial, risk management, operational, portfolio, and transactional information regarding fund investments shall be disclosed periodically to the investors.

(*b*) Any fees ascribed to the Manager or Sponsor and any fees charged to the AIF or any investee company by an associate of the Manager or Sponsor shall be disclosed periodically to the investors.

(*c*) Any inquiries/legal actions by legal or regulatory bodies in any jurisdiction, as and when occurred.

(*d*) Any material liability arising during the AIF tenure shall be disclosed, as and when occurred.

(*e*) Any breach of a provision of the placement memorandum or agreement made with the investor or any other fund documents, if any, as and when occurred.

(*f*) Change in control of the Sponsor or Manager or Investee Company.

(*g*) AIF shall provide at least on an annual basis, within **180 days** from the year end, reports to investors including the following information:

A. Financial information of investee companies.

B. Material risks and how they are managed which may include –

(*i*) concentration risk at fund level;

(*ii*) foreign exchange risk at fund level;

(*iii*) leverage risk at fund and investee company levels;

(*iv*) realization risk (i.e. change in exit environment) at fund and investee company levels;

(*v*) strategy risk (i.e. change in or divergence from business strategy) at investee company level;

(*vi*) reputation risk at investee company level;

(*vii*) extra-financial risks, including environmental, social and corporate governance risks, at fund and investee company level.

(*h*) Category III AIF shall provide **quarterly reports** to investors within **60 days** of end of the quarter.

(*i*) Any significant change in the key investment team shall be intimated to all investors.

(*j*) AIF shall provide information for systemic risk purposes, when required by the SEBI.

Question 14] Write a short note on: Valuation of investments by AIF

Ans.: Valuation [Regulation 23] :

(1) The AIF shall provide to its investors, a description of its valuation procedure and of the methodology for valuing assets.

(2) Category I and Category II AIF shall undertake valuation of their investments, at least once in every **6 months**, by an independent valuer appointed by the AIF. However, such period may be enhanced to 1 year on approval of at least 75% of the investors by value of their investment.

(3) Category III AIF shall ensure that calculation of the NAV is independent from the fund management function of the AIF and such NAV shall be disclosed to the investors at intervals not longer than a quarter for close ended funds and at intervals not longer than a month for open ended funds.

Question 15] State the obligation of manager of AIF.

Ans.: Obligation of Manager [Regulation 24] : The Manager shall be obliged to:

(*a*) Address all investor complaints

(*b*) Provide information sought by SEBI

(*c*) Maintain records specified by the SEBI

(*d*) Take all steps to address conflict of interest

(*e*) Ensure transparency and disclosure

Question 16] Write a short note on: Maintenance of Records by AIF

Ans.: Maintenance of Records [Regulation 27] : The Manager or Sponsor shall be required to maintain following records describing:

(*a*) The assets under the scheme/fund;

(*b*) Valuation policies and practices;

(*c*) Investment strategies;

(*d*) Particulars of investors and their contribution;

(*e*) Rationale for investments made.

The records shall be maintained for a period of **5 years** after the winding up of the fund.

Question 17] Briefly state the provisions relating to winding-up of alternative investment fund.

Ans.: Winding-up [Regulation 29] :

(1) An AIF set up as a trust shall be wound up:

   (*a*) When the tenure of the AIF or all schemes launched by the AIF is over or

   (*b*) If trustees forms opinion that the AIF be wound up in the interests of investors or

   (*c*) If **75% investors** by value pass a resolution that the AIF be wound up or

   (*d*) If the SEBI so directs in the interests of investors.

(2) An AIF set up as a LLP shall be wound up in accordance with the provisions of the LLP Act, 2008:

   (*a*) When the tenure of the AIF or all schemes launched by the AIF is over or

   (*b*) If **75% investors** by value pass a resolution that the AIF be wound up or

   (*c*) If the SEBI so directs in the interests of investors.

(3) An AIF set up as a company shall be wound up in accordance with the provisions of the Companies Act, 2013.

(4) An AIF set up as a body corporate shall be wound up in accordance with the provisions of the statute under which it is constituted.

(5) The AIF shall intimate the SEBI and investors of the circumstances leading to the winding up.

(6) On and from the date of intimation, no further investments shall be made on behalf of the AIF so wound up.

(7) Within 1 year from the date of intimation, the assets shall be liquidated, and the proceeds accruing to investors in the AIF shall be distributed to them after satisfying all liabilities.

(8) In *specie distribution* of assets of the AIF, shall be made by the AIF at any time, including on winding up of the AIF, as per the preference of investors, after obtaining approval of at least 75% of the investors by value of their investment in the AIF.

(9) Upon winding up of the AIF, the certificate of registration shall be surrendered to the SEBI.

Question 18] What action can be taken against AIF for violation of SEBI provisions?

Ans.: Liability for action in case of default [Regulation 35] : An AIF which contravenes any of the provisions of the Act or these regulations shall be dealt with in the manner provided under the SEBI (Intermediaries) Regulations, 2008.

Question 19] Write a short note on: Angel Fund

Ans.: Angel Fund [Regulation 19A(1)] : Angel fund means Venture Capital Fund under Category I-AIF that raises funds from angel investors and invests in accordance with the provisions of the SEBI (Alternative Investment Funds) Regulations, 2012.

Angel Investor [Regulation 19A(2)]: Angel investor means any person who proposes to invest in an angel fund and satisfies one of the following conditions:

(*a*) An individual investor who has net tangible assets of at least ₹ **2 crore** excluding value of his principal residence and who:

- has early stage investment experience, or
- has experience as a serial entrepreneur, or
- is a senior management professional with at least **10 years experience**;

(*b*) A body corporate with a net worth of at least ₹ **10 crore**; or

(*c*) An AIF or Venture Capital Fund

Angel Investor explained:

Angel Investor means an investor who provides financial backing for small start-ups or entrepreneurs. Angel investors are usually found among an entrepreneur's family and friends. Angel investors provide capital that can be a one-time injection of seed money or ongoing support to carry the company through difficult times.

An angel investor (also known as a business angel, informal investor, angel funder, private investor, or seed investor) is an affluent individual who provides capital for a business start-up, usually in exchange for convertible debt or ownership equity.

Angels typically invest their own funds, unlike venture capitalists who manage the pooled money of others in a professionally-managed fund.

Angel investments bear extremely high risks and are usually subject to dilution from future investment rounds.

The term "angel" originally comes from Broadway Theatre, where it was used to describe wealthy individuals who provided money for theatrical productions that would otherwise have had to shut down. In 1978, William Wetzel, then a professor at the University of New Hampshire and founder of its Centre for Venture Research, completed a pioneering study on how entrepreneurs raised seed capital in the USA, and he began using the term "angel" to describe the investors that supported them.

Question 20] Explain the term: "Company with family connection" under the SEBI (Alternative Investment Funds) Regulations, 2012

Ans.: Company with family connection [Regulation 19A(3)] : Company with family connection means:

(*a*) If the angel investor is an individual, any company:

- which is promoted by such an individual or his relative or
- where the individual or his relative is a director or
- where the person or his relative has control, or shares or voting rights which entitle them to 15% or more of the shares or voting rights in the company.

(*b*) If the angel investor is a body corporate, any company:

- which is a subsidiary or a holding company or
- which is part of the same group or under the same management or
- where the body corporate or its directors/partners have control, or shares or voting rights which entitle them to 15% or more of the shares or voting rights in the company.

"Relative" means a person as defined under the Companies Act, 2013.

Question 21] Write a short note on : Registration of angel funds

Ans.: Registration of angel funds [Regulation 19C] : An applicant may apply for registration to SEBI with registration fee of ₹ **2 lakhs**.

An AIF already registered, which has not made any investments, may apply for conversion of its category into an angel fund and the provisions shall apply as they apply to a fresh registration.

Question 22] Write a short note on : Investment in angel funds

Ans.: Investment in angel funds [Regulation 19D] : Angel funds shall only raise funds by way of issue of units to angel investors.

An angel fund shall have a corpus of at least ₹ **10 crore**.

Angel funds shall accept an investment of not less than ₹ **25 lakhs** from an angel investor up to a maximum period of **3 years**.

Angel fund shall raise funds through private placement by issue of placement memorandum.

Question 23] Write a short note on : Launching of schemes by angel funds

Ans.: Schemes [Regulation 19E] :

(1) The angel fund may launch schemes subject to filing of a scheme memorandum at least 10 working days prior to launch of the scheme with the SEBI.

(2) Scheme memorandum shall contain all material information about the investments proposed under the scheme.

(3) The SEBI may communicate its comments to the applicant prior to launch of the Scheme and the applicant shall incorporate the comments in the scheme memorandum prior to launch of the scheme.

(4) No scheme of the angel fund shall have more than **200 angel investors**.

Question 24] Write a short note on : Investment by Angel Funds

Ans.: Investment by Angel Funds [Regulation 19F] :

(1) Angel funds shall invest in venture capital undertakings which:

  (*a*) Complies with criteria regarding the age of the venture capital undertaking/start-up issued by Department of Industrial Policy and promotion;

  (*b*) have a turnover of less than ₹ **25 crore**;

  (*c*) are not promoted or sponsored by or related to an industrial group whose group turnover exceeds ₹ **300 crores**; and

  (*d*) are not companies with family connection with any of the angel investors who are investing in the company.

(2) Investment by an angel fund in any venture capital undertaking shall not be less than ₹ **25 lakh** and shall not exceed ₹ **5 crore**.

(3) Investment by an angel fund in the venture capital undertaking shall be locked-in for a period of **1 years**.

(4) Angel funds shall not invest in associates.

(5) Angel funds shall not invest more than 25% of the total investments under all its schemes in one venture capital undertaking.

(6) An Angel fund may also invest in the securities of companies incorporated outside India subject to conditions and guidelines issued by RBI.

Question 25] Can angel funds be listed on any recognized stock exchange?

Ans.: Prohibition of Listing [Regulation 19H] : Units of angel funds shall not be listed on any recognized stock exchange.

SEBI (VENTURE CAPITAL FUNDS) REGULATIONS, 1996

Important Note: New venture capital funds will be registered and regulated by the SEBI (Alternative Investment Funds) Regulations, 2012. However, existing venture capital funds will be permitted to continue and shall be governed by the SEBI (Venture Capital Funds) Regulations, 1996 till such fund or scheme managed by the fund is wound up. Thus, SEBI (Venture Capital Funds) Regulations, 1996 is applicable to those venture capital funds that came into existence prior to SEBI (Alternative Investment Funds) Regulations, 2012. Venture Capital Funds will not be permitted to raise any fresh funds after commencement of SEBI (Alternative Investment Funds) Regulations, 2012.

Question 26] Define the term : Venture Capital Fund (VCF)

Ans.: Venture Capital Fund [Regulation 2(m)] : Venture capital fund means a fund established in the form of a trust or a company including a body corporate and registered under these regulation which –

(*a*) has a dedicated pool of capital;

(*b*) raised in a manner specified in the Regulations; and

(*c*) invests in accordance with the Regulations.

Question 27] Define the term: Venture Capital Undertaking

Ans.: Venture Capital Undertaking [Regulation 2(n)] : Venture capital undertaking means a domestic company –

(*a*) Whose shares are not listed

(*b*) Which is engaged in the business for providing services, production or manufacture of article or things and does not include such activities or sectors which are specified in the negative list by the SEBI with the approval of the Central Government by notification in the Official Gazette.

Question 28] Write a short note on: Minimum investment in a Venture Capital Fund

Ans.: Minimum investment in a Venture Capital Fund [Regulation 11] :

(1) A VCF may raise monies from any investor whether Indian, foreign or non-resident Indian by way of issue of units.

(2) No VCF set up as a company or any scheme of a venture capital fund set up as a trust shall accept any investment from any investor which is less than ₹ **5 lakh**. This restriction shall apply to following investors:

   (*a*) Employees or the principal officer or directors of the VCF, or directors of the trustee company

   (*b*) The employees of the fund manager or AMC; or

(3) Each scheme launched or fund set up by a VCF shall have firm commitment from the investors for contribution of an amount of at least ₹ **5 Crores** before the start of operations by the venture capital fund.

Question 29] Venture Capital Funds invest in all types of securities. Comment.

CS (Executive) - Dec 2011 (3 Marks)

Ans.: Investment conditions and restrictions [Regulation 12] : All investment made or to be made by a VCF shall be subject to the following conditions:

(*a*) VCF shall disclose the investment strategy at the time of application for registration;

(*b*) VCF shall not invest more than 25% corpus of the fund in one venture capital undertaking;

(*c*) VCF may invest in securities of foreign companies subject to such conditions or guidelines that may be stipulated or issued by the RBI and the SEBI from time to time;

(*d*) shall not invest in the associated companies; and

(*e*) VCF shall make investment as enumerated below:

(*i*) At least 66.67% of the investible funds shall be invested in unlisted equity shares or equity linked instruments of venture capital undertaking.

(*ii*) Not more than 33.33% of the investible funds may be invested by way of

- Subscription to IPO of a venture capital undertaking whose shares are proposed to be listed;
- Debt or debt instrument of a venture capital undertaking in which the venture capital fund has already made an investment by way of equity;
- Preferential allotment of equity shares of a listed company subject to lock in period of 1 year;
- The equity shares or equity linked instruments of a financially weak company or a sick industrial company whose shares are listed;
- Special Purpose Vehicles which are created by a VCF for the purpose of facilitating or promoting investment in accordance with these Regulations.

(*f*) VCF shall disclose the duration of life cycle of the fund.

Question 30] Can venture capital fund be listed on recognised stock exchange?

Ans.: Prohibition on listing [Regulation 13]: No venture capital fund shall be entitled to get its units listed on any recognised stock exchange till the expiry of **3 years** from the date of the issuance of units by the venture capital fund.

Question 31] Can venture capital fund issue advertisement inviting offers from the public for the subscription or purchase of any of its units?

Ans.: Prohibition on inviting subscription from the public [Regulation 14]: No venture capital fund shall issue any document or advertisement inviting offers from the public for the subscription or purchase of any of its units.

Question 32] What is placement memorandum? List out its essential contents?

CS (Inter) - Dec 2006 (4 Marks)

Ans.: Placement memorandum or subscription agreement [Regulation 16] : The venture capital fund shall:

(*a*) issue a placement memorandum which shall contain details of the terms and conditions subject to which monies are proposed to be raised from investors; or

(*b*) enter into contribution or subscription agreement with the investors which shall specify the terms and conditions subject to which monies are proposed to be raised.

The VCF shall file the copy of the placement memorandum or the copy of the contribution or subscription agreement entered with the investors with the SEBI along with a report of money actually collected from the investor.

Contents of placement memorandum [Regulation 17] : The placement memorandum or the subscription agreement with investors shall contain the following:

(*a*) Details of the trustees or trustee company and the directors or chief executives of the VCF;

(*b*) Proposed corpus of the fund and the minimum amount to be raised for the fund to be operational;

(*c*) Minimum amount to be raised for each scheme and the provision for refund of monies to investor in the event of non-receipt of minimum amount;

(*d*) Details of entitlements on the units of VCF for which subscription is being sought;

(*e*) Tax implications that are likely to apply to investors;

(*f*) Manner of subscription to the units of the VCF;

(*g*) Period of maturity of the fund;

(*h*) Manner in which the fund shall be wound up;

(*i*) Manner in which the benefits will be distributed investors;

(*j*) Details of the fund manager or AMC and the fees to be paid to such manager;

(*k*) Details about performance of the fund managed by the Fund Manager;

(*l*) Investment strategy of the fund;

(*m*) Any other information specified by the SEBI.

Question 33] Write a short note on: Maintenance of books and records by VCF

Ans.: Maintenance of books and records [Regulation 20] : Every venture capital fund shall maintain for a period of **8 years** books of account, records and documents which shall give a true and fair picture of the state of affairs of the VCF.

Every VCF shall intimate the SEBI, in writing, the place where the books, records and documents are being maintained.

Question 34] Write a short note on: Winding-up of VCF

Ans.: Winding-up [Regulation 23] :

(1) A scheme of VCF set up as a trust shall be wound up,

  (*a*) When the period of the mentioned in the placement memorandum is over;

  (*b*) If it is the trustee forms opinion that the scheme shall be wound-up in the interests of investors;

  (*c*) If 75% of the investors in the scheme pass a resolution at a meeting of unit holders that the scheme be wound-up; or

  (*d*) If the SEBI so directs in the interests of investors.

(2) A VCF set up as a company shall be wound up in accordance with the provisions of the Companies Act, 2013.

(3) A venture capital fund set up as a body corporate shall be wound up in accordance with the provisions of the statute under which it is constituted.

(4) The VCF shall intimate the SEBI and investors of the circumstances leading to the winding-up of the Fund or Scheme.

Question 35] Write a short note on: Effect of winding-up of VCF

Ans.: Effect of winding-up [Regulation 24] :

(1) On and from the date of intimation of winding-up, no further investments shall be made on behalf of the scheme so wound up.

(2) Within 3 months from the date of intimation, the assets of the scheme shall be liquidated, and the proceeds accruing to investors in the scheme distributed to them after satisfying all liabilities.

SEBI (FOREIGN VENTURE CAPITAL INVESTORS) REGULATIONS, 2000

Question 36] Discuss briefly the eligibility criteria for registering Foreign Venture Capital Investor with the SEBI.

Ans.: Application for grant of certificate [Regulation 3] : For the purposes of seeking registration, the applicant shall make an application to the SEBI in **Form A** along with the application fee as specified in **Part A** of the **Second Schedule** to be paid in the manner specified in **Part B**.

Eligibility Criteria [Regulation 4] :

(1) For the purpose of the grant of a certificate to an applicant as a Foreign Venture Capital Investor (FVCI), the SEBI shall consider the following conditions for eligibility, namely:

- (*i*) The applicants track record, professional competence, financial soundness, experience, general reputation of fairness and integrity;
- (*ii*) Whether the applicant has been granted necessary approval by the RBI for making investments in India;
- (*iii*) Whether the applicant is an investment company, investment trust, investment partnership, pension fund, mutual fund, endowment fund, university fund, charitable institution or any other entity incorporated outside India;
- (*iv*) Whether the applicant is an AMC, investment manager or investment management company or any other investment vehicle incorporated outside India;
- (*v*) Whether the applicant is authorised to invest in VCF or carry on activity as a FVCI;
- (*vi*) Whether the applicant is regulated by an appropriate foreign regulatory authority or is an income tax payer; or submits a certificate from its banker or its promoter's track record where the applicant is neither a regulated entity nor an income tax payer;
- (*vii*) The applicant has not been refused a certificate by the SEBI;
- (*viii*) Whether the applicant is a fit and proper person.

Procedure for grant of certificate [Regulation 7] : If the SEBI is satisfied that the applicant is eligible for the grant of certificate, it shall send intimation to the applicant. The SEBI shall grant a certificate of registration in **Form B**.

Question 37] Explain the investment criteria for a foreign venture capital investor.

CS (Inter) - Dec 2006 (4 Marks)

CS (Executive) - Dec 2010 (4 Marks)

Ans.: Investment Criteria for a Foreign Venture Capital Investor [Regulation 11] : All investments to be made by foreign venture capital investors shall be subject to the following conditions:

(*a*) It shall disclose to the SEBI its investment strategy.

(*b*) It can invest its total funds committed in one foreign venture capital investor.

(*c*) it shall make investments as enumerated below:

- (*i*) At least **66.67%** of the investible funds shall be invested in **unlisted equity shares** or **equity linked instruments** of Venture Capital Undertaking;
- (*ii*) Not more than **33.33%** of the investible funds may be invested by way of:

- subscription to IPO of a venture capital undertaking whose shares are proposed to be listed;
- debt or debt instrument of a venture capital undertaking in which the foreign venture capital investor has already made an investment by way of equity;
- preferential allotment of equity shares of a listed company subject to lock in period of 1 year.

(*d*) It shall disclose the duration of life cycle of the fund;

(*e*) Special purpose vehicles which are created for the purpose of facilitating or promoting investment.

Question 38] What are the obligations of foreign venture capital investor?

CS (Executive) - Dec 2010 (4 Marks)

Ans.: General Obligations and Responsibilities [Regulation 14] : Foreign Venture Capital Investor or a global custodian acting on behalf of the foreign venture capital investor shall enter into an agreement with the domestic custodian to act as a custodian of securities for Foreign Venture Capital Investor.

Foreign Venture Capital Investor shall ensure that domestic custodian takes steps for,-

(*a*) Monitoring of investment of Foreign Venture Capital Investors in India

(*b*) Furnishing of periodic reports to the SEBI

(*c*) Furnishing such information as may be called for by the SEBI.

OBJECTIVE QUESTIONS

Question A] Expand the following abbreviations :

(1)	VC	(6)	ESOS
(2)	VCF	(7)	ESPS
(3)	AIF	(8)	SME
(4)	LLP	(9)	CBLO
(5)	CIS	(10)	FVCI

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

(1) Venture capital is money provided listed large companies that are economic super power.

(2) An Individual can create alternative investment fund.

(3) Alternative Investment Funds are same as to Mutual Funds.

(4) Category I AIF and Category II AIF shall be open ended.

(5) Units of close ended AIF cannot be listed on stock exchange.

(6) An individual person can be angel investor.

(7) There is no limit as to number of angel investors.

(8) There is prohibition on listing of angel funds in India.

(9) No venture capital fund can be listed on recognized stock exchange.

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

(1) _______ means corpus of the Alternative Investment Fund net of estimated expenditure for administration and management of the fund.

(2) Any material alteration to the alternative investment fund strategy shall be made with the consent of at least ______ of unit holders by value of their investment in the Alternative Investment Fund.

(3) Each scheme of the Alternative Investment Fund shall have corpus of at least _______

(4) Alternative Investment Fund shall not accept from an investor, an investment of value less than __________

(5) No scheme of the Alternative Investment Fund shall have more than _______ investors.

(6) Category I and II AIF shall invest not more than _______ of the investible funds in one Investee Company.

(7) Category III Alternative Investment Fund may be ______

(8) Units of close ended AIF may be listed on stock exchange subject to a minimum tradable lot of ________

(9) A body corporate with a net worth of at least _____ can be angel investor.

(10) Angel funds shall accept an investment of not less than _______ from an angel investor.

(11) No scheme of the angel fund shall have more than ________ angel investors.

(12) Investment by an angel fund in the venture capital undertaking shall be locked-in for a period of ________

(13) Every venture capital fund shall maintain for a period of ______ books of account, records and documents which shall give a true and fair picture of the state of affairs of the VCF.

Question D] Select the correct option

1. Alternative Investment Fund (AIF) means any fund established or incorporated in India in the form of _______

(I) a trust

(II) a company

(III) a LLP

(IV) a body corporate

(*a*) (III) & (II)

(*b*) (IV) & (I)

(*c*) (II), (IV) & (I)

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

2. ______ means an Alternative Investment Fund which invests primarily in debt or debt securities of listed or unlisted investee companies according to the stated objectives of the fund.

(*a*) Hedge Fund

(*b*) Private Equity Fund

(*c*) Debt Fund

(*d*) Investible Fund

3. AIF shall not invest in associates except with the approval of _____ of investors by value of their investment in the AIF.

(*a*) 75%

(*b*) 51%

(*c*) 25%

(*d*) 66.67%

4. Alternative Investment Fund __________

(A) is a privately pooled investment vehicle that collects funds from investors

(B) is not covered under the SEBI (Mutual Funds) Regulations, 1996, SEBI (Collective Investment Schemes) Regulations, 1999

(*a*) (B) only

(*b*) Neither (A) nor (B)

(*c*) (A) only

(*d*) Both (A) and (B)

5. Each scheme of the Alternative Investment Fund shall have corpus of at least _______

(*a*) ₹ 20 Crore

(*b*) ₹ 50 Crore

(*c*) ₹ 100 Crore

(*d*) ₹ 1,000 Crore

6. Alternative Investment Fund shall raise funds through private placement by issue of _______

(*a*) information memorandum

(*b*) placement memorandum

(*c*) either (a) or (b)

(*d*) none of the above

7. Which of the following CANNOT be considered as Alternative Investment Fund?

(1) Family trusts set up for the benefit of 'relatives'

(2) Employee welfare trusts or gratuity trusts

(3) Funds managed by securitisation company or reconstruction company

(4) ESOP Trusts

(a) (3) & (2) only

(b) (1) only

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

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

8. An individual investor can be angel investor who has net tangible assets of at least ______ excluding value of his principal residence.

(a) ₹ 1 Crore

(b) ₹ 2 Crore

(c) ₹ 5 Crore

(d) ₹ 3 Crore

9. Alternative Investment Fund shall not accept from an investor, an investment of value less than ________. However, in case of investors who are employees or directors of the Alternative Investment Fund or employees or directors of the Manager, the minimum value of investment shall be ________.

(a) ₹ 100 Crore; ₹ 1 Crore

(b) ₹ 50 Crore; ₹ 50 lakh

(c) ₹ 1 Crore; ₹ 25 lakh

(d) ₹ 10 Crore; ₹ 5 lakh

10. Category I & II AIFs should be _____

(a) Closed Ended

(b) Open Ended

(c) Both (a) and (b)

(d) Either (a) or (b)

11. An applicant may apply for registration to SEBI with registration fee of _______

(a) ₹ 2 lakhs

(b) ₹ 1 lakh

(c) ₹ 5 lakhs

(d) ₹ 50 thousand

12. No scheme of an AIF can have a tenure shorter than ________

(a) 4 years

(b) 3 years

(c) 5 years

(d) 10 years

13. The Manager or Sponsor shall have a continuing interest in the Alternative Investment Fund of not less than ____ of corpus or _____, whichever is lower, in the form of investment in the Alternative Investment Fund and such interest shall not be through the waiver of management fees. However, for Category III Alternative Investment Fund, the continuing interest shall be not less than _____ of corpus or ______, whichever is lower.

(a) 2.5%; ₹ 5 Crore; 5%; ₹ 10 Crore

(b) 5%; ₹ 5 Crore; 2.5%; ₹ 10 Crore

(c) 2.5%; ₹ 10 Crore; 5%; ₹ 5 Crore

(d) 2%; ₹ 2.5 Crore; 4%; ₹ 5 Crore

14. An AIF cannot have more than ______ investors in any scheme.

(a) 5,000

(b) 2,500

(c) 1,000

(d) 49

15. An angel fund shall have a corpus of at least ________

(a) ₹ 10 Crore

(b) ₹ 25 lakhs

(c) ₹ 200 Crore

(d) ₹ 150 lakhs

16. An application for grant of certificate of Alternative Investment Fund shall be made in _____ as specified in the _____ under the SEBI (Alternative Investment Funds) Regulations, 2012.

(a) Form B; Second Schedule

(b) Form A; First Schedule

(c) Form I; Third Schedule

(d) Form II; Second Schedule

17. Category I and II AIF shall invest not more than _____ of the investible funds in one Investee Company and Category III AIF shall invest not more than _____ of the investible funds in one Investee Company.

(a) 10%; 25%

(b) 25%; 10%

(*c*) 15%; 5%

(*d*) 10%; 15%

18. Category I and II AIF or schemes launched by such funds shall have a minimum tenure of _______

(*a*) 5 years

(*b*) 7 years

(*c*) 4 years

(*d*) 3 years

19. Angel funds shall accept an investment of not less than ________ from an angel investor up to a maximum period of _____

(*a*) ₹ 25 lakhs; 3 years

(*b*) ₹ 5 lakhs; 5 years

(*c*) ₹ 10 lakhs; 4 years

(*d*) ₹ 10 lakhs; 5 years

20. Extension of the tenure of the close ended AIF may be permitted up to ____ subject to approval of ____ of the unit holders by value of their investment in the AIF.

(*a*) 3 years; 1/3rd

(*b*) 2 years; 3/4th

(*c*) 2 years; 2/3rd

(*d*) 3 years; 3/4th

21. Units of close ended AIF may be listed on stock exchange subject to a minimum tradable lot of _____

(*a*) ₹ 1 Crore

(*b*) ₹ 50 Lakhs

(*c*) ₹ 25 Lakhs

(*d*) ₹ 2 Crore

22. No scheme of the angel fund shall have more than _____ angel investors.

(*a*) 49

(*b*) 200

(*c*) 149

(*d*) 199

23. The Sponsor or Manager of AIF shall appoint a custodian registered with the SEBI for safekeeping of securities if the corpus of the AIF is more than ____

(*a*) ₹ 250 Crore

(*b*) ₹ 500 Crore

(*c*) ₹ 100 Crore

(*d*) ₹ 750 Crore

24. Investment by an angel fund in any venture capital undertaking shall not be less than _______ and shall not exceed _______

(*a*) ₹ 25 lakh; ₹ 10 Crore

(*b*) ₹ 5 lakh; ₹ 2 Crore

(*c*) ₹ 50 lakh; ₹ 5 Crore

(*d*) ₹ 50 lakh; ₹ 10 Crore

25. Category III AIF shall provide ______ reports to investors within _____ of end of the quarter.

(*a*) half yearly; 30 days

(*b*) quarterly; 60 days

(*c*) monthly; 10 days

(*d*) half yearly; 60 days

26. Investment by an angel fund in the venture capital undertaking shall be locked-in for a period of _______

(*a*) 3 years

(*b*) 5 years

(*c*) 1 year

(*d*) 2 years

27. Category I & Category II AIF shall undertake valuation of their investments, at least once in every ______, by an independent valuer appointed by the AIF. However, such period may be enhanced to _____ on approval of at least ___ of the investors by value of their investment.

(*a*) 3 months; 6 months; 51%

(*b*) 6 months; 1 year; 75%

(*c*) 3 months; 1 year; 75%

(*d*) 6 months; 9 months; 25%

28. No VCF set up as a company or any scheme of a venture capital fund set up as a trust shall accept any investment from any investor which is less than ____

(*a*) ₹ 5 lakh

(*b*) ₹ 10 lakh

(*c*) ₹ 1 Crore

(*d*) ₹ 25 lakhs

29. An AIF set up as a trust shall be wound up if ______ by value pass a resolution that the AIF be wound up

(*a*) 80% investors

(*b*) 51% investors

(c) 75% investors

(d) 2/3rd investors

30. VCF shall not invest more than _______ corpus of the fund in one venture capital undertaking.

(a) 15%

(b) 25%

(c) 50%

(d) 10%

31. VCF shall make investment of at least _______ of the investible funds shall be invested in unlisted equity shares or equity linked instruments of venture capital undertaking

(a) 66.67%

(b) 33.33%

(c) 75%

(d) 25%

32. No venture capital fund shall be entitled to get its units listed on any recognized stock exchange till the expiry of _____ from the date of the issuance of units by the venture capital fund.

(a) 2 years

(b) 3 years

(c) 5 years

(d) 4 years

33. Every venture capital fund shall maintain for a period of _______ books of account, records and documents which shall give a true and fair picture of the state of affairs of the VCF.

(a) 3 years

(b) 5 years

(c) 8 years

(d) 10 years

Answer to Question A:

Abbreviation	Long Form
VC	Venture Capital
VCF	Venture Capital Fund
AIF	Alternative Investment Fund
LLP	Limited Liability Partnership
CIS	Collective Investment Schemes
ESOS	Employee Stock Option Scheme
ESPS	Employee Stock Purchase Scheme
SME	Small & Medium Enterprise
CBLO	Collateralized Borrowing & Lending Obligation
FVCI	Foreign Venture Capital Investor

Answer to Question B :

(1) **Incorrect.** Venture Capital is money provided by professionals who invest alongside investment, in young, rapidly growing companies that have the potential to develop into economic power houses.

(2) **Incorrect.** Alternative Investment Fund means any fund established or incorporated in India in the form of a trust or a company or a LLP or a body corporate.

(3) **Incorrect.** Alternative Investment Funds are very similar in structure compared to Mutual Funds. However, the AIF regulations ensure that AIF remain within reach of only the sophisticated and knowledgeable investors, while Mutual Funds are targeted at mainly retail investors.

(4) **Incorrect.** Category I AIF and Category II AIF shall be close ended. Category III Alternative Investment Fund may be open ended or close ended.

(5) **Incorrect.** Units of close ended AIF may be listed on stock exchange subject to a minimum tradable lot of ₹ 1 Crore.

(6) **Correct.** An individual investor can be angel investor if he has net tangible assets of at least ₹ 2 Crore excluding value of his principal residence.