

# FINAL EXAMINATION

(REVISED SYLLABUS - 2008)

## GROUP - III

### Paper-11 : CAPITAL MARKET ANALYSIS & CORPORATE LAWS

#### Section I : Capital Market Analysis

Q1. (a) Explain briefly the operations of Indian stock market. What are the principal weaknesses of Indian stock market?

(b) Distinguish between :

- (i) Forward contract and Future contract
- (ii) Fixed Price vs. Book-building.
- (iii) Primary Market vs. Secondary Market

**Answer 1. (a)**

The history of stock exchanges shows that the development of joint stock enterprise would never have reached its present stage but for the facilities which the stock exchanges provide for dealing with the securities. Stock exchanges have a very important function to fulfill in the country's economy.

The stock exchange is really an essential pillar of the private sector corporate economy. It discharges essential functions in the process of capital formation and in raising resources for the corporate sector. Briefly, the operations of Indian stock market can be analysed as :

**First the stock exchange provides a market place for purchase and sale of securities** viz., shares, bonds, debentures etc. It, therefore, ensures the free transferability of securities which is the essential basis for the stock enterprise system. The private sector economy cannot function without the assurance provided by the exchange to the owners of shares and bonds that they can be sold in the market at any time. At the same time, those who invest their surplus funds in securities for long-term capital appreciation or for speculative purpose can also buy scripts of their choice in the market.

**Secondly, the stock exchange provides the linkage between the savings in the household sector and investment in corporate economy.** It mobilizes savings, and channelize them in the form of securities into those enterprises which are favored by the investors on the basis of such criteria as future growth prospects, good returns and appreciation of capital.

**Thirdly, by providing a market quotation of the prices of shares and bonds** – a sort of collective judgment simultaneously reached by many buyers and sellers in the market-the stock exchange serves the role of barometer, not only of the state of health of individual companies, but also of the nation's economy. The changes in share prices are brought about by a complex set of factors, all operating in the market simultaneously. Share values as a whole are subject to secular trends set by the economic programme of the nation, and governed by factors like general economic situation, financial and monetary policies, tax changes, political environment, international - economic and financial development, etc.

**Shortcoming of Stock Markets :**

- Scarcity of floating stocks : Financial institutions, banks and insurance companies own 80 percent of the equity capital of the private sector.
- Speculation : 85 percent of the transactions on the NSE and BSE are speculative in nature.
- Price rigging : evident in relatively unknown and low quality scripts. Causes short term fluctuations in the prices.
- Insider trading : Obtaining market sensitive information to make money in the markets.

**Answer 1. (b)**

**(i) Forward contract and Future contract**

Forward contracts are private bilateral contracts and have well established commercial usage. Future contracts are standardised tradable contracts fixed in terms of size, contract date and all other features. The differences between Forward and Futures contracts are given below :

| Forward contracts                                                                      | Future contracts                                                                                                                                                                                                         |
|----------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1. The contract price is not publicly disclosed and hence not transparent.             | 1. The contract price is transparent.                                                                                                                                                                                    |
| 2. The contract is exposed to default risk by counterparty.                            | 2. The contract has effective safeguards against defaults in the form of clearing corporation guarantees for trades and daily mark to market adjustments to the accounts of trading members based on daily price change. |
| 3. Each contract is unique in terms of size, expiration date and asset type/quality.   | 3. The contracts are standardised in terms of size, expiration date and all other features.                                                                                                                              |
| 4. The contract is exposed to the problem of liquidity                                 | 4. There is no liquidity problem in the contract.                                                                                                                                                                        |
| 5. Settlement of the contract is done by delivery of the asset on the expiration date. | 5. Settlement of the contract is done on cash basis.                                                                                                                                                                     |

**(ii) Fixed Price vs. Book-building :**

| <b>Fixed Price</b>                                      | <b>Book-Building</b>                                                 |
|---------------------------------------------------------|----------------------------------------------------------------------|
| 1. Offer price is known to investor in advance.         | 1. Only the floor price and price range is known.                    |
| 2. Demand for the securities known after issue closure. | 2. Demand for the securities is visible online as the book is built. |
| 3. Application money credited to issuer Account.        | 3. Application money is credited to an escrow account.               |

**(iii) Primary Market vs. Secondary Market :**

| <b>Primary Market</b>                                                                                                                                                                         | <b>Secondary Market</b>                                                                                                                                                           |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1. The primary is that part of the capital markets that deals with the issuance of new securities. Thus, it is called as the new issues Market. This is the market for new Long term capital. | 1. The secondary market is the financial market for trading of Securities that have already been issued.                                                                          |
| 2. In a primary issue securities are issued by the company directly to the investors.                                                                                                         | 2. The market that exists just after the new issue is often refer to after market.                                                                                                |
| 3. Primary issues are used by companies for the purpose of setting up new business or for expanding or modernizing the existing business.                                                     | 3. Once a newly issued stock is listed on a stock exchange investors and speculators can easily trade on the exchange, as market makers provide bids and offers in the new stock. |
| 4. The primary market performs the crucial function of facilitating capital formation in the economy.                                                                                         | 4. Secondary market can refer to the market for any kind of already issued goods.                                                                                                 |

**Q2. Write in brief on :**

- (a) **Demutualization of stock exchanges**
- (b) **Certificate of deposit**
- (c) **Inter-connected stock exchange of India**
- (d) **Bought Out Deal**
- (e) **Qualified Institutional Buyers (QIBs)**
- (f) **Stock invest**
- (g) **Fringe Market**
- (h) **Rolling Settlement**
- (i) **Circuit Breakers**

- (j) **Fibonacci Numbers**
- (k) **Eliot Wave Principle**
- (l) **Debt for Equity Swap**
- (m) **Credit Wrapping**
- (n) **Callable Bond**
- (o) **Junk Bonds**

**Answer 2.**

**(a) Demutualization of stock exchanges :**

Historically stock exchanges were formed as 'mutual' organisations, which were considered beneficial in terms of tax benefits and matters of compliance. They are generally 'not-for-profit' and tax exempted entities. The trading members who provide broking services, also own, control and manage such exchanges for their common benefit, but do not distribute the profits among themselves. The ownership rights and trading rights are clubbed together in a membership card which is not freely transferable and hence this card at times carries a premium. In contrast, in a 'demutual' exchange, three separate sets of people own the exchange, manage it and use its services. The owners usually vest in management constituting a board of directors which is assisted by a professional team. A completely different set of people use trading platform of the exchange. These are generally 'for-profit' and tax paying entities. The ownership rights are freely transferable. Trading rights are acquired/surrendered in terms of transparent rules. Membership cards do not exist. These two models of exchanges are generally referred to as 'club' and 'institution' respectively.

There are 23 recognised exchanges in the country. Three of them are 'Association of Persons', while the balance 20 are companies, either limited by guarantee or by shares. Except one exchange (NSE), all exchanges, whether corporates or association of persons, are not-for-profit making organisations. Except for two (OTCEI and NSE), all exchanges are 'mutual' organisations. An expert committee appointed by SEBI has recently recommended demutualisation of stock exchanges since stock exchanges, brokers, associations and investors association have overwhelmingly felt that such a measure was desirable. The committee has accordingly suggested the steps for such demutualisation.

The most important development in the capital market is concerning the demutualisation of the stock exchanges. Demutualisation of exchanges means segregating the ownership from management. This move was necessitated by the fact that brokers in the management of the stock exchange were misusing their position for personal gains. Demutualisation would bring in transparency and prevent conflict of interest in the functioning of the stock exchanges. Now, all the stock exchanges in India are demutualised entities.

**(b) Certificate of deposit :**

Certificates of Deposit (CDs) is a negotiable money market instrument issued in dematerialized form or as a usance Promissory Note, for funds deposited at a bank or other eligible financial institution for a specified time period. Guidelines for issue of CDs are presently governed by various directives issued by the Reserve Bank of India, as amended from time to time. CDs can be issued by (i) scheduled commercial banks excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs); and (ii) select all-India Financial Institutions that have been permitted by RBI to raise short-term resources within the umbrella limit fixed by RBI. Banks have the freedom to issue CDs depending on their requirements. An FI 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 per cent of its net owned funds, as per the latest audited balance sheet.

**(c) Inter-connected stock exchange of India :**

Inter-connected Stock Exchange of India Limited (ISE), has been promoted by 15 Regional stock exchanges to provide trading linkage/connectivity to all the participating exchanges to widen their market. Thus, ISE is a national level exchange providing trading, clearing, settlement, risk management and surveillance support to the Inter-Connected Market System (ICMS). ISE aims to address the needs of small companies and retail investors with the guiding principle of optimising the infrastructure and harnessing the potential of regional markets to transform these into a liquid and vibrant market through the use of technology and networking. The participating exchange in ISE have in all about 4500 traders. In order to leverage its infrastructure as also to expand its nation-wide reach, ISE has also appointed dealers across various cities other than the participating exchange centers. These dealers are administratively supported through strategically located regional offices at Delhi, Calcutta, Chennai and Nagpur.

ISE, thus expects to emerge as a low cost national level exchange in the country for retail investors and small intermediaries. ISE has also floated a wholly-owned subsidiary namely, ISE Securities and Services Limited (ISS) to take membership of NSE and other premier exchanges, so that traders and dealers of ISE can access other markets in addition to the local market and ISE. This will provide the investors in smaller cities with a solution for cost-effective and efficient trading in securities.

Core objectives of the Inter-connected Stock Exchange include creation of single integrated national level solution with access to multiple markets for providing high quality, low cost services to millions of investors across the country, a liquid and vibrant national level market for all listed companies in general and small capital companies in particular and providing trading, clearing and settlement facilities to the traders and dealers across the country at their doorstep with decentralised support system. Some of the features which make ISE a new age stock exchange are as follows :

- ISE is a national level recognised stock exchange having moderate listing fees and granting listing and trading permission to small and medium sized companies having a post public issue paid-up capital of Rs. 3 crore to Rs. 5 crore (subject to the appointment of market makers) besides companies with a capital of above Rs. 5 crore.
- All traders and dealers of ISE have access to NSE through ISE Securities and Services Ltd. (ISS), which ensures continuous attention of investors.
- Proposing to introduce the 'IPO Distribution System' for offering primary market issue.
- ISE has set up an 'Investors Grievance and Service Cell' which looks after all types of complaints of investors located across the country and provides decentralised support.
- Listing of stocks with ISE would give the company an advantage of being identified as a technology-savvy and Investor-friendly company.

**(d) Bought Out Deal :**

Bought Out Deal (BOD) is a process of investment by a sponsor or a syndicate of investors/sponsors directly in a company. Such direct investment is being made with an understanding

between the company and the sponsor to go for public offering in a mutually agreed time. Bought out deal, as the very name suggests is a type of wholesale offer of equities by a company. A company allots shares in full or in lots to a sponsor at a price negotiated between the company and the sponsor(s). After a particular period of agreed upon between the sponsor and the company the shares are issued to the public by the sponsor with a premium. The holding cost of such shares by the sponsor may either be reimbursed by the company or the sponsor may absorb the profit in part or full as per the agreement, arising out of the public offering at a premium. After the public offering the shares are listed in one or more stock exchanges.

**Advantages** Bought out deal is not only advantageous to the company going for it but also to the sponsors and common investors.

- The company has the advantage of using the fund immediately without waiting as in the case of direct public issue. In case of BOD the company instantly gets funds and is able to focus its attention on project implementation without worrying for source of investment. Bought out deals are ideally suited in circumstances when money needs to be arranged fast without which the project may suffer. Lowering or eliminating issue cost from the preliminary expenses is another advantage to the company.
- The time taken to raise money in the capital market by a company takes as much as six months and this time is very high for a company in an infancy stage. The waste of time in the initial stage can be avoided by going for BOD.
- In case of a new and untried product it is easier to convince an investment banker for an investment in the company rather than the general public. Hence BOD is an innovative method of financing for such companies.
- When the market sentiment is low and the secondary market is undergoing a bear phase, a company may not like to come to the market with a public issue. In such case BOD is a superior process to get fund for the company.
- The merchant bankers also gain handsomely from a BOD. The merchant banks expect a return of around 30% from a BOD whereas private financing institutions expect a return of 40% to 60% from a BOD. The gains can be tremendous provided the sponsors select proper issues and price it attractively to the investors.
- The investors also gain from the BOD in a way that they get good issues where some merchant banker has already invested in it. The common investors do not have enough scope and information for proper evaluation of a company. The merchant bankers are professionals and can make proper appraisal of a company.

**(e) Qualified Institutional Buyers (QIBs) :**

Qualified Institutional Buyers are those institutional investors who are generally perceived to possess expertise and the financial muscle to evaluate and invest in the capital market. As per the SEBI guidelines QIBs shall mean the following :

- Public Financial Institution as defined in section 4A of the Companies Act, 1956
- Scheduled Commercial Banks
- Mutual Funds
- Foreign Institutional Investors registered with SEBI
- Multilateral and Bilateral Development Financial Institutions
- Venture Capital Funds registered with SEBI

- Foreign Venture Capital Investors registered with SEBI
- State Industrial Development Corporations
- Insurance Companies registered with the Insurance Regulatory and Development Authority (IRDA)
- Provident Funds with minimum corpus of Rs. 25 crores
- Pension Funds with minimum corpus of Rs. 25 crores.

These entities are not required to register with SEBI as QIBs. Any entities falling under the categories specified above are considered as QIBs for the purpose of participating in primary issuance process.

**(f) Stock invest :**

In case of oversubscription of issue, there have been inordinate delay in refund of excess application money and large amounts of investors' funds remain locked up in companies for long periods affecting the liquidity of the investing public. To overcome the said problem a new instrument called 'stock invest' is introduced. The Stock invest is a non-negotiable bank instrument issued by the bank in different denominations. The investor who has a savings or current account with the bank will obtain the stock invest in required denominations and will have to enclose it with the share/debenture application. On the face of the instrument provides for space for the investor to indicate the name of the issues, the number and amount of shares/ debentures applied for and the signature of the investor. The stock invests issued by the bank will be signed by it and the date of issue will also be indicated on the instruments. Simultaneously with the issue of stock invest, the bank will mark a lien for the amounts of stock invest issued in the deposit account of the investor. On full or partial allotment of shares to the investor, the Registrar to issue will fill the columns of stock invest indicating the entitlement for allotment of shares/debentures, in terms of number, amount and application number and send it for clearing.

The investor's bank account would get debited only after the shares/debentures allotted. In respect of unsuccessful applicants, the funds continue to remain in their account and earn interest if the account is a savings or a term deposit. The excess application money of partly successful applicants also, will remain in their accounts. There will be lien on the funds for a maximum of four months period. The stock invest is intended to be utilised only by the account holders and the stock invest should not be handed over to any third party for use. In case the cancelled/partly utilised stock invest is not received by an investor from the registrar, lien will be lifted by the issuing branch on expiry of four months from the date of issue against an indemnity bond from the investor.

**(g) Fringe Market :**

The fringe market is a disorganised money market, deemed to include everything that is outside the scope of the money market (i.e., the institutional money market). The fringe market includes activities like the Inter-Corporate Deposit (ICD) market, small scale trade financing, financing of investments in the stock market, discounting and lending against IOUs or promissory notes, etc. The ICDs market is the most visible feature of the fringe market. As its name indicates it essentially involves short-term borrowing and lending of funds amongst the corporations. Generally the fringe market exist, wherever the main borrowers and lenders of the funds are based, i.e., at the location of the industrial, corporate and trading establishments. The interest rates at which the funds can be lent in the fringe

market are generally higher than those operating in the money market. The risk level of the fringe market is higher too - the people who borrow at exorbitant rates are the ones who are most likely to default.

**(h) Rolling Settlement :**

The rolling settlement was introduced by SEBI on January 10, 2000. Ten stocks were selected initially and SEBI has announced a list of 156 stocks which was included in rolling settlement made by the first fortnight of May 2000. In a rolling settlement of a T + 5 period trades are settled 5 days from the date of transaction. If an investor purchases 500 shares of RIL and sells 400 shares on Monday he would be asked to settle the net outstanding of 100 shares on the following Monday. This means all open positions are squared up on the fifth or sixth day from the trading date.

In the T + 2 rolling settlement, trades are settled on the second working day. For example, trades taking place on Monday are settled on Wednesday, etc.

In a Rolling Settlement, trades executed during the day are settled based on the net obligations for the day. Say for example, if the trades pertaining to the rolling settlement are settled on a T + 2 day basis where T stands for the trade day. Hence, trades executed on a Monday are typically settled on the following Wednesday (considering 2 working days from the trade day). The funds and securities pay-in and pay-out are carried out on T + 2 day.

**(i) Circuit Breakers :**

The index-based market-wide circuit breakers were implemented in compulsory rolling settlement with effect from July 02, 2001.

The index-based market-wide circuit breaker system applies at 3 stages of the index movement, either way viz. at 10%, 15% and 20%. These circuit breakers when triggered bring about a coordinated trading halt in all equity and equity derivative markets nationwide. The marketwide circuit breakers are triggered by movement of either the BSE Sensex or the NSE S&P CNX Nifty, whichever is breached earlier. The % movement of the index and the time frame of the trading halt is given below :

- 10% movement - a one-hour market halt if the movement takes place before 1:00 p.m.
  - at or after 1:00 p.m. but before 2:30 p.m., a trading halt for ½ hour.
  - at or after 2:30 p.m. there will be no trading halt and market shall continue trading.
- 15% movement - a two-hour halt if the movement takes place before 1 p.m.
  - on or after 1:00 p.m., but before 2:00 p.m., a trading halt of one hour
  - on or after 2:00 p.m. the trading shall halt for remainder of the day.
- 20% movement - trading shall be halted for the remainder of the day.

**(j) Fibonacci Numbers :**

Fibonacci numbers have intrigued mathematicians and scientists for hundreds of years. Leonardo Fibonacci (1170-1240) was a medieval mathematician who discovered the series of numbers while studying the reproductive behaviour of rabbits. The beginning of the Fibonacci series is shown below : 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144, 233, .....

Fibonacci ratios are core knowledge for the stock and commodities trader. The market's Rules of Grammar. Every swing is related in both price and time by certain Fibonacci ratios to what has happened before. Professional traders with the money to move the market know all the Fibonacci levels that are coming up in the current move.

**(k) Elliot Wave Principle :**

One theory that attempts to develop a rationale for a long-term pattern in the stock price movements is the Elliott Wave Principle (EWP), established in the 1930s by R.N. Elliott and later popularized by Hamilton Bolton. The EWP states that major moves take place in five successive steps resembling tidal waves. In a major bull market, the first move is upward, the second downward, the third upward, the fourth downward and the fifth and final phase upward. The waves have a reverse flow in a bear market.

**(l) Debt for Equity Swap :**

This instrument is an offer from an issuer of debt securities to its debt holders to exchange the debt for the issuer common or preferred stock. The issuer who wishes to offer debt for equity swaps does so with a view to increasing equity capital for the purposes of improving its debt equity ratio and also enhance its debt raising capacity. It also helps issuers to reduce their interest expenses and enables them to replace it with dividends on stock that are payable at their discretion. Investors get attracted because of the potential appreciation in the value of the stock. There are risk considerations in view of the fact swaps may dilute earnings per share of issuer. In addition, dividends are not tax deductible while interest on tax securities is taxable.

**(m) Credit Wrapping :**

Credit wrapping is a technique by which bonds are issued by a company with a poor rating can be shored up with the assistance of an institution with a strong credit rating. It involves the institution agreeing to underwrite a proportion of the amount payable in the event of default at the time of redemption. In many cases it is the only way in which poorly rated companies can issue bonds.

**(n) Callable Bond :**

A callable bond is a bond which the issuer has the right to call in and pay off at a price stipulated in the bond contract. The price the issuer must pay to retire a callable bond when it is called is termed as 'call price'. The main advantage in callable bond is the issuers have an incentive to call their existing bonds if the current interest rate in the market is sufficiently lower than the bond's coupon rate. Usually the issuer cannot call the bond for a certain period after issue.

**(o) Junk Bonds :**

Junk bonds are corporate bonds with low ratings from a major credit rating agencies. High rated bonds are called investment grade bonds, low rated bonds are called speculative-grade bonds or less formally called as 'Junk bonds'. A bond may receive a low rating for a number of reasons. If the financial condition or business outlook of the company is poor, bonds are rated speculative-grade. Bonds are also rated speculative-grade if the issuing company already has large amounts of debt outstanding. Some bonds are rated speculative-grade; because they are subordinated to other debt i.e. their legal claim on the firm's assets in the event of default stands behind the other claim, so called senior debt. Junk bonds are traded in a dealer market rather than being traded in stock exchanges. Institutional investors hold the largest share of junk bonds. Firms with low credit ratings are willing to pay 3 to 5 percent more than the investment grade corporate debt to compensate for greater risk. Junk bonds are a high yield security, because of this reason junk bonds are widely used as a source of finance in takeovers and leveraged buy-outs. Junk bonds lie between conventional

investment as equities and investment-grade bonds. Junk bonds are riskier than investment-grade bonds but less risky than equity. Junk bonds may have cost or tax advantage that allow for some marginal increase in debt. But these advantages are not likely to induce bondholders to invest in junk bonds more recklessly than other safer debt instruments.

**Q3. (a) What should a stock market index be?**

**(b) Why are indices important?**

**(c) What is the portfolio interpretation of index movements?**

**Answer 3.**

- (a) A stock market index should capture the behavior of the overall equity market. Returns obtained by distinctive portfolios in the country, will be indicated by the movements of the index. An Index is used to give information about the price movements of products in the financial, commodities or any other markets.

A stock market index is created by selecting a group of stocks that are representative of the whole market or a specified sector or segment of the market. An Index is calculated with reference to a base period and a base index value. Stock market indexes are useful for a variety of reasons, some of them are :

- It is a lead indicator of the performance of the overall economy or a sector of the economy,
  - Stock indexes reflect highly up to date information,
  - They provide a historical comparison of returns on money invested in the stock market against other forms of investments such as gold or debt,
  - They can be used as a standard against which to compare the performance of an equity fund,
  - Modern financial applications such as Index Funds, Index Futures, Index Options play an important role in financial investments and risk management.
- (b) By looking at an index we know how the market is faring. The index is a lead indicator of how the overall portfolio will fare. Owing to direct applications in finance, in the form of index funds and index derivatives, in recent years, indices have gained more popularity. Index funds are funds which passively 'invest in the index'. Index derivatives allow people to cheaply alter their risk exposure to an index (which is called hedging) and to implement forecasts about index movements (which are called speculation). Using index derivatives, as hedging, has become a central part of risk management in the modern economy. These applications are now a multi-trillion dollar industry worldwide, and they are critically linked up to market indices. Finally, indices serve as a benchmark for measuring the performance of fund managers. For e.g., an all-equity fund, should obtain returns like the overall stock market index. A 50:50 debt: equity fund should obtain returns close to those obtained by an investment of 50% in the index and 50% in fixed income.
- (c) It is easy to create a portfolio, which will reliably get the same returns as the index. i.e. if the index goes up by 4%, this portfolio will also go up by 4%. Suppose an index is made of two stocks, one with a market cap of Rs.1000 crore and another with a market cap of Rs.3000 crore. Then the index portfolio will assign a weight of 25% to the first and 75% weight to the second. If we form a portfolio of the two stocks, with a weight of 25% on the first and 75% on the second, then the portfolio returns will equal the index returns. So, if anybody want to buy Rs.1 lakh of this two-stock index, the person would buy Rs.25,000 of the first and Rs.75,000 of the second; this portfolio would exactly impersonate the two-

stock index. A stock market index is hence just like other price indices in showing what is happening on the overall indices, the wholesale price index is a comparable example. Additionally, the stock market index is attainable as a portfolio.

*Or*

**Q3. (a) Who is Standard & Poor's, and why does their name appear with the S&P CNX Nifty?**

**(b) We sometimes hear the term 'nifty fifty' used in the US to denote a certain set of growth stocks. Is there any connection?**

**(c) (i) What is 'bid-ask bounce' ?**

**(ii) What is 'stale prices'?**

**Answer3.**

- (a) S&P owns the most important index in the world. By the name of the S&P 500 index, which is the foundation of the largest index funds and most liquid index futures markets in the world, S & P has become a familiar name in the world. When S&P came to India to look at market indices, they paid attention towards the S&P CNX Nifty as opposed to alternative indices. They now stand behind the S&P CNX Nifty, as is evidenced by the name "S&P CNX Nifty". This is a unique occasion; S&P has never endorsed a market index before.
- (b) No. It's purely coincidental. It was research that led to the choice of 50 stocks as the optimal size of an index in the Indian equity market. One day, a clever leap was made from NSE-50 to 'S&P CNX Nifty'.
- (c) (i) Supposing a stock trades at bid 1440 ask 1490. Let us consider that no news appears for ten minutes. But, over this period, say a buy order first comes in (at Rs. 1490) followed by a sell order (at Rs. 1440). This sequence of events makes it seem that the stock price has dropped by Rs.50. This is a totally false price movement! Even when no news is breaking, when a stock price is not changing, the 'bid-ask bounce' is about prices bouncing up and down between bid and ask. These changes are fake. This problem is the greatest with illiquid stocks where the bid-ask spread is wide. When an index component shows such price changes it contaminates the index.  
(ii) Suppose we look at the closing price of an index. It is supposed to reflect the state of the stock market at 3:30 PM on NSE. Suppose an illiquid stock is in the index. The last traded price (LTP) of the stock might be an hour, or a day, or a week old! The index is supposed to show how the stock market perceives the future of the corporate sector at 3:30 PM. When an illiquid stock injects these 'stale prices' into the calculation of an index, it makes the index more stale. It reduces the accuracy with which the index reflects information.

**Q4. (a) What about market manipulation - how would manipulation of an index take place, and how would an index be made less vulnerable to manipulation?**

**(b) What is 'impact cost'?**

**(c) Is the 'zero coupon' yield curve only useful for talking about zero coupon bonds?**

**Answer 4.**

- (a) The index is a large entity and is intrinsically harder to manipulate when compared to individual stocks. Obviously, larger indices are harder to manipulate than smaller indices. The weak links in an index are the large, illiquid stocks. These are the achilles heel where a manipulator obtains maximum impact upon the index at minimum cost. Optimal index manipulation

consists of attacking these stocks. This is one more reason why illiquid stocks should be excluded from a market index; indeed this aspect requires that the liquidity of a stock in an index should be proportional to its market capitalization.

- (b) Market impact cost is the best measure of the liquidity of a stock. It accurately reflects the costs faced when actually trading an index. Supposing a stock trades at bid 99 and ask 101. We say the 'ideal' price is Rs. 100. Now, supposing, a buy order for 1000 shares goes through at Rs. 102. Then it can be said that the market impact cost at 1000 shares is 2%. Likewise, if a buy order for 2000 shares goes through at Rs. 104, it is said that the market impact cost at 2000 shares is 4%. For a stock to qualify, for possible inclusion into the S&P CNX Nifty, it has to reliably have market impact cost of below 0.75 % when doing S&P CNX Nifty trades of half a crore rupees.
- (c) No. Besides zero coupon instruments, the ZCYC (Zero Coupon Yield Curve) can be used to price a wide range of securities including coupon paying bonds, derivatives, interest rate forwards and swaps. In arriving at the ZCYC for a coupon bearing instrument, what can be simply done, is stripped the 'n' cash flows into 'n' zero coupon instruments, the first 'n-1' being coupon payments and the 'n'th being the terminal coupon plus redemption amount.

**Q5. (a) What are the different types of fixed income instruments available to an investor?**

**(b) Is the 'term structure' the only factor influencing the price of a bond?**

**(c) What do you mean by ETF (Exchange Traded Funds) ? State in brief the applications of it.**

**Answer 5.**

- (a) Fixed income instruments can be categorized by type of payments. Most fixed income instruments pay to the holder a periodic interest payment, commonly known as the coupon, and an amount due at maturity, the redemption value. There exists some instruments that do not make periodic interest payments; the principal amount together with the entire outstanding amount of interest on the instrument is paid as a lump sum amount at maturity. These instruments are also known as 'zero coupon' instruments (Treasury Bills provide an example of such an instrument). These are sold at a discount to the redemption value, the discounted value being determined by the interest rate payable (yield) on the instrument.  
Fixed income instruments can also be categorized by type of issuer. The rate of interest offered by the issuer depends on its credit-worthiness. Sovereign securities issued by the Government of any country, with minimal default risk, usually offer lower rates of interest than a non-sovereign entity with some default risk. The 'credit spread' that has to be added by a non-sovereign entity with non-zero probability of default risk, over and above the interest rates offered by a sovereign body, is directly related to the default risk of the issuer - higher the default risk, higher is the spread.
- (b) No, there are other factors besides the term structure, that influence the pricing of a bond. These include, for instance, tax regulations (differential tax rates for income and capital gains) that affect the relative valuations of bonds with different cash flows. Again, illiquid bonds trade at a premium relative to liquid bonds of the same residual maturity. Some other characteristics also influence bond valuation. For trades in the same bond conducted on the same day, dispersion in prices could be attributed to transaction costs that vary with the size of the trade, an example of which could be an intra-day effect on account of new developments during the day and expectations about the directionality of the term structure risk, higher is the spread.

- (c) Exchange Traded Funds (ETFs) are just what their name implies, baskets of securities that are traded like individual stocks, on an exchange. Unlike regular open-end mutual funds, ETFs can be bought and sold throughout the trading days, like any stock.

The concept of ETF first came into existence in the USA in 1993. It took several years to attract public interest. But once it was done, the volumes took off with a retaliation. Most ETFs charge lower annual expenses than index mutual funds. However, as with stocks, one must pay a brokerage to buy and sell ETF units, which can be a significant drawback for those who trade frequently or invest regular sums of money.

The funds rely on an arbitrage mechanism to keep the prices at which they trade roughly in line with the net asset values of their underlying portfolios. For the mechanism to work, potential arbitrageurs need to have full and timely knowledge of a fund's holdings.

Applications of ETF are :

- **Managing Cash Flows** — Investment and fund managers, who see regular inflows and outflows, may use ETFs because of their liquidity and their capability to represent the market.
- **Diversifying Exposure** — If an investor is not aware about the market mechanism and does not know which particular stock to buy but likes the overall sector, investing in shares tied to an index or basket of stocks, provides diversified exposure and reduces risk.
- **Efficient Trading** — ETFs provide investors a convenient way to gain market exposure viz. an index that trades like a stock. In comparison to a stock, an investment in an ETF index product provides a diversified exposure to the market.
- **Shorting or Hedging** — Investors who have a negative view on a market segment or specific sector may want to establish a short position to capitalize on that view. ETFs may be sold short against long stock holdings as a hedge against a decline in the market or specific sector.
- **Filling Gaps** — ETFs tied to a sector or industry may be used to gain exposure to new and important sectors. Such strategies may also be used to reduce an overweight or increase an underweight sector.
- **Equitising Cash** — Investors having idle cash in their portfolios, may want to invest in a product tied to a market benchmark. An ETF, is a temporary investment before deciding which stocks to buy or waiting for the right price.

**Q6. (a) What is Investor Protection Fund (IPF) at Stock Exchanges?**

**(b) What is Arbitration? What is the process for preferring arbitration?**

**(c) Is there any difference between investing in a mutual fund and in an initial public offering (IPO) of a company?**

**Answer6.**

- (a) Investor Protection Fund is the fund set up by the Stock Exchanges to meet the legitimate investment claims of the clients of the defaulting members that are not of speculative nature. SEBI has prescribed guidelines for utilisation of IPF at the Stock Exchanges. The Stock Exchanges have been permitted to fix suitable compensation limits, in consultation with the IPF/CPF Trust. It has been provided that the amount of compensation available against a single claim of an investor arising out of default by a member broker of a Stock Exchange shall not be less than Rs. 1 lakh in case of major Stock Exchanges viz., BSE and NSE, and Rs. 50,000/- in case of other Stock Exchanges.

- (b) Arbitration is an alternative dispute resolution mechanism provided by a stock exchange for resolving disputes between the trading members and their clients in respect of trades done on the exchange.

**Process for preferring arbitration :**

The byelaws of the exchange provide the procedure for Arbitration. One can procure a form for filing arbitration from the concerned stock exchange. The arbitral tribunal has to make the arbitral award within 3 months from the date of entering upon the reference. The time taken to make an award cannot be extended beyond a maximum period of 6 months from the date of entering upon the reference.

- (c) Yes, there is a difference. IPOs of companies may open at lower or higher price than the issue price depending on market sentiment and perception of investors. However, in the case of mutual funds, the par value of the units may not rise or fall immediately after allotment. A mutual fund scheme takes some time to make investment in securities. NAV of the scheme depends on the value of securities in which the funds have been deployed.

**Q7. Good Luck Ltd. has an excess cash of Rs. 16,00,000 which it wants to invest in short-term marketable securities. Expenses relating to investment will be Rs. 40,000.**

**The securities invested will have an annual yield of 8%.**

- (i) the company seeks your advice as to the period of investment so as to earn a pre-tax income of 4%,  
 (ii) also find the minimum period for the company to break-even its investment expenditure. Ignore time value of money.

**Solution :**

**Pre-tax Income Required**

$$= \text{Rs. } 16,00,000 \times 4\% = \text{Rs. } 64,000.$$

By uninvesting 16,00,000, company has to earn Rs. 64,000. Then company has to uninvest for a period (Let P) to earn Rs. 64,000 when yield given 8%.

$$\left( 16,00,000 \times \frac{8}{100} \times \frac{P}{12} \right) - 40,000 = 64,000$$

$$\frac{P}{12} = \frac{1,04,000 \times 100}{16,00,000 \times 8}$$

$$P = 9.754.$$

To earn 4% pre tax return Rs. 16,00,000 should be invested in the shorter marketable securities for a period 9.754 months.

- (i) To break-even its investment expenditure :

$$\left( 16,00,000 \times \frac{8}{100} \times \frac{P}{12} \right) - 40,000 = 0$$

$$10,666.67P - 40,000 = 0$$

$$10,622.40P = 40,000$$

$$P = 40,000 / 10,666.67$$

$$= 3.75$$

So, the minimum period to break-even its investment expenditure is 3.75 months.

**Q8. The beta coefficient of NOCIL is 1.6. The risk free rate of return is 12% and the required rate of return is 18% on the market portfolio. If the dividend expected during the coming year is Rs 2.50 and the growth rate of dividend and earnings is 8%, at what price NOCIL can be sold based on the CAPM (Capital Asset Pricing Model).**

**Solution :**

Expected Rate of Return is calculated by applying CAPM formula:

$$\begin{aligned} E(R_i) &= R_f + \beta_i (R_m - R_f) \\ &= 12\% + 1.6 (18\% - 12\%) \\ &= 12\% + 9.6\% \\ &= 21.6\% \end{aligned}$$

Price of NOCIL is calculated with the use of dividend growth model formula:

$$R_e = R_e = \frac{D_1}{P_0} + g$$

Where,

$D_1$  = Expected dividend during the coming year

$R_e$  = Expected rate of return on NOCIL,

$g$  = Growth rate of dividend, and

$P_0$  = Price of NOCIL,

$$\begin{aligned} \text{So, } R_e &= \frac{D_1}{P_0} + g \\ 0.216 &= \frac{2.50}{P_0} + 0.08 \\ \text{or, } 0.216 - 0.08 &= \frac{2.50}{P_0} \\ \text{or, } (0.136)P_0 &= 2.50 \\ P_0 &= \frac{2.50}{0.136} = 18.38 \end{aligned}$$

**Q9. Consider two stocks P and Q :**

| Particulars | Expected Return(%) | Standard Deviation(%) |
|-------------|--------------------|-----------------------|
| Stock P     | 16%                | 25%                   |
| StockQ      | 18%                | 30%                   |

The returns on the two stocks are perfectly negatively correlated.

What is the expected return of a portfolio constructed to drive the standard deviation of portfolio return to zero?

**Solution :**

The weights that drive the standard deviation of portfolio to zero, when the returns are perfectly negatively correlated, are :

$$\begin{aligned} W_p &= \frac{\sigma_Q}{\sigma_P + \sigma_Q} \\ &= \frac{30}{25 + 30} \\ &= 0.545 \end{aligned}$$

The expected return of the portfolio is:

$$\begin{aligned} &0.545 \times 16\% + 0.455 \times 18\% \\ &= 16.91\% . \end{aligned}$$

- Q10. Mr. Ray has purchased 100 shares of Rs. 10.00 each, of Kinetic Ltd. in 2007 at Rs. 78.00 per share. The company has declared a dividend @ 40% for the year 2008-09. The market price of share as at 1.4.2008 was Rs. 104 and on 31.03.2009 was Rs. 128.00. Calculate the annual return on the investment for the year 2008-09.**

**Answer 10.**

Calculation of annual rate of return on investment for the year 2008-09

$$\begin{aligned} R &= \frac{D_1 + (P_1 - P_0)}{P_0} = \frac{4 + (128 - 104)}{104} = 0.2692 \\ &\text{or } 26.92\% . \end{aligned}$$

- Q11. The following information is available for the call and put options on the stock of Maruti Limited :**

|                             | Call   | Put    |
|-----------------------------|--------|--------|
| Time to expiration (months) | 3      | 3      |
| Risk free rate              | 10%    | 10%    |
| Exercise price              | Rs. 50 | Rs. 50 |
| Stock price                 | Rs. 60 | Rs. 60 |
| Price                       | Rs. 16 | Rs. 2  |

**Determine if the put-call parity is working.**

**Solution :**

According to put-call parity;

$$C_0 = S_0 + P_0 - E / e^{rt}$$

In the problem,  $S_0 = \text{Rs. } 60$ ,  $P_0 = \text{Rs. } 2$ ,  $E = \text{Rs. } 50$ ,  $r = 10\%$  and  $t = 0.25$  (i.e.  $3/12$ )

If the put-call parity were to work  $C_0$  should be

$$60 + 2 - 50 / e^{0.10 \times 0.25}$$

= Rs. 13.23

The price of the call option is given to be Rs 16, which is different from Rs. 13.23.

So the put-call parity is not working.

**Q12. You are having Rs. 10,000 to invest and you would like to sell Rs. 5000 in stock of HLL short to invest in RIL. Assuming no correlation between the two securities, compute the expected return and the standard deviation of the portfolio from the following characteristics :**

| Security       | HLL | RIL |
|----------------|-----|-----|
| E ( R )        | .12 | .02 |
| $\sigma$ ( R ) | .08 | .10 |

**Solution :**

Expected Return:

$$\begin{aligned} E(R)_p &= W_{HLL} E(R_{HLL}) + W_{RIL} E(R_{RIL}) \\ &= 15,000 / 10,000 \times .12 - 5,000 / 10,000 \times .02 \\ &= .18 - .01 \\ &= .17 \end{aligned}$$

Standard deviation :

$$\begin{aligned} [ W_{HLL}^2 \sigma^2(R_{HLL}) + W_{RIL}^2 \sigma^2(R_{RIL}) ]^{1/2} &= \sigma_p \\ &= [ (1.5)^2 \times (0.8)^2 + (-.5)^2 \times (.10)^2 ]^{1/2} \\ &= .130 \end{aligned}$$

**Q13. Mr. Venkataraman's portfolio consists of six securities. The individual returns of each of the security in the portfolio is given below :**

| Security | Proportion of investment in the portfolio | Return |
|----------|-------------------------------------------|--------|
| Wipro    | 10%                                       | 18%    |
| Latham   | 25%                                       | 12%    |
| SBI      | 8%                                        | 22%    |
| ITC      | 30%                                       | 15%    |
| RNL      | 12%                                       | 6%     |
| DLF      | 15%                                       | 8%     |

Calculate the weighted average of return of the securities consisting the portfolio.

**Solution :**

| Security     | Weight (W) | Return (%) ( R) | (W X R)      |
|--------------|------------|-----------------|--------------|
| Wipro        | 0.10       | 18              | 1.80         |
| Latham       | 0.25       | 12              | 3.00         |
| SBI          | 0.08       | 22              | 1.76         |
| ITC          | 0.30       | 15              | 4.50         |
| RNL          | 0.12       | 6               | 0.72         |
| DLF          | 0.15       | 8               | 1.20         |
| <b>Total</b> |            |                 | <b>12.98</b> |

So, portfolio return is 12.98%.

**Q14. A stock that pays no dividends is currently selling at Rs. 100. The possible prices for which the stock might sell at the end of one year with associated probabilities are :**

| End of year price | Probability |
|-------------------|-------------|
| Rs. 90            | 0.1         |
| Rs. 100           | 0.2         |
| Rs. 110           | 0.4         |
| Rs. 120           | 0.2         |
| Rs. 130           | 0.1         |

- Calculate the expected rate of return by year end,
- Calculate the standard deviations of the expected rate of return.

**Solution :**

|                 |     |     |     |     |     |
|-----------------|-----|-----|-----|-----|-----|
| (a) Probability | 0.1 | 0.2 | 0.4 | 0.2 | 0.1 |
| Return          | -10 | 0   | 10  | 20  | 30  |

$$\begin{aligned}
 E(R) &= 0.1(-10) + 0.2(0) + 0.4(10) + 0.2(20) + 0.1(30) \\
 &= -1.0 + 0 + 4.0 + 4 + 3.0 \\
 &= 10.0\%
 \end{aligned}$$

$$\begin{aligned}
 (b) \sigma &= [0.1(-10-10)^2 + 0.2(0-10)^2 + 0.4(10-10)^2 + 0.2(20-10)^2 + 0.1(30-10)^2]^{0.5} \\
 &= 10.95\%.
 \end{aligned}$$

**Q15.(a) What do you mean by Portfolio rebalancing?**

**(b) Write about myths and realities of derivatives.**

**Answer 15.**

- Portfolio rebalancing :** It is the action of bringing a portfolio of investments that has deviated away from one's target asset allocation back into line. Under-weighted securities can be purchased with newly saved money; alternatively, over-weighted securities can be sold to purchase under-weighted securities. The investments in a portfolio will perform according to the market. As time goes on, a portfolio's current asset allocation can move away from an

investor's original target asset allocation. If left un-adjusted, the portfolio could either become too risky, or too conservative. The goal of rebalancing is to move the current asset allocation back in line to the originally planned asset allocation.

Determining an effective rebalancing strategy is a function of the portfolio's assets: their expected returns, their volatility, and the correlation of their returns. For example, a high correlation among the returns of a portfolio's assets means that they tend to move together, which will tend to reduce the need for rebalancing. In addition, the investment time horizon affects the rebalancing strategy. A portfolio with a short time horizon is less likely to need rebalancing because there is less time for the portfolio to drift from the target asset allocation. In addition, such a portfolio is less likely to recover the trading costs of rebalancing.

**(b) Myths and Realities about Derivatives :**

Derivatives increase speculation and do not serve any economic purpose. Numerous studies of derivatives activity have led to a broad consensus, both in the private and public sectors that derivatives provide numerous and substantial benefits to the users. Derivatives are a low-cost, effective method for users to hedge and manage their exposures to interest rates, commodity prices, or exchange rates. The need for derivatives as hedging tool was felt first in the commodities market. Agricultural futures and options helped farmers and processors hedge against commodity price risk. After the fallout of Bretton wood agreement, the financial markets in the world started undergoing radical changes. This period is marked by remarkable innovations in the financial markets such as introduction of floating rates for the currencies, increased trading in variety of derivatives instruments, on-line trading in the capital markets, etc. As the complexity of instruments increased many folds, the accompanying risk factors grew in gigantic proportions. This situation led to development derivatives as effective risk management tools for the market participants. Looking at the equity market, derivatives allow corporations and institutional investors to effectively manage their portfolios of assets and liabilities through instruments like stock index futures and options. An equity fund, for example, can reduce its exposure to the stock market quickly and at a relatively low cost without selling off part of its equity assets by using stock index futures or index options. By providing investors and issuers with a wider array of tools for managing risks and raising capital, derivatives improve the allocation of credit and the sharing of risk in the global economy, lowering the cost of capital formation and stimulating economic growth. Now that world markets for trade and finance have become more integrated, derivatives have strengthened these important linkages between global markets, increasing market liquidity and efficiency and facilitating the flow of trade and finance.

**Q16. Write in brief :**

- (i) LEAPS,
- (ii) Basket Trade,
- (iii) Mezzanine Finance,

**Answer 16.**

**(i) LEAPS / Long-Term Equity Anticipation Securities:**

Long-term stock options or index options, with expiration dates up to three years away. LEAPs are very similar to standard options except for the fact that they expire much further in the future. LEAPS are available in two forms, calls and puts. Options were originally created with expiry cycles of 3, 6, and 9 months, with no option term lasting more than a

year. Options of this form, for such terms, still constitute the vast majority of options activity. LEAPS were created relatively recently and typically extend for terms of 2 years out. Equity LEAPS always expire in January. For example, if today were November 2005, one could buy a Microsoft January call option that would expire in 2006, 2007, or 2008. (The further out the expiration date, the more expensive the option.)

They can be safer than traditional options because it is somewhat easier to predict stock movement over longer periods. Like options, they allow an investor to lock in a fixed price for the underlying security. Therefore, like options, they can be effective for both leverage and insurance purposes. Expiration generally occurs 36 months after purchase, and LEAPs are American style, so they can be exercised at any time before expiration. Strike prices usually range around 25% above or below the price of the underlying stock when the LEAP is first offered.

- (ii) **A basket trade** — It is an order to purchase or to sell a set of 15 or more securities. This type of trade is utilized to invest large amounts of money into a specific portfolio or index. For many types of investors, basket trades are a helpful investment strategy. They can assist fund managers who want to rework a portfolio of investments. They can also assist individual investors that want to address specific areas of interest. To limit the monetary risk because of movements by the index, investors may choose to purchase or sell all the constituents of an index by utilizing a basket trade. One advantage of basket trading includes the ability for investors to create baskets of stocks according to specific investment needs.

(iii) **Mezzanine Finance:**

Mezzanine finance is unsecured debt (or preference shares) offering a high return with a high risk. This type of debt generally offers interest rates two to five percentage points more than that on senior debt and frequently gives the lenders some right to a share in equity values should the firm perform well. Mezzanine finance tends to be used when bank borrowing limits are reached and the firm cannot or will not issue more equity. The finance it provides is cheaper (in terms of required return) than would be available on the equity market and it allows the owners of a business to raise large sums of money without sacrificing control. It is a form of finance which permits the firm to move beyond what is normally considered acceptable debt/equity ratios (gearing or leverage levels).

**Q17. (a) 100 share of Reliance Ltd. are purchased on Monday. Provided there are no holidays in between, settlement should take place on \_\_\_\_\_ ?**

- (i) Wednesday (T + 2)
- (ii) Tuesday (T + 1)
- (iii) Thursday (T + 3)
- (iv) Friday (T + 4)

**(b) In case the security has not been traded on a particular day, \_\_\_\_\_ at the NSE is to be considered as the closing price.?**

- (i) the average closing price for the last one week
- (ii) the theoretical closing price
- (iii) the latest available closing price
- (iv) none of the above

**(c) Securities and funds pay out takes place on \_\_\_\_\_ working days after the trade date**

- (i) 'T + 3'
- (ii) 'T + 1'
- (iii) 'T + 2'
- (iv) within 24 hours of sale

**(d) NSE has implemented \_\_\_\_\_ in compulsory rolling settlement with effect from July 02, 2001.**

- (i) securities-based market-wide circuit breakers
- (ii) index-based market-wide circuit breakers
- (iii) market-wide based securities-wise circuit breakers
- (iv) none of the above

**(e) \_\_\_\_\_ can be traded in the Limited Physical Market?**

- (i) Illiquid shares
- (ii) Futures and Options
- (iii) Odd lots
- (iv) Government Securities

**(f) Where a recognised stock exchange acting in pursuance of any power given to it by its bye-laws, refuses to list the securities of any company, the company shall be entitled to be furnished with reasons for such refusal and the company may appeal to the \_\_\_\_\_ against such refusal.**

- (i) SEBI
- (ii) recognized stock exchange
- (iii) Securities Appellate Tribunal (SAT)
- (iv) High Court

**(g) Surveillance and Control (SURCON) is that period after market close during which, the users have \_\_\_\_\_ only.**

- (i) order entry access
- (ii) trade cancellation access
- (iii) trade modification access
- (iv) inquiry access

**(h) At the end of the trade cycle, the trades are \_\_\_\_\_ to determine the obligations of the trading members to deliver securities/funds as per settlement schedule.**

- (i) grossed
- (ii) aggregd
- (iii) netted
- (iv) offset

**(i) For liquid securities, the VaR margins are based on the \_\_\_\_\_ of the Security.**

- (i) volatility
- (ii) returns
- (iii) liquidity
- (iv) exposure limit

**(j) The stop loss orders are prioritised in the stop loss book with the—**

- (i) most likely order to trigger first and the least likely to trigger last.
- (ii) least likely order to trigger first and the most likely to trigger last.
- (iii) time-price priority algorithm
- (iv) none of the above

**(k) Two buy orders enter into the system and are unmatched :**

**200 shares @ Rs. 72.75 at time 10:30 a.m.**

**300 shares @ Rs. 72.75 at time 10:31 a.m.**

**Which order will get a priority for getting executed.**

- (i) Order no. 1
- (ii) Order no. 2
- (iii) both will have equal priority
- (iv) none

**(l) Fixed Deposit Receipts (FDRs) issued by approved banks can be submitted as an \_\_\_\_\_ to NSCCL by trading members.**

- (i) surety.
- (ii) indemnity
- (iii) warranty
- (iv) additional base capital

**(m) Upfront margin rates applicable for all securities in Trade for Trade – segment (TT) is \_\_\_\_\_ .**

- (i) 50%
- (ii) 100 %
- (iii) 200%
- (iv) 150%

**(n) Institutional transactions are identified by the use of the \_\_\_\_\_ at the time of order entry.**

- (i) user code
- (ii) user id
- (iii) participant code
- (iv) client id

**(o) Two sell orders enter into the system and are unmatched :**

**200 shares @ Rs. 72.75 at time 10:30 a.m.**

**300 shares @ Rs. 72.70 at time 10:31 a.m.**

**Which order will get a priority for getting executed.**

- (i) Order no. 1
- (ii) Order no. 2
- (iii) both will have equal priority
- (iv) none

**(p) What does 'AUI' indicate as a message code in 'Full Message window' in the NEAT system?**

- (i) Auction Initiation Messages
- (ii) Auction User Interface messages
- (iii) All messages related to user interface
- (iv) All messages related to Auctions

**(q) Two buy orders enter into the system and are unmatched :**

**200 shares @ Rs. 72.75 at time 10:30 a.m.**

**300 shares @ Rs. 72.80 at time 10:31 a.m.**

**Which order will get a priority for getting executed.**

- (i) Order no. 1
- (ii) Order no. 2
- (iii) both will have equal priority
- (iv) none

**(r) The trading members can participate in the Exchange initiated auctions by entering orders as a**

- (i) participant
- (ii) initiator
- (iii) solicitor
- (iv) none of the above

**(s) Which of the following do not issue securities in the primary market?**

- (i) FIIs
- (ii) State Governments
- (iii) Companies
- (iv) None of the above

**(t) Security sigma means the of the security computed as at the end of the previous trading day.**

- (i) mean
- (ii) volatility
- (iii) impact cost
- (iv) none of the above

**Answer 17.**

- (a) i.
- (b) iii.
- (c) iii.
- (d) ii.
- (e) iii.
- (f) iii.
- (g) iv.
- (h) iii.
- (i) i.
- (j) i.
- (k) i.
- (l) iv.
- (m) ii.
- (n) iii.
- (o) ii.
- (p) i.
- (q) ii.
- (r) iii.
- (s) i.
- (t) ii.

**Q18.** The unit price of RSS Scheme of a mutual fund is Rs 10. The Public Offer Price (POP) of the unit is Rs 10.204 and the redemption price is Rs 9.80. Calculate :

- (i) Front-end load, and
- (ii) Back-end load.

**Solution :**

- (i) Calculation of Front-end load

$$\text{Public Offer Price} = \frac{\text{Net asset value}}{1 - \text{Front - end load}}$$

Where, POP is Rs 10.204; Net Asset Value (NAV) is Rs 10.

$$10.204 = \frac{10}{(1 - F)}$$

$$10.204 (1 - F) = 10,$$

$$10.204 - 10.204F = 10,$$

$$10.204F = 10.204 - 10,$$

$$F = \frac{0.204}{10.204} = 0.01999,$$

So, Front-end load = 2%

(ii) Calculation of Back-end load (B)

$$\text{Redemption price} = \frac{\text{Net asset value}}{1 - \text{Back - end load}},$$

$$9.80 = \frac{10}{(1 - B)},$$

$$9.80 (1 - B) = 10,$$

$$9.80 - 9.80B = 10,$$

$$-9.80B = 10 - 9.80,$$

$$-B = \frac{0.20}{9.80} = .0204, \text{ or, } 2.04\%$$

So, Back-end load = 2.04%.

## Section II : Corporate Law & Corporate Governance

**Q1. "A joint stock company is an artificial person created by law with a perpetual succession and a common seal". Do you agree with this definition of a company?**

**Answer 1.**

- (i) **Separate legal entity.** A company is in law regarded as an entity separate from its members. In other words, it has an independent corporate existence. Any of its members can enter into contracts with in the same manner as any other individual can and he cannot be held liable for the acts of the company even if he holds virtually the entire share capital. The company's money and property belong to the company and not to the shareholders (although the shareholders own the company).

Thus, Ram & Co. Limited is an entirely different person from Ram even if he holds practically all the shares in the company. Its property is not the property of Ram.

The importance of the separate entity of a company was, however, firmly established in the following case :

*Salomon v. salomon & Co. Ltd.*, (1897) A.C. 22. S sold his boots business to a newly formed company for £ 30,000. His wife, one daughter and four sons took up one share of £ 1 each. S took 23,000 shares of £ 1 each and £ 10,000 in the company. The debentures gave S a charge over the assets of the company as the consideration for the transfer of the business. Subsequently when the company was wound up, its assets were found to be worth £ 6,000 and its liabilities amounted to £ 17,000 of which £ 10,000 were due to S and £ 7,000 due to unsecured creditors. The unsecured creditors claimed that S and the company were one and the same person and that the company was a mere agent for S and hence they should be paid in priority to S. Held, the company was, in the eyes of the law, a separate person independent from S and was not his agent. S, though virtually he holder of all the shares in the company, was also a secured creditor and was entitled to repayment in priority to the unsecured creditors.

**Consequences of the principle of separate corporate personality.** For instance, with reference to the example of Ram & Co. Limited given below :

- (a) Ram has no insurable interest in the property of Ram & Co. Limited.
  - (b) When Ram dies, the company continues to exist. His shares, and not the assets of the company, vest in his personal representatives.
  - (c) The nationality of the company does not depend on the nationality of Ram.
- (ii) **Limited liability.** A company may be a company limited by shares or a company limited by guarantee. In a company limited by shares, the liability of members is limited to the unpaid value of the shares. For example, if the face value of a share in a company is Rs. 10 and a member has already paid Rs. 7 per share, he can be called upon to pay not more than Rs. 3 per share during the lifetime of the company. In a company limited by guarantee, the liability of members is limited to such amount as the members may undertake to contribute to the assets of the company, in the event of its being wound up.
- (iii) **Perpetual succession.** A company is a juristic person with a perpetual succession. As such it never dies; nor does its life depend on the life of its members. It is not in any manner

affected by insolvency, mental disorder or retirement of any of its members. It is created by a process of law and can be put an end to only by a process of law. Member may come and go but the company can go on for ever (until dissolved). It continues to exist even if all its human members are dead. Even where during the war all the members of a private company, while in general meeting, were killed by a bomb, the company survived; not even a hydrogen bomb could have destroyed it [*K/9 Meat Supplies (Guildford) Ltd., Re* (1966) 3 All. E.R. 320].

Perpetual succession, therefore, means that a company's existence persists irrespective of the change in the composition of its membership. Thus its continued existence is not affected by a constant change in its membership.

- (iv) **Common seal.** Since a company has no physical existence, it must act through its agents and all such contracts entered into by its agents must be under the seal of the company. The common seal acts as the official signature of the company.
- (v) **Transferability of shares.** The capital of a company is divided into parts, called shares. These shares are, subject to certain conditions, freely transferable, so that no shareholder is permanently or necessarily wedded to company. When the joint stock companies were established the great object was the the shares should be capable of being easily transferred.
- (vi) **Separate property.** As a company is a legal person distinct from its members, it is capable of owning, enjoying and disposing of property in its own name. Although its capital and assets are contributed by its shareholders, they are not the private and joint owners of its property. The company is the real person in which all its property is vested and by which it is controlled, managed and disposed of.
- (vii) **Capacity to sue.** A company can sue and be sued in its corporate name. It may also inflict or suffer wrongs. It can in fact do or have done to it most of the things which may be done by or to a human being.

*Or*

**Q1. "A company is a legal entity distinct from its members". In what cases do the courts ignore this principle?**

**Answer 1.**

The various cases in which corporate veil has been lifted are as follows :

- (i) **Protection of revenue.** The Courts may ignore the corporate entity of a company where it is used for tax evasion [*Juggilal v. Commer. of Income-tax*, A.I.R. (1969) S.C. 982]. Tax planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning.

*Sir Sinshaw Maneckjee Petit*, Re, A.I.R. (1927) Bom. 371 D, an assessee, who was receiving huge dividend and interest income, transferred his investments to 4 private companies formed for the purpose of reducing his tax liability. These companies transferred the income to D as a pretended loan. Held, the companies were formed by D purely and simply as a means of avoiding tax obligation and the companies were nothing more than the assessee himself. They did not business but were createe simply as legal entities to ostensibly receive the dividends and interest and to hand them over to D as pretended loans.

- (ii) **Prevention of fraud or improper conduct.** The legal personality of a company may also be disregarded in the interest of justice where the machinery of incorporation has been used for some fraudulent purpose like defrauding creditors or defeating or circumventing law.
- Jones v. Lipman*, (1962) All E.R. 442. *L* agreed to sell a certain land to *J*. He subsequently changed his mind and to avoid the specific performance of the contract, he sold it to a company which was formed specifically for the purpose. The company had *L* and a clerk of his solicitors as the only members. *J* brought an action for the specific performance against *L* and the company. The Court looked to the reality of the situation, ignored the transfer, and ordered that the company should convey the land to *J*.
- (iii) **Determination of character of a company whether it is enemy.** A company may assume an enemy character when persons in *de facto* control of its affairs are residents in an enemy country. In such a case, the Court may examine the character of persons in real control of the company, and declare the company to be an enemy company.
- Daimler Co. Ltd. v. Continental Tyre & Rubber Co. Ltd.*, (1916) 2 A.C. 307. A company was incorporated in England for the purpose of selling in England tyres made in Germany by a German company which held the bulk of shares in the English company. The holders of the remaining shares, except one, and all the directors were Germans, resident in Germany. During the First World War, the English company commenced an action for recovery of a trade debt. Held, the company was an alien company and the payment of debt to it would amount to trading with the enemy, and therefore the company was not allowed to proceed with the action.
- (iv) **Where the company is a sham.** The Courts also lift the veil where a company is a mere cloak or sham (hoax). The following case illustrates the point :
- Gilford Motor Co. Ltd. v. Horne*, (1933) Ch. 935 C.A. Horne, a former employee of a company, was subject to a covenant not to solicit its customers. He formed a company to carry on a business which, if he had done so personally, would have been a breach of the covenant. An injunction was granted both against him and the company to restrain them from carrying on the business.
- (v) **Company avoiding legal obligations.** Where the use of an incorporated company is being made to avoid legal obligations, the Court may disregard the legal personality of the company and proceed on the assumption as if no company existed.
- (vi) **Company acting as agent or trustee of the shareholders.** Where a company is acting as agent for its shareholders, the shareholders will be liable for the acts of the company. It is a question of fact in each case whether the company is acting as agent for its shareholders. There may be an express agreement to this effect or an agreement may be implied from the circumstances of each particular case.
- (vii) **Avoidance of welfare legislation.** Avoidance of welfare legislation is as common as avoidance of taxation and the approach of the Courts in considering problems arising out of such avoidance is generally the same as avoidance of taxation. It is the duty of the Courts in every case where ingenuity is expended to avoid welfare legislation to get behind the smoke screen and discover the true state of affairs.
- (viii) **Protecting public policy.** The Courts invariably lift the corporate veil to protect the public policy and prevent transactions contrary to public policy. Thus, where there is a conflict with public policy, the Courts ignore the form and take into account the substance [*Connors v. Connors Ltd.*, (1940) 4 All E.R. 174].

**Q2. Write short notes on:**

- i. **Lifting the corporate veil,**
- ii. **Share Warrant,**
- iii. **Shelf prospectus,**
- iv. **Information Memorandum,**
- v. **Red Herring Prospectus,**
- vi. **Issue of sweat equity shares,**
- vii. **Issue of shares at a discount,**
- viii. **Loans to Directors,**
- ix. **Number of Directorships,**

**Answer 2.**

- (i) **Lifting the corporate veil** : From the juristic point of view, a company is a legal person distinct from its members [*Salomon v. Salomon & Co. Ltd.*, (1897) A. C. 22]. This principle may be referred to as 'the veil of incorporation'. The Courts in general consider themselves bound by this principle. The effect of this principle is that there is a frictional veil (and not a wall) between the company and its members. That is, the company has a corporate personality which is distinct from its members.

The human ingenuity, however, started using this veil of corporate personality blatantly as a cloak for fraud or improper conduct. This it became necessary for the Courts to break through or lift the corporate veil or crack the shell of corporate personality and look at the persons behind the company who are the real beneficiaries of the corporate fiction.

- (ii) **Issue of share warrants to bearer** (Sec. 114) : A share warrant is a document issued by a public company stating that its bearer is entitled to the shares specified therein. It is transferable by mere delivery and is a substitute for the share certificate.

A public company limited by shares may convert its fully paid-up shares into share warrants. One great advantage of issuing warrants is that shares can be transferred by mere delivery of the warrant. The registration of the transfer of shares in such a case with the company is not necessary.

Conditions for issue of share warrants —

- (a) The shares shall be fully paid up.
- (b) The Articles shall authorise the issue of share warrants.
- (c) Prior approval of the Central Government shall be obtained.
- (d) The share warrants shall be issued under the common seal of the company.

The holder of a share warrant is entitled to the shares specified therein and the shares may be transferred by delivery of the share warrant. A share warrant is by mercantile usage a negotiable instrument.

- (iii) **Shelf prospectus** : 'Self prospectus' means a prospectus issued by any financial institution or bank for one or more issues of the securities or class or securities specified in that prospectus.

Any public financial institution, public sector bank or scheduled bank whose main object is financing, shall file a self prospectus. 'Financing' means making loans to or subscribing in the capital of a private industrial enterprise engaged in infrastructural financing or, such other company as the Central Government may notify in this behalf.

A company filing a self prospectus with the Registrar shall not be required to file prospectus afresh at every stage of offer of securities by it within a period of validity of such shelf prospectus. It shall be required to file an information memorandum on all material facts relating to new charges created, changes in the financial position as have occurred between the first offer of securities, previous offer of securities and the succeeding offer of securities within the time prescribed by the Central Government, prior to making of a second or subsequent offer of securities under the shelf prospectus.

An information memorandum shall be issued to the public along with shelf prospectus filed at the stage of the first offer of securities and such prospectus shall be valid for a period of one year from the date of opening of the first issue of securities under that prospectus.

Where an update of information memorandum is filed every time an offer of securities is made, such memorandum together with the shelf prospectus shall constitute the prospectus.

- (iv) **Information memorandum** [Sec, 60-B as inserted by the Companies (Amendment) Act, 2000] : Information memorandum. Sec. 2(19-B) as introduced by the Companies (Amendment) Act, 2000 means a process undertaken prior to the filing of a prospectus by which a demand for the securities proposed to be issued by a company is elicited, and the price and the terms of issue for such securities is assessed, by means of a notice, circular, advertisement or document.
- (v) **'Red Herring Prospectus' (RHP)** : It is a prospectus which does not have details of either price or number of shares being offered or the amount of issue. This means that in case price is not disclosed, the number of shares and the upper and lower price bands are disclosed. On the other hand, an issuer can state the size and the number of shares are determined later. An RHP and Draft Offer Document can be filed with ROC without the price band and the issuer, in such a case will notify the floor price or a price band by way of an advertisement on day prior to the opening of the issue. In the case of book-built issues, it is a process of price discovery and the price cannot be determined until the bidding process is completed. Hence, such details are not shown in the Red Herring Prospectus filed with ROC in terms of the provisions of the Companies Act. Only on completion of the bidding process, the details of the final price are included in the offer document. The offer document filed thereafter with ROC is called a prospectus.
- (vi) **Issue of Sweat Equity Shares** : For the purposes of Sec. 79-A, the expression 'sweat equity shares' means equity shares issued at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions by whatever name called [Explanation II to Sec. 79-A(1)].  
 The expression "a company" means the company incorporated, formed and registered under the Companies Act, 1956 and includes its subsidiary company incorporated in a country outside India [Explanation I to Sec. 79-A (1)].  
 Issue of sweat equity shares— Notwithstanding anything contained in Sec. 79 (which deals with the power of a company to issue shares at a discount), a company may issue sweat equity shares of a class of shares already issued if the following conditions are fulfilled, namely—
  - (a) the issue of sweat equity shares is authorised by a resolution passed by the company in the general meeting;
  - (b) the resolution specifies the number of shares, current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;

- (c) not less than one year has at the date of the issue elapsed since the date on which the company was entitled to commence business;
- (d) the sweat equity shares of the listed company are issued in accordance with the regulations made by the Securities and Exchange Board of India in this behalf [Sec. 79-A (1)].
- (vii) **Issue of Shares at Discount** : A company cannot issue shares at a discount except as provided in Sec. 79.

**Conditions for issue of shares at a discount :**

A company may issue shares at a discount if the following conditions are fulfilled, namely ;

- (a) Shares to be of a class already issued — the shares to be issued at a discount must be of a class already issued.
- (b) Resolution of company and sanction by Company Law Board — the issue of shares at a discount must have been authorised by a resolution passed by the company in general meeting and sanctioned by the Company Law Board.
- (c) Maximum rate of discount — the resolution must specify the maximum rate of discount at which the shares are to be issued. If the maximum rate of discount specified in the resolution exceeds 10 per cent, the Company Law Board shall not sanction it unless it is of opinion that a higher percentage of discount may be allowed in the special circumstances of the case.
- (d) Company working for a year — the company must have been working for at least a year from the date it was entitled to commence business before it can issue shares at a discount.
- (e) Shares to be issued within two months of sanction of Company Law Board — the shares to be issued at a discount must be issued within two months after the date on which the issue is sanctioned by the Company Law Board.

These conditions are intended to ensure that the discount is not unreasonable. Thus under condition (a) the shares must be similar to those already issued so that the market value can be ascertained, and under condition (d) the company must have been trading for some time to give the market value a chance to settle down. Moreover, once the Company Law Board has approved the discount, the issue must under condition (e) be made very soon for, if the market value falls further the issue will not be successful.

- (viii) **Loans to Directors** : Without obtaining the previous approval of the Central Government, a company (referred to as 'the lending company') shall not, directly or indirectly, make any loan to—
  - (a) (i) any director of the company, or (ii) to the directors of its holding company, or (iii) to any partner or relative of any director ;
  - (b) any firm in which any such director or relative is a partner ;
  - (c) any private company of which any such director is a director or member ;
  - (d) any body corporate at whose general meeting any director or directors controls or control not less than 25 per cent of the total voting power ; and
  - (e) any body corporate whose Board of directors or manager is accustomed to act in accordance with the directions of the Board of directors, or of any director or directors, of the lending company.

Sec. 295 also prohibits a company from—

- (i) giving of any guarantee for a loan taken by a director from any other person and providing of any security for any such loan, and
- (ii) providing of any guarantee or security for a loan given by a director to any other person.

These restrictions do not apply to any loan made, guarantee given or security provided by a private company (unless it is a subsidiary of a public company), or by a banking company. The exclusion of banking companies makes it clear that loans to directors of a bank are contemplated as part of its business.

A holding company may also give loans to its subsidiary. Again, a guarantee or security may also be given by a holding company in respect of any loan made to its subsidiary.

- (ix) **No person to be a director of more than 15 companies** (Sec. 275) — A person shall not hold office at the same time as director in more than 15 companies.

**Exclusion of certain directorships** (Sec. 278). In calculating the number of companies of which a person may be a director, the following companies shall be excluded, viz.,

- (a) a private company which is neither a subsidiary nor a holding company of a public company ;
- (b) an unlimited company ;
- (c) an association not carrying on business for profit or which prohibits the payment of a dividend ; and
- (d) a company in which such person is only an alternate director.

**Choice of person becoming director of more than 15 companies** (Sec. 277). Where a person already holding the office of director in 15 companies is appointed as a director of any other company, the appointment shall not take effect unless such person has, within 15 days of his ready a director. The new appointment of such person as director shall take effect only if such choice is made ; and it shall become void if the choice is not made within 15 days of the day on which the appointment was made.

**Q3. Discuss the scope of the doctrine of indoor management. To what extent has the doctrine been incorporated in the Companies Act, 1956?**

**Answer 3.**

There is one limitation to the doctrine of constructive notice of the Memorandum and the Articles of a company. The outsiders dealing with the company are entitled to assume that *as far as the internal proceedings of the company are concerned, everything has been regularly done*. They are presumed to have read these documents and to see that the proposed dealing is not inconsistent therewith, but they are not bound to do more ; they need not inquire into the regularity of the internal proceedings as required by the Memorandum and the Articles. They can presume that all is being done regularly. This limitation of the doctrine of constructive notice is known as the “doctrine of indoor management”, or the rule in *Royal British Bank v. Turquand*, or just *Turquand Rule*.

Thus, whereas the doctrine of constructive notice protects the company against outsiders, the doctrine of indoor management seeks to protect outsiders against the company.

*Royal British Bank v. Turquand*, (1856) 6 E. & B. 327. The directors of a company had issued a bond to T. They had the power under the Articles to issue such bond provided they were authorised

by a resolution passed by the shareholders at a general meeting of the company. No such required resolution was passed by the company. *Held*, T could recover the amount of the bond from the company on the ground that he was entitled to assume that the resolution had been passed.

The gist of the rule is that persons dealing with limited liability companies are not bound to inquire into the regularity of the internal proceedings and will not be affected by irregularities of which they had no notice.

The rule is based on public convenience and justice :

*First*, the Memorandum and the Article are public documents. They are open to inspection by everybody. But the details of internal proceedings are not open to public inspection. An outsider is presumed to know the constitution of a company, but not what may or may not have taken place within the doors that are closed to him.

*Secondly*, the lot of creditors of a limited liability company is not a particularly happy one : it would be unhappier still if the company could escape liability by denying the authority of the officers to act on its behalf.

*Or*

**Q3. "Every shareholder of a company is also known as member while every member may not be known as shareholder", comment.**

**Answer 3.**

Two essential conditions have to be fulfilled by any person to become a member of a company other than by subscribing to its MOA. They are :

- i) an agreement in writing to become a member, and
- ii) an entry in the register of members.

Until and unless a transfer is registered, the transferee of shares cannot become a member even though he may be the shareholder. But a shareholder in whose favour a share certificate is issued by the company is a member notwithstanding the omission of his name in the register of members (N. Satyaprasad Rao vs VLN Sastry).

Until a transfer is registered in the books of the company, the member who has transferred the shares continues to receive dividends even though he has ceased to be a shareholder. Similarly, the holder of share-warrants, even though a shareholder, is not a member.

In case of transmission, a person can become a shareholder in consequence or by reason of death or bankruptcy of a member; but he will become a member only when the company puts his name in the register of members.

One can become a member of a company in any one of the following ways :

- (i) subscribing to the MoA;
- (ii) agreeing in writing - by application and allotment, transfer, or transmission;
- (iii) holding shares and having his name entered as the beneficial owner in the records of the depository; or
- (iv) allowing his name to be on the register of members or otherwise allowing to be held out as a member.

**Q4. "No dividend can be paid by a company except out of profits". Comment.****Answer 4.**

The dividend is declared by a company by a resolution passed at the annual general meeting. The Board of directors determines the rate of dividend to be declared and recommends it to the meeting of shareholders. The rate determined by the Board is to be sanctioned by the members of the company in general meeting. The members may reduce the rate recommended by the Board but they cannot increase it. The directors must state in their report to be attached to the company's balance sheet, to be laid before the annual general meeting the amount which they recommend to be paid by way of dividend.

A company may, if authorised by its Articles, pay dividends in proportion to the amount paid up on each share. Where unequal amounts have been paid on some shares, the dividend may be unequal as among different shareholders. In the absence of such a clause in the Articles, members are entitled to dividend in proportion to the nominal value of the shares, and not in proportion to the amounts paid thereon [*Oakbank Oil Co. v. Crum*, (1882) 8 App. Cas. 65].

**Dividend to be paid only out of profits** (Sec. 205). The dividend can be declared or paid by a company for any financial year only —

- (a) out of profits of the company for that year arrived at after providing for depreciation in the manner laid down in the Act, or
- (b) out of the profits of the company for any previous financial year of years arrived at after providing of depreciation, and remaining undistributed, or
- (c) out of both, or
- (d) out of moneys provided by the Central Government or a State Government for the payment of dividend in pursuance of a guarantee given by that Government.

**Dividend in the event of inadequacy or absence of profits.** Normally, dividends are paid out of current year's profits. In the event of inadequacy or absence of profits in any year, the company can declare dividends out of the accumulated profits earned by it in previous years. Any declaration of dividend not in accordance with the rules framed by the Government in this regard shall require the previous approval of the Central Government.

*Or*

**Q4. Can a company buy its own shares? If so, under what circumstances?****Answer 4.**

Secs. 77-A and 77-AA permit a company to purchase its own shares or other specified securities referred to as buy-back subject to certain conditions. Sec. 77-B prohibits buy-back in certain circumstances.

**Power of company to purchase its own shares (Sec. 77-A) :**

Notwithstanding anything contained in the Companies Act, 1956, a company may purchase its own shares or other specified securities (hereinafter referred to as buy-back). This is, however, subject to provisions as contained in Sec. 77-A (2) and Sec. 77-B.

Thus a company may purchase its own shares or other specified securities from—

- (i) out of its free reserves ; or
- (ii) out of the securities premium account ; or

- (iii) out of the proceeds of an earlier issue other than fresh issue of shares made specifically for buy-back purposes [Sec. 77-A(1)].

**Conditions for buy-back.** No company shall purchase its own shares or other specified securities as referred to above unless—

- (a) the buy-back is authorised by its Articles,
- (b) a special resolution has been passed in general meeting of the company authorising the buy-back,

However, the said special resolution shall not be required to be passed if the following conditions are satisfied :

- (i) the buy-back is for less than 10 per cent of the total paid-up equity capital and the free reserves of the company, and
- (ii) such buy-back has been authorised by the Board of Directors by means of a resolution passed at its meeting,

Provided no company can come out with a fresh proposal to buy back its shares if within period of 365 days from the date of preceding offer of buy back,

- (iii) the buy-back is off less than 25 per cent of the total paid-up capital and free reserves of the company purchasing its own shares or other specified securities,
- (iv) the ratio of the debt owed by the company is not more than twice the capital and its free reserves after such buy-back,
- (v) all the shares or other specified securities are fully paid-up,
- (vi) the buy-back of shares or other specified securities listed on a stock exchange is in accordance with the regulations made by the Securities and Exchange Board of India (SEBI) in this behalf,
- (vii) the buy-back in respect of unlisted shares or other specified securities is in accordance with the guidelines as may be prescribed [Sec. 77-A(2)].

**Q5. Distinction between :**

- (a) **Shareholder and Member**
- (b) **Bonus Issue and Right Issue of Shares**
- (c) **Share & Stock**
- (d) **Memorandum & Articles of association**
- (e) **Public company & Private company**
- (f) **Mergers & Acquisitions**
- (g) **Fixed charge & Floating charge**
- (h) **Debenture & Debenture Stock**

**Answer 5.**

- (a) **Shareholder and Member :**

The 'members' or 'shareholders' of a company are the person who collectively constitute the company as a corporate entity. The terms 'member' and 'shareholder' and 'holder of a share' are used interchangeably. They are synonymous in the case of a company limited by shares, a company limited by guarantee and having a share capital and an unlimited company

whose capital is held in definite shares. But in the case of an unlimited company or a company limited by guarantee, a member may not be a shareholder, for, such a company may not have a share capital.

**(b) Bonus Issue of Shares & Right Issue of Share :**

An offer of free additional shares to existing shareholders. A company may decide to distribute further shares as an alternative to increasing the dividend payout. Also known as a "scrip issue" or "capitalization issue". In other words, it can be explained as -new shares are issued to shareholders in proportion to their holdings. For example, the company may give one bonus share for every five shares held.

Under a *secondary market offering* or *seasoned equity offering* of shares to raise money, a company can opt for a rights issue to raise capital. The rights issue is a special form of shelf offering or shelf registration. With the issued rights, existing shareholders have the privilege to buy a specified number of new shares from the firm at a specified price within a specified time. A rights issue is in contrast to an *initial public offering* (primary market offering), where shares are issued to the general public through market exchanges.

**(c) Share & Stock :**

The capital of a company is divided into certain indivisible units of a fixed amount. These units are called shares. 'Share' means share in the share capital of a company. It includes stock except where a distinction between stock and share is expressed or implied [Sec. 2(46)]. A share has also been defined as "an interest having a money value and made up of diverse rights specified under the Articles of Association." [*Commr of Income-tax v. Standard Vacuum Oil Co. Ltd.*, A.I.R. (1966) S.C. 1393]. It carries with it certain rights and liabilities while the company is a going concern or while the company is being wound up. In this sense it may be defined as a "bundle of rights and obligations". [*Vishwanath v. East India Distilleries*, (1957) 27 Comp. Cas. 175].

A share is evidenced by a share certificate (Sec. 84). A share certificate is issued by a company under its common seal. It specifies the shares.

Each share to be distinguished by appropriate number (Sec. 83). Each share in a company having share capital is distinguished by its appropriate number.

Stock is the aggregate of fully paid-up shares, consolidated and divided, for the purpose of convenient holding into different parts. It may be transferred or split up into fractions of any amount, without regard to the original face value of the share. It also denotes—

- (i) that a company has recognised the fact of complete payment of the shares, and
- (ii) that they can be assigned in fragments which could not be done before.

Stock can validly be issued only when the shares are fully paid-up. The issue of partly paid-up stock is a nullity. This, in other words, means that only fully paid-up shares can be converted into stock.

A company limited by shares may, if authorised by its Articles by ordinary resolution passed in a general meeting, convert its fully paid-up shares into stock. When shares are converted into stock, notice shall be given to the Registrar within 30 days of the conversion. The register of members shall then show the amount of stock held by each of the members concerned instead of the amount of shares.

(d) **Memorandum of Association & Articles of Association :**

**Memorandum of Association :**

- (i) It is the charter of the company indicating the nature of its business, its nationality, and its capital. It also defines the company's relationship with outside world.
- (ii) It defines the scope of the activities of the company, or the area beyond which the actions of the company cannot go.
- (iii) It, being the charter of the company, is the supreme document.
- (iv) Every company must have its own Memorandum.
- (v) There are strict restrictions on its alteration. Some of the conditions of incorporation contained in it cannot be altered except with the sanction of the Company Law Board.
- (vi) Any act of the company which is ultra vires the Memorandum is wholly void and cannot be ratified even by the whole body of shareholders.

**Articles of Association :**

- (i) They are the regulations for the internal management of the company and the subsidiary to the Memorandum.
- (ii) They are the rules for carrying out the objects of the company as set out in the Memorandum.
- (iii) They are subordinate to the Memorandum. If there is a conflict between the Articles and the Memorandum, the latter prevails.
- (iv) A company limited by shares need not have Articles of its own. In such a case, Table A applies.
- (v) They can be altered by a special resolution, to any extent, provided they do not conflict with the Memorandum and the Companies Act.
- (vi) Any act of the company which is ultra vires the Articles (but is intra vires the Memorandum) can be confirmed by the shareholders.

(e) **Public company and a Private company :**

- (i) **Minimum capital.** A private company must have a minimum paid-up capital of Rs. 1,00,000 whereas a public limited company must have a minimum paid-up capital of Rs. 5,00,000.
- (ii) **Minimum number.** The minimum number of persons required to form a public company is 7. It is 2 in case of private company.
- (iii) **Maximum number.** There is no restriction on maximum number of members in a public company, whereas the maximum number cannot exceed 50 in a private company.
- (iv) **Number of directors.** A public company must have at least 3 directors whereas a private company must have at least 2 directors (Sec. 252).
- (v) **Restriction on appointment of directors.** In the case of a public company, the directors must file with the Registrar a consent to act as directors or sign undertaking for their qualification shares. The directors of a private company need not do so (Sec. 266).
- (vi) **Restriction on invitation to subscribe for shares.** A public company invites the general public to subscribe for the shares in, or the debentures of, the company. A private company by its Articles prohibits any such invitation to the public.

- (vii) **Transferability of shares/debentures.** In a public company, the shares and debentures are freely transferable (Sec. 82). In a private company the right to transfer shares and debentures is restricted by the Articles.
- (viii) **Special privileges.** A private company enjoys some special privileges. A public company enjoys no such privileges.
- (ix) **Quorum.** If the Articles of a company do not provide for a larger quorum, 5 members personally present in the case of a public company are quorum for a meeting of the company. It is 2 in the case of a private company (Sec. 174).
- (x) **Managerial remuneration.** Total managerial remuneration in a public company cannot exceed 11 per cent of the net profits (Sec. 198). No such restriction applies to a private company.

- (f) **Mergers and acquisitions (M&A)** refers to the aspect of corporate strategy. Corporate finance and management dealing with the buying, selling and combining of different companies that can aid, finance, or help a growing company in a given industry grow rapidly without having to create another business entity.

An acquisition, also known as a takeover or a buyout, is the buying of one company by another. An acquisition may be friendly or hostile. In the former case, the companies cooperate in negotiations; in the latter case, the takeover target is unwilling to be bought or the target's board has no prior knowledge of the offer. Acquisition usually refers to a purchase of a smaller firm by a larger one. Sometimes, however, a smaller firm will acquire management control of a larger or longer established company and keep its name for the combined entity. This is known as a reverse takeover. Another type of acquisition is reverse merger, a deal that enables a private company to get publicly listed in a short time period. A reverse merger occurs when a private company that has strong prospects and is eager to raise financing buys a publicly listed shell company, usually one with no business and limited assets. The acquisition process is very complex, with many dimensions influencing its outcome.

- (g) **Fixed Charge & Floating Charge :** A fixed or specific charge is one which is created on some specific and definite assets of the company, e.g., a charge on land and building. It precludes the company from dealing in the property without the consent of the holder of the charge. The company can, if it wants to deal in that property, do so subject to the charge.

A floating charge is an equitable charge which is created on some class of property which is constantly changing, e.g., a charge on stock-in-trade, trade debtors, etc. The company can deal in such property in the normal course of its business until the charge becomes to carry on its business in the ordinary course as if no charge had been created.

- (h) **Debentures & Debenture Stock :** By the purchase of stocks anyone become the owners of the company. Their fortunes rise and fall with that of the company. If the stocks of the company soar in value, their investment pays off high dividends, but if the stocks decrease in value, the investments are low paying. Higher the risk anyone take, higher the rewards anyone gets.

Debentures are more secure than stocks, in the sense that payments are guaranteed with high interest rates. You are paid an interest on the money you lend the company until the maturity period, after which whatever you invested in the company is paid back to you. The interest is the profit you make from debentures. While stocks are for those who are willing to take risks for the sake of high returns, debentures are for people who want a safe and secure income.

*Or*

**Q5. What is the statutory limitation to the borrowing power of the directors of a company?**

**Answer 5.**

Every trading company, unless prohibited by its Memorandum or Articles, has implied power to borrow money for the purposes of its business. It has also the power to give security for the loan by creating a mortgage or charge on its property. The ground for the rule is that "the exigencies of commerce render such a power necessary." A non-trading company has no implied power to borrow. It requires express power to do so. This power, in case of such a company, must be taken in the Memorandum or the Articles.

When a company has express or implied power to borrow, it can borrow subject to the limits set by the Memorandum or the Articles.

A public company having a share capital cannot exercise borrowing power unless certificate of commencement of business is obtained by it [Sec. 149 (1)].

If the borrowing is in excess merely of the powers of the directors but not of the company, it can be ratified and rendered valid by the company. In such a case the loan binds both the lender and the company as if it had been made with the company's authority in the first place. If the company refuses to ratify the directors' act, the normal principles of agency apply. A third party who deals with an agent knowing that the agent is exceeding his authority has no right of action against the principal. However if the excess borrowing consists of non-compliance with some internal regulation of the company, the lender may rely on the rule in *Royal British v. Turquand*, and recover the amount of the loan from the company.

*Or*

**Q5. "The power of the Registrar of Companies to strike off the name of a defunct company is meant to be used in cases where a company is not legally dissolved when it should be so dissolved". Comment.**

**Answer 5.**

A company is said to be 'defunct' when it is not carrying on business or when it is not in operation. Sec. 560 deals with defunct companies. If a company has ceased to carry on business, the Registrar may strike it off the Register as a defunct company in accordance with Sec. 560.

**Procedure to be followed by the Registrar :**

- (i) **Letter by Registrar to inquire if company is in operation.** Where the Registrar has reasonable cause to believe that a company is not carrying on business or is not in operation, he shall send to the company by post, a letter inquiring whether the company is carrying on business or is in operation.
- (ii) **Registered letter if no reply received within one month.** If the Registrar does not receive an answer within one month of the sending of the letter, he shall, within 14 days after the expiry of the month, send to the company by post, a registered letter referring to the first letter, and stating that no answer thereto has been received. He shall further mention in the letter that if no reply is received to the second letter within one month, a notice will be published in the Official Gazette with a view to striking the name of the company off the Register.

- (iii) **Publication in the Official Gazette to strike off name.** If the Registrar either receives an answer that the company is not carrying on business, or does not receive any answer within one month of the sending of the registered letter, he may publish in the Official Gazette and send to the company by registered post, a notice that at the expiration of 3 months from the date of that notice, the name of the company will be struck off the Register and the company will be dissolved. The company may, however, within three months show cause why it should not be dissolved.
- (iv) **Same procedure in winding up if no liquidator is acting or no return is received.** The above procedure is also followed where a company is being wound up and the Registrar has reasonable cause to believe either that no liquidator is acting, or that the affairs of the company have been completely wound up, and returns required to be made by the liquidator have not been made for a period of 6 consecutive months.

**Q6. (a) State the reasons for passing the Competition Act, 2002.**

**(b) What are its powers?**

**Answer 6.**

- (a) In the context of the new economic policy paradigm, India has chosen to enact a new competition law called the Competition Act, 2002. In fact, the MRTP Act has metamorphosed into the new law, Competition Act, 2002. The new law is designed to repeal the extant MRTP Act. As of now, only a few provisions of the new law have been brought into force and the process of constituting the regulatory authority, namely, the Competition Commission of India under the new Act, is on. The remaining provisions of the new law will be brought into force in a phased manner.

To achieve its objective of not permitting an "appreciable effect on competition in India", the Competition Act, 2002 deals with three situations;

- Prohibition of anti competitive agreements,
- Abuse of dominant position, and
- Regulation of combinations (covered acquisitions, mergers and amalgamations)

In October 1999, the Government of India appointed a High Level Committee on Competition Policy and Competition Law to advise a modern competition law for the country in line with international developments and to suggest a legislative framework, which may entail a new law or appropriate amendments to the MRTP Act. The Committee presented its Competition Policy report to the Government in May 2000. The draft competition law was drafted and presented to the Government in November 2000. After some refinements, following extensive consultations and discussions with all interested parties, the Parliament passed in December 2002 the new law, namely, the Competition Act, 2002.

Competition Law for India was triggered by Articles 38 and 39 of the Constitution of India. These Articles are a part of the Directive Principles of State Policy. Pegging on the Directive Principles, the first Indian competition law was enacted in 1969 and was christened the Monopolies and Restrictive Trade Practices, 1969 (MRTP Act). Articles 38 and 39 of the Constitution of India mandate, inter alia, that the State shall strive to promote the welfare of the people by securing and protecting as effectively, as it may, a social order in which justice social, economic and political shall inform all the institutions of the national life, and the State shall, in particular, direct its policy towards securing ;

- that the ownership and control of material resources of the community are so distributed as best to sub serve the common good; and
- that the operation of the economic system does not result in the concentration of wealth and means of production to the common detriment.

An Act which provides, keeping in view of the economic development of the country, for the establishment of a Commission to prevent practices having adverse effect on competition, to promote and sustain competition in markets, to protect the interests of consumers and to ensure freedom of trade carried on by other participants in markets, in India, and for matters connected therewith or incidental thereto.

**(b) Power of Commission to regulate its own procedure :**

- (i) The Commission shall not be bound by the procedure laid down by the Code of Civil Procedure, 1908, but shall be guided by the principles of natural justice and, subject to the other provisions of this Act and of any rules made by the Central Government, the Commission shall have powers to regulate its own procedure including the places at which they shall have their sittings, duration of oral hearings when granted, and times of its inquiry.
- (ii) The Commission shall have, for the purposes of discharging its functions under this Act, the same powers as are vested in a civil court under the Code of Civil Procedure, 1908, while trying a suit, in respect of the following matters, namely :—
  - (a) summoning and enforcing the attendance of any person and examining him on oath;
  - (b) requiring the discovery and production of documents;
  - (c) receiving evidence on affidavits;
  - (d) issuing commissions for the examination of witnesses or documents;
  - (e) subject to the provisions of sections 123 and 124 of the Indian Evidence Act, 1872, requisitioning any public record or document or copy of such record or document from any office;
  - (f) dismissing an application in default or deciding it ex parte;
  - (g) any other matter which may be prescribed.
- (iii) Every proceeding before the Commission shall be deemed to be a judicial proceeding within the meaning of sections 193 and 228 and for the purposes of section 196 of the Indian Penal Code (45 of 1860) and the Commission shall be deemed to be a civil court for the purposes of section 195 (2 of 1974 and Chapter XXVI of the Code of Criminal Procedure, 1973.
- (iv) The Commission may call upon such experts, from the fields of economics commerce, accountancy, international trade or from any other discipline as it deems necessary, to assist the Commission in the conduct of any inquiry or proceeding before it.
- (v) The Commission may direct any person—
  - (a) to produce before the Director General or the Registrar or an officer authorised by it, such, books, accounts or other documents in the custody or under the control of such person so directed as many be specified or described in the direction, being documents relating to any trade, the examination of which may be required for the purposes of this Act;

- (b) to furnish to the Director General or the Registrar or any officer authorised by it, as respects the trade or such other information as may be in his possession in relation to the trade carried on by such person, as may be required for the purposes of this Act.
- (vi) If the Commission is of the opinion that any agreement referred to in section (iii) or "abuse of dominant position referred to in section (iv) or the combination referred to in section (v) has caused or is likely to cause an appreciable adverse effect on competition in the relevant market in India and it is necessary to protect, without further delay, the interests of consumers and other market participants in India, it may conduct an inquiry or adjudicate upon any matter under this Act after giving a reasonable oral hearing to the parties concerned.

**Q6. Briefly discuss the provisions of the Competition Act, 2002 relating to:**

- (i) Power of Central Government to exempt,**
- (ii) Restriction on disclosure of information.**

**Answer 6.**

- (i) The Central Government may, by notification, exempt from the application of the Competition, Act, 2002, or any provisions thereof, and for such period as it may specify in such notification—
  - (a) Any class of enterprises if such exemption is necessary in the interest of security of the State or public interest;
  - (b) Any practice or agreement arising out of an in accordance with any obligation assumed by India under any treaty, agreement or convention with any other country or countries;
  - (c) Any enterprise which performs a sovereign function on behalf of the Central Government or a State Government;

Provided that in case an enterprise is engaged in any activity including the activity relatable to the sovereign functions of the Government, the Central Government may grant exemption only in respect of activity relatable to the sovereign functions.
- (ii) No information relating to any enterprise, being an information which has been obtained by or on behalf of the Commission for the purpose of the Competition Act, shall, without the previous permission in writing of the enterprise, be disclosed otherwise than in compliance with or for the purpose of the Act or any other law for the time being force.

*Or*

**Q6. (a) What do you mean "right to information" by the RTI Act,2004? What are the Objectives of the said Act?**

**(b) Define the following terms under the said act:**

- (i) "competent authority", (ii) "record", (iii) "public authority", (iv) appropriate government".**

**Answer 6.**

- (a) A Bill to operationalise the right to information by setting out the practical regime for people to secure access to information under the control of public authorities, consistent with

public interest, in order to promote openness, transparency and accountability and in relation to matters connected therewith or incidental thereto.

- (i) This Act may be called the Right to Information Act 2004,
- (ii) It extends to the whole of India except the State of Jammu and Kashmir,
- (iii) It shall come into force within 120 days of it being enacted,
- (iv) Where State legislation exists dealing with the right to access information; a person will have the right to seek information under the State law as well as under this Act, if the information pertains to a subject under the State List in Schedule 7 of the Constitution of India.
- (v) Objectives of the Act :

The objectives of the Act are to —

- (i) give effect to the Fundamental Right to Information, which will contribute to strengthening democracy, improving governance, increasing public participation, promoting transparency and accountability and reducing corruption
- (ii) establish voluntary and mandatory mechanisms or procedures to give effect to right to information in a manner which enables persons to obtain access to records of public authorities in a swift, effective, inexpensive and reasonable manner.
- (ii) promote transparency, accountability and effective governance of all public authorities by, including but not limited to, empowering and educating all persons to : understand their rights in terms of this Act in order to exercise their rights in relation to public authorities;
- (iv) - understand the functions and operation of public authorities; and effectively participating in decision making by public authorities that affects their rights.

(b) (i) “Competent authority” means :

- (a) The Speaker in the case of the House of the People or the Legislative Assembly and the Chairman in the case of the Council of States or the Legislative Council,
- (b) The Chief Justice of India in the case of Supreme Court,
- (c) The Chief Justice of the High Court in the case of a High Court,
- (d) The President or the Governor, as the case may be, in case of other authorities created by or under the Constitution,
- (e) The administrator appointed under article 239 of the Constitution.

(ii) “Record” means :—

- (a) any document, manuscript and file,
- (b) any microfilm, microfiche and facsimile copy of a document,
- (c) any reproduction of image or images embodied in such microfilm (whether enlarged or not) and,
- (d) any other material produced by a computer or by any other device.

(iii) “Public authority” means any authority or body established or constituted :—

- (a) by or under the Constitution,
- (b) by any law made by the appropriate Government, and includes any other body owned or controlled by the appropriate Government and includes panchayati raj institutions and other community bodies, like district councils, and village or locality durbars, performing public functions in areas notified under schedule 5 and 6 of the constitution.

- (iv) "Appropriate Government" means in relation to a public authority established, constituted, owned, substantially financed by funds provided directly or indirectly or controlled —
- (a) by the Union Government, the Union Government;
  - (b) by the State Government, The State Government;
  - (c) by the Union territory, The Union Government.

**Q7. Mrs Kochhar is a Director in 14 public limited companies on 30th November, 2008. This apart, she is an alternate director in another public limited company. The following particulars are made available to you, relating to her appointment as Director in various companies in annual general meetings (AGM) held :**

| Name of Company      | Date of AGM         |
|----------------------|---------------------|
| Daya Organics Ltd.   | 1st December, 2008  |
| Vimala Plastics Ltd. | 29th November, 2008 |

**Balaji Vaishnav Association (a company registered under section 25 of the Companies Act, 1956) 30th November, 2008**

**Based on the provisions of the Companies Act, 1956, you are required to advise Mrs. Kochhar, as to the options available to her for accepting or refusing the aforesaid appointments.**

**Answer 7.**

Section 275 of the Companies Act, 1956 debars any person to hold office as a director or more than 15 company's simultaneously.

As per the provisions of Section 277(2) of the Companies Act, 1956, where a person holds directorship of 14 or less companies is appointed as a director of other companies, and such appointments make the total number of his directorships more than 15, then the person concerned has to choose the directorships which he/she wishes to continue to hold or to accept so that the total number of directorship, old or new, henceforth to be held by him does not exceed 15.

The said section further provides that none of the new appointments shall be effective until such a choice is to be made and in case of failure of the person, to make such a choice within 15 days of the day on which the last of the new appointments was made, all the new appointments shall become void.

Section 278 of the Companies Act, 1956 states that for the purpose of section 275 and 277 the number of companies are not be counted are :

- (a) A private company unless it is a subsidiary of a public company,
- (b) An unlimited company,
- (c) An association not carrying on business for profit or which prohibits the payment of dividend,
- (d) A company in which such person is only an alternate director,

In view of the abovementioned legal provisions, Mrs. Kochhar, Who is already a director in 14 companies, has to consider the following aspects :

Alternate directorship or directorship in section 25 company is not affected. Hence she can take up the directorship in Balaji Vaishnav Association, the company registered u/s. 25.

The appointment in Vimala Plastics takes the number to 15 on 29-11-2008, and in Daya organics Ltd. on 1st December, 2008 takes the number of directorship to 16.

Hence within 15 days from the date on which the last appointment was made viz. 1st December, 2008, Mrs. Kochhar has to decide upon one of the two companies in which she would tak up the directorship. If she fails to decide, the two new appointments shall become void and shall not take effect.

### **Corporate Governance**

**Q8. State the additional requirements stipulated in clause 49 of the Listing Agreement which are silent in section 292A of the Companies Act, 1956.**

**Answer 8.**

**Additional requirements stipulated as per Clause 49 :**

The following additional requirements are stipulated as per Clause 49 of the Listing Agreements which are silent in Section 292A of the Companies Act, 1956 :

- (i) The audit committee should invite such of the executives, as it considers appropriate (and particularly head of the finance function) to be present at the meeting of the committee, but on occasions it may also meet without the presence of any executive of the company,
- (ii) The company secretary shall act as secretary to the committee,
- (iii) The audit committee shall meet at least thrice a year. Once meeting shall be held before finalization of annual accounts and once in every six months,
- (iv) The quorum of the audit committee shall be two members or one-third of the members of the audit committee-whichever is higher and minimum of two independent directors,
- (v) The powers and role of the audit committee are elaborately contained in sub-paragraphs C&D of paragraph II.

**Q9. State the CII (Confederation of Indian Industries) Code for desirable Corporate Governance with 14 key aspects.**

**Answer 9.**

The CII code has recommended the following 14 key aspects which should be shared with the board :

- (i) Annual operating plans and budgets together with updated long-term plans,
- (ii) Capital budgets, manpower and overhead budgets,
- (iii) Quarterly results for the company as a whole and its operating divisions for business segments,
- (iv) Show cause, demand and prosecution notices received from the revenue authorities which are considered to be materially important,
- (v) Internal audit reports, including cases of theft and dishonesty of a material nature,
- (vi) Fatal or serious accidents, dangerous occurrences, and any affluent or pollution problems,
- (vii) Default in payment of interest or nonpayment of the principal on any public deposit, and/or to any secured creditors or financial institutions,
- (viii) Defaults such as nonpayment of inter-corporate deposits by or to the company, or materially substantial non-payments for goods sold by the company,
- (ix) Any issue which involves possible public or product liability claims of a substantial nature, including any judgment or order which may have either passed, strictures on the conduct of the company, or taken an adverse view regarding another enterprise that can have negative implications for the company,
- (x) Details of any joint venture or collaboration agreement,
- (xi) Transactions that involve substantial payment towards goodwill, brand equity, or intellectual property,

- (xii) Recruitment and remuneration of senior officers just below the board level, including appointment for removal of the Chief Financial Officer and the Company Secretary,
- (xiii) Labour problems and their proposed solutions,
- (xiv) Quarterly details of foreign exchange exposure and the steps taken by management to limit the risk of adverse exchange rate movement, if material.

These issues can be classified into financial issues and non-financial issues which are not required to be presented to the Board statutorily.

**Q10. Write in brief OECD (Organisation for Economic Co-operation and Development) Principles on Corporate Governance.**

**Answer 10.**

The OECD Council meeting at Ministerial level on 27-28 April 1998, called upon the OECD to develop, in conjunction with national governments, a set of corporate governance standards and guidelines. In order to fulfill this objective, the OECD established the Ad-hoc Task Force on Corporate Governance to develop a set of non-binding principles that embody the views of Member countries on this issue.

The principles contained in this document are built upon experiences from national initiatives in Member countries and previous work carried out within the OECD, including that of the OECD Business Sector Advisory Group on Corporate Governance.

- (a) The corporate governance framework should protect shareholders' rights,
- (b) Shareholders have the right to participate in, and to be sufficiently informed on, divisions concerning fundamental corporate changes,
- (c) Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings,
- (d) Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed,
- (e) Markets for corporate control should be allowed to function in an efficient and transparent manner,
- (f) Shareholders, including institutional investors, should consider the costs and benefits of exercising their voting rights.

**The role of stakeholders in Corporate Governance :**

The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active cooperation between corporations and stakeholders in creating wealth jobs, and the sustainability of financially sound enterprises.

- (i) The corporate governance framework should assure that the rights of stakeholders that are protected by law are respected,
- (ii) Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights,
- (iii) The corporate governance framework should permit performance-enhancing mechanisms for stakeholder participation,
- (iv) Where stakeholders participate in the corporate governance process, they should have access to relevant information.

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

- Board members should act on a fully informed basis, on good faith, with due diligence and care, and in the best interest of the company and shareholders,
- Where board decisions may affect different shareholders groups differently, the board should treat all shareholders fairly,
- The board should ensure compliance with applicable law and take into account the interests of stakeholders,
- The board should be able to exercise objective judgement on corporate affairs independent, in particular, from management,
- In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information.

**Q11. Write a note on the role of the Board of Directors (BOD) in strategic management in relation to Corporate Financial Governance.**

**Answer 11.**

**BOD for Corporate Financial Governance**

A board of directors (BOD) is involved in strategic management to the extent that it carries out three tasks :

(1) Monitoring, (2) Evaluating and Influencing, and (3) Initiating and Determining.

The BOD continuum in Table below, shows the possible degree of involvement (from low to high) in the strategic management process. As types, boards can range from phantom board with no real involvement to catalyst boards with a very high degree of involvement.

**Table : Degree of involvement of BOD in strategic management**

| <b>Low<br/>(Passive)</b>                                     |                                                                                             |                                                                       |                                                                                                                               |                                                                                                                                                      | <b>High<br/>(Active)</b>                                                                                                                  |
|--------------------------------------------------------------|---------------------------------------------------------------------------------------------|-----------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Phantom</b>                                               | <b>Rubber<br/>Stamp</b>                                                                     | <b>Minimal<br/>Review</b>                                             | <b>Nominal<br/>Participation</b>                                                                                              | <b>Active<br/>Participation</b>                                                                                                                      | <b>Catalyst</b>                                                                                                                           |
| Never knows what do do if anything. No degree of involvement | Permits Officers to make all decisions. It votes as the officers recommend on action issues | Formally reviews selected issues that officers bring to its attention | Involved to a limited degree in the performance or review of selected key decisions, indicators, or programmes of management. | Approves, questions, and makes final decisions on mission, strategy, & objectives. Has active board committees. Performs fiscal & management audits. | Takes the leading role in establishing & modifying the mission, objectives, strategy & policies. It has a very active strategy committee. |

Research on the issue suggests that active board involvement in strategic management is positively related to corporate financial governance.

The role of the board of directors in strategic management is to carry out three basic tasks :

**Monitor** : By acting through its committees, a board can keep abreast of development inside and outside the corporation, bringing to management's attention developments it might have overlooked.

**Evaluate and influence** : A board can examine management's proposals, decisions, and actions, agree or disagree with them to give advice and offer suggestions, outline alternatives. More active boards perform this task in addition to monitoring.

**Initiate and determine** : A board can delineate a corporation's mission and specify strategic options to its management. Only the most active board take on this task in addition to previous ones.

Highly involved boards tend to be very active. They take their tasks of monitoring, evaluating and influencing plus initiates and determines very seriously. They provide advice when necessary and keep management alert. As depicted in the Table above, their heavy involvement in the strategic management process places them in the active participation or even catalyst positions.

**Q12. "A good Corporate Governance should have certain basic principles", Enumerate them.**

**Answer 12.**

**Principles of corporate governance** : A good corporate governance should include the following principles :

- (i) **Review of Operation**—There should be review of operations of the company at a regular interval. It may include comparison of monthly/quarterly production and sales targets with actuals, cash flow analysis, etc.
- (ii) **Compliance with Statutory and Regulatory Requirements**— The Board should ensure compliance with various statutory and regulatory requirements. It may include clearance of statutory dues, compliance with FERA regulations, following suitable accounting policies and standards, etc.
- (iii) **Appointment of various committees**—There should be appointment of various committee to look after different matters. There can be following committees—(a) Audit Committee, (b) Grievance Committees, (c) Remuneration Committee and (d) Investment Committee, etc.
  - (a) *Audit committee*—It should meet periodically to review the effectiveness of the system of internal controls and reports to shareholders.
  - (b) *Grievance committee*—It should look after the grievances from customers, suppliers, creditors in respect of price, quality, discount, etc. It should also look after the problems of executives/employees of the organisation.
  - (c) *Remuneration committee*—Its role should be to fix remuneration of non-executive directors. It may be fixed in relation to company performance.
  - (d) *Investment committee*—It should look after the investment decisions. It should be in accordance with the guidelines approved by the Board. Shareholders expect that investment decisions are judicious and do not incur any losses, which affect shareholders's interest.

(iv) **Contribution of employees' Union**—Employees or worker's union should also contribute significantly to good corporate behaviour by promoting work culture. In this case, inclusion of employees or worker's representative on the board may be thought of.

(v) **Contribution to Community Development**—A good corporate governance should help community development programmes by active participation. It should adopt measures for pollution control, and follow fair and ethical business practices.

Good corporate governance calls for accountability for all concerned. The Shareholders, directors, auditors, executives, advisers and other staff who are associated with the working of the corporate should combine their efforts to improve the system and ensure good management practices.

It can, thus, be stated that a joint stock company is of the shareholders, and has to be controlled by the shareholders and run by Boards and managers for the shareholders. The process of corporate governance has to be consistent with this, and nothing else.

**Q13. State in brief the salient features of Corporate Governance as well as the significance of it.**

**Answer 13.**

**Salient Features :**

'Corporate governance' has the following features :

- (a) It deals with how a company fulfill its obligations to investors and stakeholders,
- (b) It is about commitment to values and ethical business conduct and a high degree of transparency,
- (c) It is about creating shareholder wealth while ensuring a fair play to all other stakeholders and society at large [Stakeholders mean people other than shareholders—that is, creditors, employees, govt. society, etc.],
- (d) It is about financial transparency and the related role of directors and auditors,
- (e) No vital information is concealed from the board, and
- (f) The directors have to make a statement about the effectiveness of the system of internal control.

In a corporate enterprise, shareholders are the owners of the company and their responsibilities lie in selecting the board of directors. Good corporate governance is the outcome of logical and rational decision taken at the board level. It is stipulated that the board should discuss and approve, specifically, the following among others—

- (i) all major investment and disinvestment proposals,
- (ii) changes in financial, operational and marketing structure,
- (iii) appointment of internal auditors, their scope of function and audit findings, and
- (iv) progress of different projects under implementation.

**Significance of Corporate Governance :**

The significance of corporate governance can be best understood from several constituents of it. Some significant ones must include the following :

| Emphasis               | Operational fields                                                                                                                                                                                                              |
|------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| (i) Risks              | Management should be prepared to take risks and show entrepreneurship.                                                                                                                                                          |
| (ii) Protection        | Shareholders interests must be protected fairly and squarely.                                                                                                                                                                   |
| (iii) Insiders Trading | Corporate governance, in its excellent operational aspects, should not permit insiders trading.                                                                                                                                 |
| (iv) Transparency      | There should be transparency in terms of full disclosure of information to enable shareholders to evaluate managers in their stewardship functions and to be decisive if managers are not performing according to expectations. |

The hall mark of sound corporate governance is that it must pave the way for a fair balance between shareholders and management interests.

The Chartered Institute of Management Accountants (CIMA), in their evidence to the UK Hampel Committee on Corporate Governance, stressed as below :

“The Cadbury Code on Corporate Governance must be given extra eight by reflecting expected best practice rather than just recommended practice.”

- (i) that all public interest companies should be expected to have an internal audit function (except in the minority of cases where this would be inappropriate owing to the nature of the organisation),
- (ii) that the internal audit function’s report should cover the whole system of controls established by management, not just internal financial controls,
- (iii) that public reporting on internal control is of limited value and should focus on the measures in place rather than try to assess their effectiveness, and
- (iv) that the benefits of private reporting i.e., between internal and external auditors, Audit Committees and senior management need to be more positively portrayed and the practice encouraged.

CIMA encouraged the Committee to look at the broader control environment of which the financial aspects of corporate governance form but a part, and in particular, at corporate ethics, codes of conduct and behaviour.

The crying call of today is to strengthen the theme of One World—One Market. A forward thrust is needed to operationalise the practical aspects of corporate governance to help strengthen efficient operations of market economy.

It is the global need to develop a sound and workable system of corporate governance so that corporate ills are eliminated, sickness is reduced to the minimum, wealth is multiplied, corporate savings register an upswing contribution of corporate sector to shareholders, and above all corporate sector makes transparent and significant contribution to the stakeholders.