

*For CA Final*

# STRATEGIC FINANCIAL MANAGEMENT

***CA MAYANK KOTHARI***

Incorporating  
***SFM Theory***

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***MAYANK KOTHARI'S CLASSES.***

*Education is our future, let's grow together.*

## Importance of SFM Theory [Analysis of theory questions asked in past exams]

| Sr. No.      | Name of the Chapter                   | May 2005  | Nov 2005  | May 2006  | Nov 2006  | May 2007  | Nov 2007  | May 2008  | Nov 2008  | Jun 2009 | Nov 2009  | May 2010  | Nov 2010  | May 2011  | Nov 2011  | May 2012  | Nov 2012  | May 2013  | Nov 2013  | Average Marks [past 8] | %           | Rank |
|--------------|---------------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|------------------------|-------------|------|
| 1            | Capital Budgeting                     | -         | -         | 3         | 4         | -         | -         | 4         | -         | -        | -         | 4         | 4         | 4         | 4         | -         | -         | -         | 4         | 2.5                    | 12%         | IV   |
| 2            | Indian Capital Market                 | 16        | 14        | 6         | 4         | 12        | 9         | 4         | 4         | -        | 6         | 4         | -         | 12        | 4         | -         | 8         | 4         | -         | 4                      | 19%         | I    |
| 3            | Financial Services                    | 10        | 5         | 4         | 4         | 4         |           | 12        |           |          | 4         | 8         | 8         |           |           |           | 4         | 8         | -         | 3.5                    | 16%         | II   |
| 4            | Leasing Decisions                     | -         | -         | -         | 4         | -         | -         | -         | 4         | -        | -         | -         | -         | -         | -         | -         | -         | -         | -         | 0                      | 0%          | -    |
| 5            | Dividend Decisions                    | -         | -         | 3         | 4         | -         | -         | -         | -         | -        | -         | -         | -         | -         | -         | -         | -         | -         | -         | 0                      | 0%          |      |
| 6            | Derivatives                           | -         | -         | 8         | -         | -         | 8         | -         | 4         | -        | -         | -         | 4         | 4         | 4         | 4         | -         | -         | -         | 2                      | 9%          | V    |
| 7            | Bond Valuation                        | -         | -         | -         | -         |           | -         | -         | -         | 3        | -         | -         | -         | -         | -         | 4         | -         | -         | -         | 0.5                    | 2%          | VI   |
| 8            | Portfolio Management                  | -         | -         | 9         | 6         | -         | -         | -         | -         | -        | -         | -         | -         | -         | -         | -         | -         | -         | -         | 0                      | 0%          | -    |
| 9            | Mutual Funds                          | 4         | 8         | 3         | -         | -         | -         | -         | 4         | -        | -         | 4         | 4         | -         | 4         | -         | -         | -         | 4         | 2                      | 9%          | V    |
| 10           | Money Market Operations               | -         | -         | -         | 4         | -         | -         | 12        | -         | -        | -         | -         | -         | -         | -         | 4         | 4         | 4         | 4         | 2                      | 9%          | V    |
| 11           | Foreign Exchange Risk Management      | -         | -         | -         | -         | -         | 3         | -         | 4         | -        | -         | -         | -         | 8         | 4         | 8         | -         | -         | 4         | 3                      | 14%         | III  |
| 12           | Merger, Acquisition and Restructuring | -         | -         | -         | -         | 4         | -         | -         | 4         | -        | -         | -         | -         | -         | 4         | -         | 4         | 4         | 4         | 2                      | 9%          | V    |
| <b>Total</b> |                                       | <b>26</b> | <b>27</b> | <b>36</b> | <b>30</b> | <b>20</b> | <b>20</b> | <b>32</b> | <b>24</b> | <b>3</b> | <b>10</b> | <b>20</b> | <b>20</b> | <b>28</b> | <b>24</b> | <b>20</b> | <b>20</b> | <b>20</b> | <b>20</b> | <b>21.5</b>            | <b>100%</b> |      |

Matter of discussion: **SFM Theory Notes**

For CA Final- Strategic Financial Management

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The discussion in the present text is academic and does not tantamount to expertise/professional service to the readers on the related subject matter. Further comments and suggestions for improving quality of the book are welcome and will be gratefully acknowledged.

- **CA Mayank Kothari**

You are going to win tomorrow. It will be a great victory. Those who didn't believe you will regret, those who loved you will be proud of your success. You are the best in this world and nobody can stop you from achieving your dreams.

You are the creator of your own destiny.

I don't know how much you are already prepared for,  
I don't know what you are going to do next in your life.

But for this time, we both have same target, same goal.  
To do the best in this exam and move on for an exciting journey of your life leaving behind all these books.

Believe me, you will be the happiest person on this earth when you are going to see PASS PASS in your scorecard.

This matter's a lot to you, because after that you will celebrate your success, plan for the future, plan for the earnings. Car, House, Marriage, Vacations, Hangouts and lot more.

All these things are waiting for you.

For this time

Promise me one thing

You are going to leave all the unnecessary things,  
You are going to dedicate whole 24 hours to studies,  
This time you will be the most passionate, craziest, and deadliest for everybody waiting outside.

**Hold your breath, decide on one thing and just go get it.**

- CA Mayank Kothari

**YOUR WORK**  
is going to fill a large  
part of your life, and  
**THE ONLY WAY**

*to be truly satisfied is to do what you believe is*

**GREAT WORK.**

*And the only way to do great work is to*  
**love what you do.**

*If you haven't found it yet,*

**KEEP LOOKING, AND**  
**DON'T SETTLE.**

*As with all matters of the heart,  
you'll know when you find it.*

## ***Words of Acknowledgment***

---

When a dream turns into a reality, it's my duty to acknowledge those who have been the real strength behind my work.

I am thankful to my teacher **CA D.G.Sharma** sir founder member of CAPS. He has been my inspiration throughout my academic journey of Chartered Accountancy. It's his dedication and passion towards the profession that lead me to work hard towards success in Chartered Accountancy.

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**CA Garvita Agrawal**, thank you so much for your efforts in helping me with my book and other important decisions. I am glad to have a friend like you.

Finally,

Thank you  
**Mom & Dad**  
For believing in your son.  
Your everyday supports means a lot to me.

- **CA Mayank Kothari**

# Message for You (in no particular order)

SFM is the most systematic subject for increasing our ability with respect to application of knowledge which is ultimate need to excel in any type of field.

If learnt with anyone in depth, a great career opportunity one can open for this financial world.

With matter of time & practice, it can be gripped over easily & can be the most scoring subject in your own.

- **CA Hardik Chordia**  
[CA CPT- AIR 4, CA IPCC- AIR 42,  
CS Executive- AIR 15, CS- Professional –AIR 8]

Do not think about the results, it creates unnecessary pressure and we end up wasting important time.

Remember the words of Krishna  
“Karma kal, fal ki icha mat kar”

We should be confident enough and believe  
that nobody can stop us if we have strong willing power.

- **CA Tanmay Agrawal**  
[CA PE II – AIR 35,  
Presently working with Big 4 Firm]

Badlon ke darmiyan kuch aisi sajish hui,  
Mera ghar mitti ka tha mere hi ghar par baarish hui.

Institute ko zid hai bijliyan girane ki,  
Aur mujhe bhi zid hai vahi aashiyen banane ki.

Success lies between anger and tranquillity  
which is called as a curiosity.  
- possess it, utilise it & pass it.

- **CA Gaurav Kriplani**  
[Presently working with Big 4 Firm]

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## Capital Budgeting

**Q1 What are the issues that need to be considered by an Indian Investor and incorporated within the Net Present Value (NPV) Model for the evaluation of Foreign Investment Proposals?**

**Answer:** Following are the issues that need to be considered in NPV Model for evaluation of foreign investment proposals:

- 1) Taxes on Income associated with foreign projects**
  - a. Heavy Indirect Taxes
  - b. Difference in definition of taxable income from country to country
  - c. Tax treaties entered into with different countries
- 2) Political Risks:**
  - a. Risk of seizure of property
  - b. Risk of nationalization of industry without paying full compensation
  - c. Restrictions on employment of foreign managerial personnel
  - d. Restrictions on imports of raw material
- 3) Economic Risk:**
  - a. Fluctuation in Exchange Rates
  - b. Inflation

**Q2 Distinguish between Net Present Value and Internal Rate of Return.**

**Answer:**

| Basis                        | Net present value (NPV)                                    | Internal rate of return (IRR)                                      |
|------------------------------|------------------------------------------------------------|--------------------------------------------------------------------|
| Expressed in                 | Value in units of a currency                               | Percentage terms                                                   |
| Cash flows are assumed to be | Reinvested at <b>the cost of capital</b>                   | Reinvested at <b>an internal rate of return</b>                    |
| Additional wealth            | NPV <b>takes into account</b> additional wealth            | IRR <b>does not consider</b> additional wealth                     |
| Cash Flows                   | <b>NPV can be used</b> even if the cash flows are changing | <b>IRR method cannot be used</b> if the cash flows are changing    |
| Users                        | For <b>general public</b> NPV is better method to grasp.   | <b>Business managers</b> are more comfortable with the IRR method. |

**Q3 Write short note on Certainty Equivalent Approach.**

**Answer:**

- ✓ CE is an approach for dealing with risk in capital budgeting to reduce the forecasts of cash flows to some conservative level.
- ✓ One of the ways of incorporating risk is Certainty Equivalent Method, wherein the expected cash flows are adjusted to reflect the project risk.
- ✓ The cash flows are brought down because higher the risk less is the probability of those cash flows being certain.
- ✓ The certainty equivalent approach adjusts future cash flows rather than discount rate.
- ✓ Certainty equivalent coefficient lies between 0 and 1.
- ✓ CE coefficient of 1 indicates that the cash flow is certain or there is no risk.

**Q4 What is Sensitivity Analysis in Capital Budgeting?****Answer:**

- ✓ Sensitivity analysis is used in Capital Budgeting for measuring the risk.
- ✓ It helps in assessing information as to how sensitive are the estimated parameters of the project such as cash flows, discount rate, and the projects life to the estimation errors.
- ✓ It answers questions like:
  - i) What happens to the present value if cash flows are, say Rs. 50000 than the expected Rs. 80,000?
  - ii) And what will happen to NPV if economic life of the project is only 3 years rather than expected 5 years?
- ✓ Sensitivity analysis involves three steps:
  - i) Identification of all those variables having an influence on the projects NPV or IRR.
  - ii) Definition of the underlying quantitative relationship among the variables.
  - iii) Analysis of the impact of the changes in each of the variables on the NPV of the project.
- ✓ In Sensitivity Analysis, decision maker always asks himself the question – What IF?

**Q5 Write short note on Social Cost Benefit Analysis.****Answer:**

- ✓ Cost-benefit analysis is a process for **evaluating the merits of a particular project** or course of action in a systematic and rigorous way.
- ✓ Social cost-benefit analysis refers to cases **where the project has a broad impact across society** and, as such, is usually carried out by the government.
- ✓ It should therefore be emphasized that the costs and benefits considered by (social) 'cost-benefit' analysis are not limited to easily quantifiable changes in material goods, but should be construed in their widest sense, measuring **changes in individual 'utility' and total 'social welfare'** (though economists frequently ex-press those measures in money-metric terms).
- ✓ In its essence cost-benefit analysis is extremely, indeed trivially, simple: evaluate costs C and benefits B for the project under consideration and **proceed with it if, and only if, benefits match or exceed the costs.**
- ✓ Cost-Benefit Analysis (CBA) estimates and totals up the equivalent money value of the benefits and costs to the community of projects to establish whether they are worthwhile. These projects may be dams and highways or can be training programs and health care systems.

**Q6 What is Capital Rationing?****Answer:**

- ✓ Capital Rationing means the utilization of existing funds in most profitable manner by selecting the acceptable projects in the descending order or ranking with limited available funds.
- ✓ The firm must be able to maximise the profits by combining the most profitable proposals.
- ✓ Capital rationing may arise due to external factors (hard capital rationing) such as high borrowing rate and internal factors (soft capital rationing) such as limits imposed by management on spending of funds.
- ✓ Either the internal rate of return method or the net present value method may be used in ranking investments.
- ✓ Where there is a multi period capital rationing linear programming techniques should be used to maximise NPV.

**Q7 Explain the concept of 'Zero date of project' in project management.****Answer:**

- ✓ Zero date of project means a date is fixed from which implementation of the project begins.
- ✓ It is a starting point of incurring cost. The project completion period is counted from the zero date.
- ✓ Pre Project activities should be completed before zero date. These activities are:
  - i) Identification of project
  - ii) Determination of plant capacity
  - iii) Selection of technical help
  - iv) Selection of site
  - v) Selection of survey of soil/plot etc.
  - vi) Manpower planning and recruiting key personnel
  - vii) Cost and finance scheduling

**Q8 Write short note on Risk Adjusted Discount Rate.****Answer:**

- ✓ RADR, where the various project risks are dealt with by changing the discount rate.
- ✓ The project having
  - i) average risk is discounted at the organization's cost of capital,
  - ii) higher risk is discounted at the rate higher than the cost of capital,
  - iii) low risk is discounted at the rate lower than the cost of capital.
- ✓ Here discount rate is adjusted to incorporate the risk of the project
- ✓ RADR when underlying consideration is Risk Premium

$$r_k = i_f + n + d_k$$

Where,

 $i_f$  = risk free rate of interest,  $n$  = adjustment for firms normal risk,  $d_k$  = risk premium

- ✓ RADR when underlying consideration is Risk Factor

$$r_k = i_f + (K_e - i_f) \times \text{Risk Factor}$$

Where,  $K_e$  = Cost of equity of the firm**Q9 Distinguish between Risk Adjusted Discounted Rate (RADR) and Certainty Equivalent Approach (CEA).****Answer:**

| Comparison between RADR and CEA |                              |                                                                                                                                        |                                                                                   |
|---------------------------------|------------------------------|----------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------|
| Sr. No.                         | Particulars                  | Risk adjusted discount rate                                                                                                            | Certainty equivalent approach                                                     |
| 1                               | Method of incorporating risk | by adjusting the Discount Rate                                                                                                         | by adjusting Cash Flows                                                           |
| 2                               | NPV Formula                  | deals with the <b>denominator</b> of the NPV formula                                                                                   | deals with the <b>numerator</b> of the NPV formula                                |
| 3                               | Variation in the risk        | in RADR there is an implied assumption that, the risk of the proposal <b>increases at a constant rate</b> over the life of the project | Whereas, the CE approach incorporates <b>different risk for different years</b> . |



**Q10 What is hard and soft capital rationing?****Answer:**

**Hard Capital Rationing:** When the external environment imposes a condition as to availability of financial resources for a firm to deploy on its capital projects, the resulting paucity of capital forces rationing of the resources to deserving projects. This situation is called hard capital rationing. External capital rationing is nothing but the hard capital rationing.

**Soft Capital Rationing:** Sometimes restrictions are imposed by the executive board of the company, even though funding is available from the external environment. Such situation is called as the soft capital rationing. Internal capital rationing is nothing but soft capital rationing.

**Q11 What is Project Cost Accounting?****Answer:**

- ✓ Project cost accounting is essentially a service that supports Project Management. It is the process of recognizing, measuring, recording and reporting the project cost data (MIS) to its stakeholders about the project milestones and costs.
- ✓ One of the most important requirements of Project Cost Accounting is estimating the "Cost to Completion" and therefore, differs from "financial and corporate accounting" significantly.
- ✓ Project costing starts with a Budget, a benchmark, with which the current performance is continuously measured. Note that "What cannot be measured cannot be managed/controlled" (Peter Drucker).
- ✓ Reporting on cost overruns, physical overruns, time overruns is the essential part of the Project Costing.
- ✓ Finally, timeliness in reporting on project costs and milestone overruns is much more important than precision in reporting.

**Q12 What are the advantages of post completion audit?****Answer:**

Post completion audit evaluates actual performance with projected performance. It verifies both revenues and costs. The advantages of completing post completion audit are:

- ✓ The experience gained is highly valuable for future decision making since it can highlight mistakes that can be avoided and areas of improvements brought about.
- ✓ Identify individuals with superior abilities in planning and forecasting.
- ✓ It helps in discovering biases in judgement.
- ✓ It induces healthy caution among the sponsors of projects as project sponsors make over-optimistic projections for their proposals.
- ✓ It helps in exerting discipline in the investment planning and control process.

"Would you like me to give you a formula for success? It's quite simple, really. Double your rate of failure. You are thinking of failure as the enemy of success. But it isn't at all. You can be discouraged by failure or you can learn from it. So go ahead and make mistakes. Make all you can. Because remember that's where you will find success."

**Q13 What are the Steps in Simulation Analysis?**

**Answer:**

1. Modelling the project: The model shows the relationship of NPV with parameters and exogenous variables.
2. Specify values of parameters and probability distributions of exogenous variables.
3. Select a value at random from probability distribution of each of the exogenous variables.
4. Determine NPV corresponding to the randomly generated value of exogenous variables and pre specified parameter variables.
5. Repeat steps (3) & (4) a large number of times to get a large number of simulated NPVs.
6. Plot frequency distribution of NPV.

**Q14 Many companies calculate the internal rate of return of the incremental after -tax cash-flows from financial leases.**

**What problems do you think this may give rise to? To what rate should the internal rate of return be compared? Discuss.**

**Answer:**

Main problems faced in using Internal Rate of Return can be enumerated as under:

- (1) The IRR method cannot be used to choose between alternative lease bases with different lives or payment patterns.
- (2) If the firms do not pay tax or pay at constant rate, then IRR should be calculated from the lease cash-flows and compared to after-tax rate of interest. However, if the firm is in a temporary non-tax paying status, its cost of capital changes over time, and there is no simple standard of comparison.
- (3) Another problem is that risk is not constant. For the lessee, the payments are fairly riskless and interest rate should reflect this. The salvage value for the asset, however, is probably much riskier. As such two discount rates are needed. IRR gives only one rate, and thus, each cash-flow is not implicitly discounted to reflect its risk.
- (4) Multiple roots rarely occur in capital budgeting since the expected cash-flow usually changes sign once. With leasing, this is not the case often. A lessee will have an immediate cash inflow, a series of outflows for a number of years, and then an inflow during the terminal year. With two changes of sign, there may be, in practice frequently two solutions for the IRR.

**Q15 How would standard deviation of the present value distribution help in Capital Budgeting decisions?**

**Answer:**

Standard deviation is a statistical measure of dispersion; it measures the deviation from a central number i.e. the mean.

In the context of capital budgeting decisions especially where we take up two or more projects giving somewhat similar mean cash flows, by calculating standard deviation in such cases, we can measure in each case the extent of variation. It can then be used to identify which project is least riskier in terms of variability of cash flows.

A project, which has a lower coefficient of variation will be preferred if sizes are heterogeneous. Besides this, if we assume that probability distribution is approximately normal we are able to calculate the probability of a capital budgeting project generating a net present value less than or more than a specified amount.

**Q16 Write short notes on Real Options in Capital Budgeting.****Answer:**

Real options are the options companies have when making capital investment decisions. A company has the option to invest in such a project but can delay the decision. It can also put an existing operation on hold; it can expand an investment or reduce it.

The traditional analytical methods of project evaluation (IRR, NPV etc.) assume management's passive commitment to a certain operating strategy, viz. initiate the project immediately and operate it continuously at a set scale until the end of its pre specified expected useful life. These methods typically ignore the synergistic effects that an investment project can create. Sometimes the performance of one project will allow you to perform a second project that would not have been possible without the first (e.g. many research and development projects). Similarly, there could be significant value in waiting for additional information that could make an impact on the success of a project. Therefore the existing analytical methods usually underestimate investment opportunities because they ignore management's flexibility to alter decisions as new information becomes available.

The real option methodology is an approach to capital budgeting that relies on option pricing theory to evaluate projects. Insights from option based analysis can improve estimates of project value and therefore has potential in many instances to significantly enhance project management. However Real Options approach is intended to supplement, and not replace, capital budgeting analysis based on standard DCF methodologies.

**Options in capital budgeting**

The following is a list of options that may exist in a capital budgeting projects

**1. Long Call**

- a. Right to invest at some future date, at a certain price.
- b. Generally any flexibility to invest to enter a business, to expand a business.

**2. Long Put**

- a. Right to sell the business at some future date at a certain price.
- b. Right to abandon at some future date at a zero or some certain price.
- c. Generally, any flexibility to disinvest, to exit from a business.

**3. Short Call**

- a. Promise to sell if the counterparty wants to buy
- b. Generally, any commitment to disinvest upon the action of another party

**4. Short Put**

- a. Promise to buy if the counterparty wants to sell
- b. Generally, any commitment to invest upon the action of another party

**Q17 Why option based analysis fits in with capital budgeting framework?****Answer:**

If one were to look at the most celebrated option pricing model (OPM) to value financial options, viz., Black-Scholes Model, there are five factors which influence the call (or put) option value (the original B-S Model for European options). These five factors have a remarkable similarity to the factors that are used in the traditional DCF methodology. Take a look at the following table that maps the variables used in DCF model and the 'naïve' NPV model:

| DCF Model                                                 | Variable    | Black Scholes Model                     |
|-----------------------------------------------------------|-------------|-----------------------------------------|
| 1. Investment into the project                            | X or K or E | Exercise price                          |
| 2. Present value of the cash flows from the project       | $S_0$       | Spot price of the underlying            |
| 3. Length of a time of project may be delayed             | t           | Time to expire                          |
| 4. Time value of money                                    | r           | Risk free rate                          |
| 5. Riskiness of the operating cash flows from the project | $\sigma^2$  | Variance of returns from the underlying |

### Q18 Write short notes on Techniques of Social Cost Benefit Analysis

Answer:

- ✓ **Goods & Services:** social gain/losses from outputs and inputs of a project are measured by the willingness of the consumers to pay for the goods.
- ✓ **Labour:** Social cost of labour is lower than market wage because of massive un/under employment along with traditions, changes in life style etc. Removal of labour from farms should not cause reduction in agricultural output as other members work harder to offset the loss. Employing labour on nonfarm activities is costless. Shadow wage is zero.
- ✓ **Foreign Exchange:** Existence of extensive trade controls leads to official undervaluation of foreign exchange. Official exchange rate understates the benefit of exports and costs of imports in terms of domestic resources. An upward adjustment is necessary.
- ✓ **Social Rate of Discount:** Market rate of interest does not reflect society's preference for current consumption over future consumption. Choice of social discount rate is based on value judgment about weights to be attached to the welfare of future generations compared to that of present generations.
- ✓ **Shadow Price of Investment:** Society as a whole gives importance to future generations than that accorded by private decision makers. Imperfections of capital markets lead to less than optimal total investment.

## Indian Capital Market

### Q 1 Distinguish between Primary Market and Secondary Market.

Answer:

| No. | Basis                     | Primary Market                                                                                    | Secondary Market                                                                                                          |
|-----|---------------------------|---------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------|
| 1   | Nature of Securities      | The primary market deals with new securities i.e. securities which are traded for the first time. | The secondary market deals with the old securities.                                                                       |
| 2   | Nature of Financing       | It provide additional funds to the issuing company directly.                                      | Whereas secondary market does not provide additional funds to the concerned company.(there is indirect supply of capital) |
| 3   | Organisational Difference | The primary market is not rooted in any particular area and has no geographical existence.        | The stock exchanges have physical existence and are located in a particular geographical area.                            |

**Q 2 Name the Leading Stock Exchanges in India and Abroad.****Answer:****Stock Exchanges in India**

- a) Bombay Stock Exchange (BSE)
- b) National Stock Exchange (NSE)

**Stock Exchanges Abroad**

- a) New York Stock Exchange (NYSE)
- b) Nasdaq (National Association of Securities Dealers Automated Quotations.)
- c) London Stock Exchange

**Q3 What are the functions of Stock Exchanges?****Answer:**

**(a) Liquidity and Marketability of Securities:** Stock exchange provides a ready and continuous market for purchase and sale of securities. Investors can at any time sell one and purchase another security, thus giving them marketability.

**(b) Fair Price Determination:** Due to nearly perfect information, active bidding takes place from both sides. This ensures fair price to be determined by demand and supply forces.

**(c) Sources of Long Term Funds:** Corporate, Government and public bodies raise funds from equity markets.

**(d) Helps in Capital Formation:** Stock exchange accelerates the process of capital formation. It creates the habit of saving, investing and risk taking among the investing class and converts their savings into profitable investment. It acts as an instrument of capital formation. In addition, it also acts as a channel for right (safe and profitable) investment.

**(e) Reflects the General State of the Economy:** Stock exchange indicates the state of health of companies and the national economy. It acts as a barometer of the economic situation / conditions.

**(f) Regulates Company Management:** Listed companies have to comply with rules and regulations of concerned stock exchange and work under the vigilance (i.e. supervision) of stock exchange authorities.

**(g) Provides Clearing House Facility:** Stock exchange provides a clearing house facility to members. It settles the transactions among the members quickly and with ease. The members have to pay or receive only the net dues (balance amount) because of the clearing house facility.

**Q4 What is Stock Market Index?****Answer:**

- ✓ A stock index or a stock market index is a list of figures and stocks that are used to indicate the combined value of its constituents.
- ✓ The stock index is applied as a device for representing the essential features of its constituent stocks.
- ✓ Stock indices function as an indicator of the general economic scenario of a country.
- ✓ If the stock market indexes are on the high, it reflects that the overall financial condition of the different companies in the country and the general economy of the country are stable.
- ✓ If, however, there is a plunge noticed in the stock market index, it is indicative of poor economic condition of the companies and therefore, the general economy.

Stock Market Index answers to the question “how is the market doing?” A base year is set along with a basket of base shares.

“If you chase two rabbits, both will escape. Believe in doing one job at a time. Do it perfectly. You may look around and you will find that those who did few things in life were the most successful ones. Whatever you are doing, do it with 100% focus, dedication, willpower and all efforts.”

Each stock exchange has a flagship index like in India Sensex of BSE and Nifty of NSE and outside India is Dow Jones, FTSE, Nasdaq etc.

#### Q5 What do the fluctuations of Index Say?

Answer:

- Stocks are valued by **discounting future earnings** of the company; therefore stock indices reflect expectation about future performance of the companies listed in the stock market.
- When the Index goes up, the market thinks that the future returns will be higher than they are at present and when it goes down, the market thinks that the future returns will be lower than they are at present.

#### The concept behind the Index

Stock price are sensitive to the following news:

- Company specific news
- Country specific news (budget, elections, government policies, wars etc.)

On any one day there is some good news and bad news related to specific companies, which offset with each other. This news does not affect the index. However, the country specific news, which is common to all stocks, affects the index.

#### Q6 How is the Index calculated?

Answer:

Step 1: Calculate market capitalization (or market cap) of each individual company comprising the index. [Market price per share x Total no. of outstanding shares]

Step 2: Calculate total market capitalization by adding the individual market capitalization of all companies in the Index.

Step 3: Computing index of the next day requires the index value and the total market capitalization of the previous day and is computed as follows:

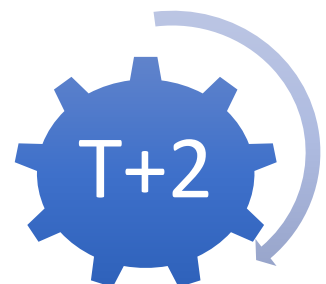
$$\text{Index value} = \text{Index on previous day} \times \frac{\text{total market capitalization for current day}}{\text{total capitalisation of previous day}}$$

Note: Indices may also be calculated by price weighted method. Here the share price of constituent companies forms the weights. However almost all equity indices world-wide are calculated using market capitalization weighted method (the one used above).

#### Q7 Write short note on Settlement Cycle and Trading Hours.

Answer:

- ✓ Equity spot markets follow a T+2 rolling settlement.
- ✓ This means that any trade taking place on Monday gets settled by Wednesday.
- ✓ All trading on stock exchanges takes place between 9:55 am and 3:30 pm, Indian Standard Time (+ 5.5 hours GMT), Monday through Friday.
- ✓ Delivery of shares must be made in dematerialized form, and each exchange has its own clearing house, which assumes all settlement risk, by serving as a central counterparty.



**Q8 What is Clearing Houses?****Answer:**

- ✓ Clearing house is an exchange associated body charged with the function of ensuring the financial integrity of each trade.
- ✓ Orders are cleared by means of clearinghouse acting as a seller to all the buyers and buyer to all the sellers.
- ✓ It provides range of services related to the guarantee of contracts, clearing and settlement of trades and management of risk for their members and associated exchanges.

**Q9 What is the role of clearing house?****Answer:**

- ✓ Ensuring adherence to the system and procedures for smooth trading.
- ✓ Minimising credit risk by being a counter party to all trades.
- ✓ Daily accounting of gains and losses.
- ✓ Ensuring delivery of payment for assets on maturity dates for all outstanding contracts.
- ✓ Monitors the maintenance of speculation margins.

**Q10 Write short note on Trading Mechanism.****Answer:**

- ✓ Trading at both the exchanges takes place through an open electronic limit order book, in which order matching is done by the trading computer.
- ✓ There are no market makers or specialists and the entire process is order-driven, which means that market orders placed by investors are automatically matched with the best limit orders. As a result, buyers and sellers remain anonymous.
- ✓ The advantage of an order driven market is that it brings more transparency, by displaying all buy and sell orders in the trading system.
- ✓ However, in the absence of market makers, there is no guarantee that orders will be executed.
- ✓ All orders in the trading system need to be placed through brokers, many of which provide online trading facility to retail customers.

**Q11 What are the major capital market instruments?****Answer:**

- a) Debt Instruments
- b) Equities (Common stock)
- c) Preference Shares
- d) Derivatives

**Q12 Write short notes on American Depository Receipts (ADRs).****Answer:**

- ✓ **An American depository receipt (ADR) is a negotiable security that represents securities of a non-US company that trades in the US financial market.**
- ✓ ADRs allow U.S. investors to invest in non-U.S. companies and give non-U.S. companies easier access to the U.S. capital markets. Many non-U.S. issuers use ADRs as a means of raising capital or establishing a trading presence in the U.S.

Benefits to the US Investors

1. One of ADRs' top advantages is the facilitated diversification into foreign securities.
2. ADRs also allow easy comparison to securities of similar companies as well as access to price and trading information, if listed.

3. Transfer of ADR does not require any stamp duty hence the transfer of underlying shares does not require any stamp duty.
4. The dividends are paid to the holders of ADRs in US dollars.

### Q13 Write short notes on Global Depository Receipts (GDRs).

**Answer:**

- ✓ **Global Depository Receipts are negotiable certificates with publicly traded equity of the issuer as underlying security.**
- ✓ The principal purpose of GDR is to provide international investor with local settlement.
- ✓ The issuer issuing the shares has to pay dividends to the depository in the domestic currency. The depository has to then convert the domestic currency into dollars for onward payment to receipt holders. GDRs bear no risk of capital repayment.
- ✓ GDRs are also issued with warrants attached to them. Warrants give the investor an option to get it converted into equity at a later date.

### Q14 Explain Moving Averages.

**Answer:**

Moving averages are frequently plotted with prices to make buy and sell decisions. The two types of moving averages used by chartists are:

1. Arithmetic Moving Average(AMA)
2. Exponential Moving Average(EMA)

1. **Arithmetic Moving Average (AMA):** An n period AMA at period t is nothing but the simple average of the last n period prices.

$$AMA_{n,t} = 1/n[P_t + P_{t-1} + \dots + P_{t-(n-1)}]$$

2. **Exponential Moving Average (EMA):** Unlike AMA, which assigns equal weight of 1/n to each of the n prices used for computing the average, the Exponential Moving Average (EMA) assigns decreasing weights, with the highest weight being assigned to the latest price. The weights decrease exponentially, according to a scheme specified by exponential smoothing constant, also known as the exponent, a.

$$EMA_t = aP_t + (1 - a)(EMA_{t-1})$$

### Q 15 Write short notes on 'Stock Lending Scheme'.

**Answer:**

- ✓ In stock lending, the legal title of a security is temporarily transferred from a lender to a borrower.
- ✓ The lender retains all the benefits of ownership, other than the voting rights.
- ✓ The borrower is entitled to utilize the securities as required but is liable to the lender for all benefits.
- ✓ A securities lending programme is used by the lenders to maximize yields on their portfolio. Borrowers use the securities lending programme to avoid settlement failures.
- ✓ Securities lending provide income opportunities for security holders and creates liquidity to facilitate trading strategies for borrowers. It is particularly attractive for large institutional shareholders as it is an easy way of generating income to offset custody fees and requires little involvement of time.



**Q 16 Explain the functions of Merchant Bankers?****Answer:**

The basic function of merchant bankers is marketing of corporate and other securities.

In this process, he performs a number of services concerning various aspects of marketing viz. origination, underwriting, and distribution of securities.

Other activities or services performed by merchant bankers in India include:

- ✓ Project promotion services
- ✓ Project Finance
- ✓ Management and marketing of new issues
- ✓ Underwriting of new issues
- ✓ Syndication of new issues
- ✓ Syndication of credit
- ✓ Leasing services
- ✓ Corporate advisory services
- ✓ Providing venture capital
- ✓ Operating mutual funds and off shore funds
- ✓ Investment management or portfolio management services
- ✓ Bought out deals
- ✓ Providing assistance for technical and financial collaborations and joint ventures
- ✓ Management of and dealing in commercial paper
- ✓ Investment services for non resident Indians

**Q 17 Write short notes on 'Book Building'.****Answer:**

Book building is a technique used for marketing a public offer of equity shares of a company. It is a way of raising more funds from the market. After accepting the free pricing mechanism by the SEBI, the book building process has acquired too much significance and has opened a new lead in development of capital market.

A company can use the process of book building to fine tune its price of issue. When a company employs book building mechanism, it does not pre-determine the issue price (in case of equity shares) or interest rate (in case of debentures) and invite subscription to the issue. Instead it starts with an indicative price band (or interest band) which is determined through consultative process with its merchant banker and asks its merchant banker to invite bids from prospective investors at different prices (or different rates). Those who bid are required to pay the full amount. Based on the response received from investors the final price is selected. The merchant banker (called in this case Book Runner) has to manage the entire book building process. Investors who have bid a price equal to or more than the final price selected are given allotment at the final price selected. Those who have bid for a lower price will get their money refunded.

In India, there are two options for book building process. One, 25 per cent of the issue has to be sold at fixed price and 75 per cent is through book building. The other option is to split 25 per cent of offer to the public (small investors) into a fixed price portion of 10 per cent and a reservation in the book built portion amounting to 15 per cent of the issue size. The rest of the book built portion is open to any investor.

The greatest advantage of the book building process is that this allows for price and demand discovery. Secondly, the cost of issue is much less than the other traditional methods of raising capital. In book building, the demand for shares is known before the issue closes. In fact, if there is not much demand the issue may be deferred and can be rescheduled after having realised the temper of the market.

**Q 18 Write short notes on 'Green Shoe Option'.**

**Answer:**

**The green shoe option allows companies to intervene in the market to stabilise share prices during the 30-day stabilisation period immediately after listing. This involves purchase of equity shares from the market by the company-appointed agent in case the shares fall below issue price.**

**Guidelines for exercising green shoe option**

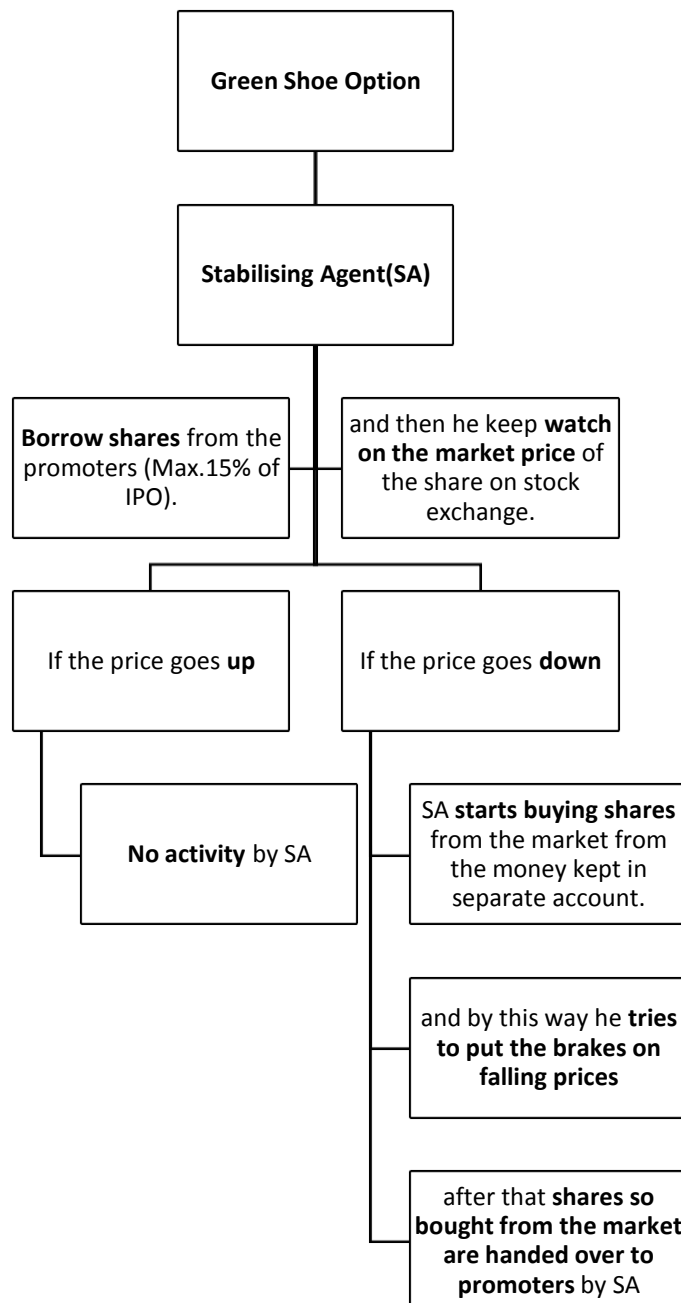
- The guidelines require the promoter to lend his shares (not more than 15% of issue size) which is to be used for price stabilisation to be carried out by a stabilising agent (normally merchant banker or book runner) on behalf of the company.
- The stabilisation period can be up to 30 days from the date of allotment of shares to bring stability in post listing pricing of shares.
- After making the decision to go public, the company appoints underwriters to find the buyers for their issue. Sometimes, these underwriters also help the corporate in determining the issue price and the kind of equity dilution i.e. how many shares will be made available for the public.
- But with the turbulent times prevailing in the market place, it is however quite possible that the IPO undersubscribed and trades below its issue price.
- This is where these underwriters invoke the green shoe option to stabilise the issue.

**How green shoe option works**

- As said earlier, the entire process of a greenshoe option works on over-allotment of shares. For instance, a company plans to issue 1 lakh shares, but to use the greenshoe option; it actually issues 1.15 lakh shares, in which case the over-allotment would be 15,000 shares. Please note, the company does not issue any new shares for the over-allotment.
- The 15,000 shares used for the over-allotment are actually borrowed from the promoters with whom the stabilising agent signs a separate agreement. For the subscribers of a public issue, it makes no difference whether the company is allotting shares out of the freshly issued 1 lakh shares or from the 15,000 shares borrowed from the promoters.
- Once allotted, a share is just a share for an investor. For the company, however, the situation is totally different. The money received from the over-allotment is required to be kept in a separate bank account (i.e. escrow account)

**Role of the stabilising agent**

1. The stabilizing agent start its process only after trading in the share starts at the stock exchanges.
2. In case the shares are trading at a price lower than the offer price, the stabilizing agent starts buying the shares by using the money lying in the separate bank account. In this manner, by buying the shares when others are selling, the stabilizing agent tries to put the brakes on falling prices. The shares so bought from the market are handed over to the promoters from whom they were borrowed.
3. In case the newly listed shares start trading at a price higher than the offer price, the stabilizing agent does not buy any shares.



### Q19 Write short notes on Euro Convertible Bonds.

#### Answer:

- ✓ Euro Convertible bonds are quasi-debt securities (unsecured) which can be converted into depository receipts or local shares.
- ✓ ECBs offer the investor an option to convert the bond into equity at a fixed price after the minimum lock in period.
- ✓ The price of equity shares at the time of conversion will have a premium element. The bonds carry a fixed rate of interest.
- ✓ These are bearer securities and generally the issue of such bonds may carry two options viz., call option and put option. A call option allows the company to force conversion if the market price of the shares exceeds a particular percentage of the conversion price. A put option allows the investors to get his money back before maturity.

- ✓ In the case of ECBs, the payment of interest and the redemption of the bonds will be made by the issuer company in US dollars. ECBs issues are listed at London or Luxemburg stock exchanges.
- ✓ Indian companies which have opted ECBs issue are Jindal Strips, Reliance, Essar Gujarat, Sterlite etc.
- ✓ Indian companies are increasingly looking at Euro-Convertible bond in place of Global Depository Receipts because GDRs are falling into disfavour among international fund managers.
- ✓ An issuing company desirous of raising the ECBs is required to obtain prior permission of the Department of Economic Affairs, Ministry of Finance, and Government of India.
- ✓ The proceeds of ECBs would be permitted only for following purposes:
  - (i) Import of capital goods.
  - (ii) Retiring foreign currency debts.
  - (iii) Capitalising Indian joint venture abroad.
  - (iv) 25% of total proceedings can be used for working capital and general corporate restructuring.

**Q20 Explain the term Buy Back of Securities.****Answer:**

Companies are allowed to buy back equity shares or any other security specified by the Union Government. In India Companies are required to extinguish shares bought back within seven days. In USA Companies are allowed to hold bought back shares as treasury stock, which may be reissued. A company buying back shares makes an offer to purchase shares at a specified price. Shareholders accept the offer and surrender their shares.

The following are the management objectives of buying back securities:

- (i) To return excess cash to shareholders, in absence of appropriate investment opportunities.
- (ii) To give a signal to the market that shares are undervalued.
- (iii) To increase promoters holding, as a percentage of total outstanding shares, without additional investment. Thus, buy back is often used as a defence mechanism against potential takeover.
- (iv) To change the capital structure.

**Q21 Explain the term “Short Selling”****Answer:**

In purchasing stocks, you buy a piece of ownership in the company. The buying and selling of stocks can occur with a stock broker or directly from the company. Brokers are most commonly used. They serve as an intermediary between the investor and the seller and often charge a fee for their services.

In finance short selling (also known as shorting or going short) is the practice of selling securities or other financial instruments that are not currently owned, and subsequently repurchasing them ("covering").

The short seller borrows shares and immediately sells them. The short seller then expects the price to decrease, when the seller can profit by purchasing the shares to return to the lender.

The procedure:

Here's the skinny: when you short sell a stock, your broker will lend it to you. The stock will come from the brokerage's own inventory, from another one of the firm's customers, or from another brokerage firm. The shares are sold and the proceeds are credited to your account. Sooner or later, you must "close" the short by buying back the same number of shares (called covering) and returning them to your broker. If the price drops, you can buy back the stock at the lower price and make a profit on the difference. If the price of the stock rises, you have to buy it back at the higher price, and you lose money.

Most of the time, you can hold a short for as long as you want, although interest is charged on margin accounts, so keeping a short sale open for a long time will cost more. However, you can be forced to cover if the lender wants the stock you borrowed back. Brokerages can't sell what they don't have, so yours will either have to come up with new shares to borrow, or you'll have to cover. This is known as being called away. It doesn't happen often, but is possible if many investors are short selling a particular security.

Because you don't own the stock you're short selling (you borrowed and then sold it), you must pay the lender of the stock any dividends or rights declared during the course of the loan. If the stock splits during the course of your short, you'll owe twice the number of shares at half the price.

## **Financial Services**

### **Q1 What are the functions of Investment Banks.**

**Answer:**

1. Managing an IPO
2. Hiring the manager
3. Due Diligence and Drafting
4. Marketing
5. Acting as an intermediary between Acquirer and Target Company.
6. Follow on offering of stock
7. Issue of debt
8. Private Placement

### **Q 2 Distinguish between Investment Banks and Commercial Banks.**

**Answer:**

| <b>Basis</b>                                                 | <b>Investment Bank</b>                                                                                                               | <b>Commercial Bank</b>                                                                                                            |
|--------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------|
| <b>1. Function</b>                                           | Investment banks help their clients by acting as an intermediary between the buyers and the sellers of securities (stocks or bonds). | Commercial banks are engaged in the business of accepting deposits from customers and lending money to individuals and corporate. |
| <b>2. Acceptance of deposits</b>                             | Investment banks do not take deposits from customers.                                                                                | Commercial banks can legally take deposits from customers.                                                                        |
| <b>3. Ownership for the product selling to the customers</b> | Investment banks do not own the securities and only act as an intermediary for smooth transaction of buying and selling securities.  | Commercial banks own the loans granted to their customers.                                                                        |
| <b>4. Source of Income</b>                                   | Investment banks earn underwriting commission.                                                                                       | Commercial banks earn interest on loans granted to their customers.                                                               |

**Q 3 What is Credit Rating?****Answer:**

- An expression of opinion of rating agency,
- The opinion is in regard to a debt instrument,
- The opinion is as on a specific date,
- The opinion is dependent on risk evaluation,
- The opinion depends on the probability of interest and principal obligations being met timely.

**Q 4 What are the different Credit Rating Agencies in India****Answer:****Q 5 Explain the Credit Rating Process/ How credit rating is being issued?****Answer:****1) Request from issuer and analysis**

A company approaches a rating agency for rating a specific security. A team of analysts interact with the company's management and gathers necessary information.

**2) Rating Committee**

On the basis of information obtained and assessment made, team of analysts present a report to the Rating committee. The issuer is not allowed to participate in this process as it is an internal evaluation of the rating agency. The nature of credit evaluation depends on the type of information provided by the issuer.

**3) Communication to management and appeal**

The rating decision is communicated to the issuer and then the rating is shared with the issuer. If the issuer disagrees, an opportunity of being heard is given to him. Issuer appealing against a rating decision is asked to submit relevant material information. The Rating Committee reviews the decision although such a review may not alter the rating. The issuer may reject a rating and rating score need not be disclosed to the public.

**4) Pronouncement of the rating**

If the rating decision is accepted by the issuer, the rating agency makes a public announcement of it.

**5) Monitoring of the assigned rating**

The rating agencies monitor the on-going performance of the issuer and the economic environment in which it operates.

**6) Rating watch**

Based on the constant scrutiny carried out by the agency it may place a rated instrument on Rating Watch. The rating may change for the better or for the worse. Rating watch is followed by a full scale review for confirming or changing the original rating.

"If you always put limits on what you can do, physical or anything else, it'll spread over into the rest of your life. It'll spread into your work, into your morality, into your entire being. There are no limits. There are plateaus, but you must not stay there, you must go beyond them. If it kills you, it kills you. A man must constantly exceed his level." – Bruce Lee

**Q 6 What are the uses of Credit Rating?****Answer:****For Users**

- Aids in investment decisions.
- Helps in fulfilling regulatory obligations.
- Provides analysts in Mutual Funds to use credit ratings as one of the valuable inputs to their independent evaluation system.

**For Issuers**

- Requirement of meeting regulatory obligations as per SEBI guidelines.
- Recognition given by prospective investors providing value to the ratings which helps them to raise debt/equity capital.

**Q 7 What is Scripless Trading System?**

**Answer:** The depository holds electronic custody of securities and also arranges for transfer of ownership of securities on the settlement dates. This system is known as 'scripless trading system'.

**Q 8 What is the difference between Debit Card and Credit Card?**

**Answer:** The basic difference between the two is the fact that a credit card takes the form of a personal loan from the issuing bank to the consumer while a debit card is more like a cheque, money is directly deducted from a person's bank account to pay for transaction.

**Q 9 Explain CAMEL model in Credit Rating.****Answer:**

**CAMEL stands for Capital, Asset, Management, Earnings and Liquidity. The CAMEL model adopted by the rating agencies deserves special attention; it focuses on the following aspects:**

- a) **Capital:** Composition of retained earnings and external funds; Fixed dividend component for preference shares and fluctuating component for equity shares and adequacy of long term funds adjusted to gearing levels; ability of issuer to raise further borrowings.
- b) **Assets:** Revenue generating capacity of existing/ proposed assets, fair values, technological/ physical obsolescence, linkage of asset values to turnover, consistency, appropriation of methods of depreciation and adequacy of charge to revenues. Size, ageing and recoverability of monetary assets.
- c) **Management:** Extent of involvement of management personnel, team work, authority, timeliness, effectiveness and appropriateness of decision making along with directing management to achieve corporate goals.
- d) **Earnings:** Absolute levels, trends, stability, adaptability to cyclical fluctuations ability of the entity to service existing and additional debts proposed.
- e) **Liquidity:** Effectiveness of working capital management, corporate policies for stock and creditors, management and the ability of the corporate to meet their commitment in the short run.

**Q 10 What is Depository?****Answer:**

- ✓ Depository means one who receives a deposit of money, securities, instruments or other property, a person to whom something is entrusted, a trustee, a person or group entrusted with the preservation or safe keeping of something.
- ✓ The depository is an organization where the securities of a shareholder are held in the form of electronic accounts, in the same way as a bank holds money.

- ✓ There are two security depositories 1) NSDL- National Securities Depository Limited (1996)  
2) CDSL- Central Depository Services Limited (1999)

**Q 11 What is the difference between Physical and Dematerialised Share Trading?**

**Answer:**

| Physical Share Trading                                                              | Dematerialised Share Trading                                     |
|-------------------------------------------------------------------------------------|------------------------------------------------------------------|
| 1) For <b>buy transaction</b> , delivery is to be sent to company for registration. | 1) No need to send the document to the company for registration. |
| 2) <b>Open delivery</b> can be kept                                                 | 2) Not possible to keep delivery open.                           |
| 3) <b>Processing time</b> is long                                                   | 3) Processing time is less                                       |
| 4) <b>Stamp Charges @ 0.5%</b> are levied for transfer                              | 4) No stamp charges are required for transfer                    |
| 5) For <b>sales transaction</b> , no charges other than brokerage are levied.       | 5) Sales transactions are also charged.                          |
| 6) <b>Actual delivery</b> of share is to be exchanged                               | 6) No actual delivery of share is needed.                        |

**Q 12 What are the benefits of Credit Cards over Debit Cards?**

**Answer:**

- With a **flexible spending limit**, a cardholder can take advantage of the easy loan facility of a credit card, and can use it to purchase items or spend money that he expects in the near future, not just money that he presently has in his account.
- Most of the major features of a debit card such as **withdrawal of cash from ATMs** are available on credit cards as well.
- A credit card has **greater security measures**.
- A credit card can be used as a convenient way to **check and record your spending**.
- Since there is a fixed credit limit, a cardholder **cannot overstretch his purchases**.

**Q 13 What is meant by Online Share Trading?**

**Answer:** Online stock trading is an internet based stock trading facility where investor can trade shares through a website without any manual intervention from the broker. It also provides investors with rich, interactive information in real time including market updates, investment research and robust analysis.

**Q 14 What are the advantages and disadvantages of depository system?**

**Answer:**

**Advantages:**

- Transaction costs are reduced.
- Immediate Transfer: Transfer of securities is effected immediately.
- Paper work is minimized.
- Safe: Securities are held in a safe and convenient manner.
- No stamp duty: Stamp duty for transfer is eliminated.
- Bad deliveries, fake securities and delays in transfers are eliminated.
- Routine changes viz. change in address of one person owning securities issued by different companies can be taken care of simultaneously for all securities with little delay.



**Disadvantages:**

- **Human Fraud:** Unlawful transfers by individuals against whom insolvency proceedings are pending or transfer by attorney holders with specific or limited powers are possible.
- **Additional record keeping:** In built remate provisions for rematerialization exist to take care of the needs of individuals who wish to hold securities in physical form. Companies will invariably need to maintain records on a continuous basis for securities held in physical form. Periodical reconciliation between demat segment and physical segment is very much necessary.
- **Cost of Depository Participant (DP)** A one time fee is levied by the depository participant which small investors consider to be an avoidable cost.
- **Systematic Failure:** Unforeseen failures, intentional or otherwise, on the part of the individuals entrusted with protecting data integrity, could lead to chaos.

**Q 15 What are the advantages of Online Stock Trading?****Answer:**

| Standardized Procedure                                                                                                                     | One stop Shop                                                                                                                          | Flexibility                                                                                                                   | Time                                                                                                                                                               | Informed Research                                                                                                         |
|--------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"> <li>• Customer can easily expect the time when cash or shares to be credited to his account.</li> </ul> | <ul style="list-style-type: none"> <li>• Bank statements and transaction statements can be viewed at the click of a button.</li> </ul> | <ul style="list-style-type: none"> <li>• Customers can modify the placed orders according to the market movements.</li> </ul> | <ul style="list-style-type: none"> <li>• Customers can trade online in a real time basis as buying and selling of shares happen with a press of button.</li> </ul> | <ul style="list-style-type: none"> <li>• Customers can directly see the stock analysis provided by the broker.</li> </ul> |

**Q 16 What are the disadvantages of Online Stock Trading?****Answer:**

| Time required                                                                                                                                                                            | Internet Connectivity                                                                                                                                                        | Limited Knowledge                                                                                                                                                                                      |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"> <li>• Customers have to spend lots of time seating in front of terminal to monitor stock prices. It's not suitable for busy professionals.</li> </ul> | <ul style="list-style-type: none"> <li>• Online trading requires high speed internet connectivity. But many rural and urban areas don't have this facility today.</li> </ul> | <ul style="list-style-type: none"> <li>• Sometimes customers don't have knowledge regarding how to use the online trading portal. And also lack the financial awareness about stock market.</li> </ul> |

**Q 17 Write short notes on 'Debt Securitisation'.****Answer:**

**Debt securitisation** is a method of recycling of funds. It is especially beneficial to financial intermediaries to support the lending volumes. Assets generating steady cash flows are packaged together and against this assets pool market securities can be issued. The process can be classified in the following three functions.

1. **The origination function:** A borrower seeks a loan from finance company, bank or housing company. On the basis of credit worthiness repayment schedule is structured over the life of the loan.
2. **The pooling function:** Similar loans or receivables are clubbed together to create an underlying pool of assets. This pool is transferred in favour of a SPV (Special Purpose Vehicle), which acts as a trustee for the investor. Once, the assets are transferred they are held in the organizers portfolios.
3. **The securitisation function:** It is the SPV's job to structure and issue the securities on the basis of asset pool. The securities carry coupon and an expected maturity, which can be asset based or mortgage based. These are generally sold to investors through merchant bankers. The investors in this type of securities are generally institutional investors like mutual fund, insurance companies etc. The originator usually keeps the spread.

Generally, the process of securitisation is without recourse i.e. the investor bears the credit risk of default and the issuer is under an obligation to pay to investors only if the cash flows are received by issuer from the collateral.

**Q 18 Write short notes on 'Depository Participant'.****Answer:**

- ✓ Under this system, the securities (shares, debentures, bonds, Government securities, MF units etc) are held in electronic form just like cash in a bank account.
- ✓ To speed up the transfer mechanism of securities from sale, purchase, transmission, SEBI introduced Depository Services also known as Dematerialization of listed securities.
- ✓ It is the process by which certificates held by investors in physical form are converted to an equivalent number of securities in electronic form.
- ✓ The securities are credited to the investor's account maintained through an intermediary called Depository Participant (DP).
- ✓ Shares/Securities once dematerialized lose their independent identities. Separate numbers are allotted for such dematerialized securities. Organization holding securities of investors in electronic form and which renders services related to transactions in securities is called Depository.

**Q 19 Write short notes on 'Asset Securitisation'.****Answer:**

- ✓ Securitisation is a process of transformation of illiquid asset into security which may be traded later in the open market. It is the process of transformation of the assets of a lending institution into negotiable instruments. The term 'securitisation' refers to both switching away from bank intermediation to direct financing via capital market and/or money market, and the transformation of a previously illiquid asset like automobile loans, mortgage loans, trade receivables, etc. into marketable instruments.
- ✓ This is a method of recycling of funds. It is beneficial to financial intermediaries, as it helps in enhancing lending funds. Future receivables, EMI and annuities are pooled together and transferred to a special purpose vehicle (SPV). These receivables of the future are shifted to mutual funds and bigger financial institutions. This process is similar to that of commercial banks seeking refinance with NABARD, IDBI, etc.

## Leasing Decisions

### Q 1 Write short note on Cross Border Leasing.

**Answer:**

Cross-border leasing is a leasing arrangement where lessor and lessee are situated in different countries. This presents significant additional issues related to tax avoidance and tax shelters.

A major objective of the cross border leasing is to reduce the overall cost of financing through utilization by the lessor of tax depreciation allowances to reduce its taxable income. The tax savings are passed through to the lessee as a lower cost of finance. The basic prerequisites are relatively high tax rates in the lessor's country, liberal depreciation rules and either very flexible or very formalistic rules governing tax ownership.

**Other important objectives of the cross border leasing include the following:**

1. The lessor is often able to utilize nonrecourse debt to finance a substantial portion of the equipment cost. The debt is secured by among other things, a mortgage on the equipment and by an assignment of the right to receive payments under the lease.
2. Also depending on the structure, in some countries the lessor can utilize very favourable "leveraged lease" financial accounting treatment for the overall transaction.
3. In some countries it is easier for a lessor to repossess the leased equipment following a lessee default because the lessor is an owner and not a mere secured lender.
4. Leasing provides the lessee with 100% financing.

### Q 2 Distinguish between Financial and Operating lease.

**Or What are the salient features of Financial and Operating lease?**

**Answer:**

| Basis                                              | Financial Lease                                                                     | Operating Lease                                                                |
|----------------------------------------------------|-------------------------------------------------------------------------------------|--------------------------------------------------------------------------------|
| <b>Lease term</b>                                  | Covers the economic life of the equipment.                                          | Covers significantly less than the economic life of the equipment.             |
| <b>Cancellation</b>                                | Financial lease cannot be cancelled during the primary lease period.                | Operating lease can be cancelled by the lessee prior to its expiration.        |
| <b>Amortization</b>                                | The lease rentals are more or less fully amortized during the primary lease period. | The lease rentals are not sufficient enough to amortize the cost of the asset. |
| <b>Risk of obsolescence</b>                        | The lessee is required to take the risk of obsolescence.                            | The lessee is protected against the risk of obsolescence.                      |
| <b>Costs of maintenance, taxes, insurance etc.</b> | Incurred by the lessee unless the contract provides otherwise.                      | Incurred by the lessor.                                                        |

**Q 3 What is Sales and Lease back leasing?****Answer:**

Leaseback, short for 'sale-and-leaseback,' is a financial transaction, where one sells an asset and leases it back for the long-term; therefore, one continues to be able to use the asset but no longer owns it.

After purchasing an asset, the owner enters a long-term agreement by which the property is leased back to the seller, at an agreed rate. One reason for a leaseback is for the seller to raise money by offloading a valuable asset to a buyer who is presumably interested in making a long-term secured investment.

**Q 4 What is Sales Aid Lease?****Answer:**

**Sale aid lease:** When the leasing company (lessor) enters into an agreement with the manufacturer of the equipment, to market the latter's product through its own leasing operations, it is called "sales-aid-lease". Leasing company gets a commission from the manufacturer on such sales.

**Q 5 What are the advantages and disadvantages of leasing?****Answer:****Advantages**

- 100% Financing
- Protection against obsolescence
- Off-balance-sheet financing
- Tax advantages
- Leasing Increases Lessee's Capacity To Borrow
- Absence Of Restrictive Convenience
- Flexible requirements according to user needs

**Disadvantages**

- Cash outflow soon after the acquisition of asset
- Seller's warranty may not be there
- Hypothecation by bank
- High cost of financing

**Q 6 Write short notes on Bower-Herringer-Williamson method of lease evaluation****Answer:**

This method segregates the financial and tax aspects of lease financing. If the operating advantage of a lease is more than its financial disadvantage or vice-versa lease will be preferred.

**The procedure of evaluation is briefly as follows:**

1. Compare the present value of debt with the discounted value of lease payments (gross), the rate of discount being the gross cost of debt capital. The net present value is the financial advantage (or disadvantage).
2. Work out the comparative tax benefit during the period and discount it at an appropriate cost of capital. The present value is the operating advantage (or disadvantage) of leasing.
3. If the net result is an advantage, select leasing.

## Dividend Decisions

**Q 1 What are the factors determining dividend policy of the company?**

**Or What are the determinants of dividend policy?**

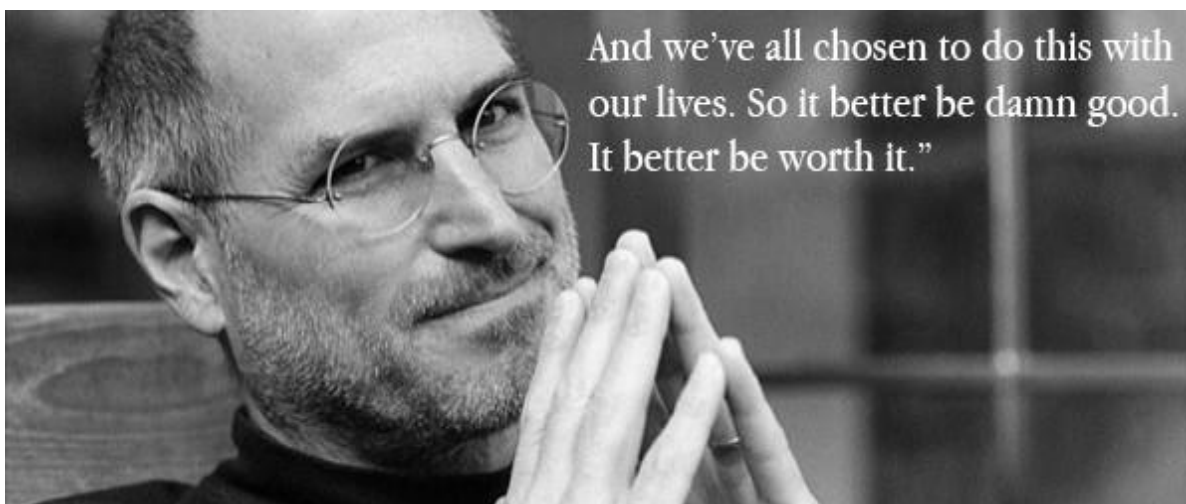
**Answer:**

**The factors that affect the dividend policy of the company are:**

1. **Liquidity:** Payment of dividend results in cash outflow. A company may have adequate earning but it may not have sufficient funds to pay dividends.
2. **Repayment of debt:** If debt is scheduled for payment then it may be difficult for the company to pay dividend.
3. **Stability of profits:** A company which has stable earnings can afford to have a higher dividend payout ratio.
4. **Financial needs of the company:** If the company has profitable projects and it is costly to raise funds, it may decide to retain the earnings.
5. **Legal considerations:** Legal stipulations do not require a dividend declaration but they specify the requirements under which dividends must be paid.
6. **Shareholders preference:** The dividend policy of a firm is likely to be affected by the owner's considerations of (i) the tax status of the shareholders, (ii) their opportunities of investments and (iii) dilution of ownership.
7. **State of Capital Market:**
  - a. Favourable Market: Liberal dividend policy.
  - b. Unfavourable market: Conservative dividend policy.
8. **Inflation:** Inflation should also be considered in dividend policy.

**Factors determining dividend policy of the company:**

1. Liquidity
2. Repayment of debt
3. Stability of profits
4. Financial needs of the company
5. Legal considerations
6. Shareholders preference
7. Stat of the capital market
8. Inflation



**Q2 Write short notes on Optimum Dividend Payout****Answer:**

Investors put their money in the shares of a company in order to earn income on the investment by way of dividend and capital appreciation.

But what if you have the option to earn more than what the company will pay you via dividend and capital appreciation. It's obvious that you will choose that option and are not going to put the money in shares.

Shareholders expect some returns from the company. It's termed as cost of equity for the company ( $K_e$ ) and the return that the company will earn on its investment is ( $r$ )

Considering this as the basis we come across three different situations:

**A. When the company is earning more than what the investor would have earned**

Means:

1. Investors expectation( $K_e$ ) are **less** than what the company earns( $r$ )
2.  $K_e < r$
3. Means the company is **growth company**.
4. Investors will be willing to **let the company retain the profits** and do not declare dividends in anticipation of the more returns in the future.
5. Hence the optimum payout ratio will be 0%

**B. When the company is earning exactly same as the investor would have earned**

Means:

1. Investors expectation( $K_e$ ) are **equal to** what the company earns( $r$ )
2.  $K_e = r$
3. Means the company is **normal company**.
4. **Investors will be indifferent** at this point as it does not matter whether company retain or distribute the profit as dividend
5. Hence the optimum payout ratio **does not matter here**.

**C. When the company is earning less than what the investor would have earned**

Means:

1. Investors expectation ( $K_e$ ) are **more** than what the company earns( $r$ )
2.  $K_e > r$
3. Means the company is **declining company**.
4. Investors will be willing to **let the company distribute all its profits** by way of dividends
5. Hence the optimum payout ratio will be 100%

**Q3 Explain the concept of Homemade Dividends****Answer:**

**A form of investment income that comes from the sale of a portion of shares held by a shareholder. This differs from dividends that shareholders receive from a company according to the number of shares the shareholder has.**

The existence of homemade dividends is the reason some financial analysts believe that looking at a company's dividend policy is not important. If investors desire an income stream they will either sell their shares when they want the income or they will invest in other income-generating assets.

**Let's take an example**

ABC Ltd. is quoted at ₹50 and Sundar is holding 100 shares of this company. Now if the company declare a dividend of ₹2/share then you would expect the market prices ex-dividend to go down to Rs.48 after the record date.

1. The total wealth of the Sundar is  $100 \times 50 = 5000$
2. Once the dividend has been paid it will become  $100 \times 48 + 200 = 5000$
3. If Sundar was expecting more than Rs.2/dividend then he can add money to his pocket by selling 2 shares

Market value + Dividend + Sale Proceeds

$$(100 - 2) \times 48 + 100 \times 2 + 48 \times 2 = 5000$$

Thus in all the above cases wealth of the shareholders was same and dividend policy of the company is irrelevant.

#### Q4 Explain various dividend policies

Answer:

##### 1. CONSTANT DIVIDEND PER SHARE

Some companies may follow the policy of paying constant dividend per share every year **irrespective of the earnings of that year.**

This is because companies would **like to retain some amount for the payment of dividend in the bad years as well.**

When the company thinks it has reached a certain satisfied level of earnings then it can increase the annual dividend per share.

This type of policy is preferred by the investors who are **dependent on dividend income** for their expenses as the policy ensures regular amount of dividend.

e.g. Rs 20 per share will be paid every year.

##### 2. CONSTANT PERCENTAGE OF EARNINGS

Some companies may like to follow the policy of paying constant % of earnings every year. This ratio which is based on the earnings of the company **is known as the dividend payout ratio.**

By this the amount of dividend every year will be **in direct proportion to the earnings of the company.**

This policy will ensure that the shareholders will get **more returns in the year of high profits and they will get no returns in case company incurs losses.**

e.g. 20% will be paid as dividend out of the profits of every year

##### 3. SMALL CONSTANT DIVIDEND PER SHARE PLUS EXTRA

Companies can adopt the policy to pay dividend which consist of two amount. First part will be certain **fixed amount of dividend** and other is variable dividend means extra.

Fixed amount of dividend will be paid every year irrespective of the performance of the company. Variable amount will depend each year on the performance of the company. If the company earns high profits it can payout some extra dividend treating as variable amount and if the company earns normal profits only then company can either pay small amount as variable or else can even skip paying variable amount.

This way company can ensure that **investors are satisfied with regular income and also with variables on the occasions.** Even when the company fails to pay extra dividend it will not have any depressing effect on investors.

e.g ₹20 per share plus 5% of the profits of every year.

## Derivatives

**Q 1 What are derivatives? Who are the users of derivatives? What is the purpose of use? Enumerate the difference between Cash and Derivative Market.**

**Answer:**

A Derivative is an agreement between buyer and seller for an underlying asset which is to be bought/sold on certain future date.

Derivative does not have any value of its own but its value, in turn, depends on the value of the other physical assets which are called underlying assets.

### **Users of derivative market and purpose of use**

1. **Hedgers:** Use derivatives to reduce risk of unfavourable price movement in the market to provide offsetting compensation against the underlying asset (kind of insurance).
2. **Speculators:** These are traders who use derivatives in the expectation of making a profit through market fluctuations.
3. **Arbitrageurs:** Arbitrageurs simply sell the asset in the overpriced market and simultaneously buy it in the cheaper market in order to gain from the different price of underlying in two different markets.

### **Difference between cash and derivative market**

1. In cash market **tangible assets** are traded whereas in derivative market contracts based on tangible or intangibles assets like index or rates are traded.
2. In cash market, we can purchase even one share whereas in futures and options **minimum lots** are fixed.
3. Cash market is more **risky** than futures and options segment because in Futures and Options risk is limited upto 20%.
4. Cash assets may be meant for **consumption or investment**. Derivative contracts are for **hedging, arbitrage or speculation**.
5. Buying securities in cash market **involves putting up all the money upfront** whereas buying futures simply involves putting up the margin money.
6. With the purchase of shares of the company in cash market the **shareholder becomes part owner** of the company. While in futures it does not happen.

**Q 2 What is the difference between Forward Contract and Futures Contract?**

**Answer:**

| <b>Basis</b>              | <b>Forward Contract</b>                               | <b>Futures Contract</b>                                                    |
|---------------------------|-------------------------------------------------------|----------------------------------------------------------------------------|
| <b>Trading</b>            | Traded in Over-the Counter (OTC) market.              | Traded on an Exchange.                                                     |
| <b>Default Risk</b>       | Traded privately and hence bears the risk of default. | Are exchange traded who provides the protection and hence no default risk. |
| <b>Margin requirement</b> | Involves no margin payment.                           | Initial margin is required to be paid as a good faith money.               |
| <b>Uses</b>               | Used for hedging purposes.                            | Used for both hedging and speculating purposes.                            |
| <b>Transparency</b>       | Not transparent as the contract is private in nature. | Transparency is maintained and is reported by the exchange.                |
| <b>Delivery</b>           | Settled by physical delivery.                         | Settled by net cash payment only                                           |



|                          |                                                       |                                                                                                            |
|--------------------------|-------------------------------------------------------|------------------------------------------------------------------------------------------------------------|
|                          |                                                       | and very few by actual delivery.                                                                           |
| <b>Size of contract</b>  | No standardised size.                                 | Standard in terms of quantity or amount as the case may be.                                                |
| <b>Maturity</b>          | Any valid business date agreed to by the two parties. | Standard Date. Usually one delivery date such as the second Tuesday of every month.                        |
| <b>Currencies Traded</b> | All currencies                                        | Major Currencies                                                                                           |
| <b>Cash Flow</b>         | None until maturity date.                             | Initial margin plus ongoing variation margin because of mark to market and final payment on maturity date. |

**Q 3 Write short note on Embedded Derivatives.****Answer:**

**An embedded derivative is a derivative instrument that is embedded in another contract- the host contract. The host contract might be an equity or debt instrument, a lease, an insurance contract or a sale or purchase contract.**

Suppose entity XYZ enters into a contract to issue a bond, and the payment of interest and principal of the bond is indexed with the price of gold. Here, the payment will increase or decrease according to the movement in the price of gold; and the debt instrument is host contract with an embedded derivative.

**Q 4 What do you know about the Swaptions and their uses?****Answer:**

Interest rate swaption is an option on an interest rate swap whereby holder gets the right but not the obligation to enter into an interest rate swap at the specific fixed rate on an agreed future date.

**Uses of swaptions**

- Swaptions can be used as an effective tool to swap into or out of fixed rate or floating rate interest obligations, according to a treasurer's expectation on interest rates. Swaptions can also be used for protection if a particular view on the future direction of interest rates turned out to be incorrect.
- Swaptions can be applied in a variety of ways for both active traders as well as for corporate treasurers. Swap traders can use them for speculation purposes or to hedge a portion of their swap books. It is a valuable tool when a borrower has decided to do a swap but is not sure of the timing.
- Swaptions are useful for borrowers targeting an acceptable borrowing rate. By paying an upfront premium, a holder of a payers swaption can guarantee to pay a maximum fixed rate on a swap, thereby hedging his floating rate borrowings.
- Swaptions have become useful tools for hedging embedded option which is common in the natural course of many businesses.

**Q 5 Write short note on Caps, Floors and Collars [CFC].****Answer****Caps:**

- A cap provides a guarantee that the coupon rate each period will not be higher than agreed limit. It will be capped at certain ceiling.
- It's a derivative instrument where the buyer of the cap receives payment at the end of each period where the rate of interest exceeds the agreed strike price.

**Floors:**

- A floor provides a guarantee that the coupon rate each period will not be lower than agreed limit. It will be floored at certain ceiling.
- It's a derivative instrument where the buyer of the floor receives payment at the end of each period where the rate of interest goes below the agreed strike price.

**Collars:**

- Collar provides a guarantee that the coupon rate each period will not fall below lower limit and will not go beyond upper limit. It will be capped at upper limit and floored at lower limit.
- It's a combination of caps and floors.
- It's a derivative instrument where the buyer of the collar receives payment at the end of each period where the rate of interest goes below the lower limit or goes beyond the upper limit.

**Q 6 What are the features of futures contract?****Answer:**

- ✓ These are **traded on organised exchanges**.
- ✓ **Standardised contract** terms like the underlying assets, the time of maturity and the manner of maturity etc.
- ✓ Associated with clearing house to **ensure smooth functioning** of the market.
- ✓ **Margin requirements and daily settlement** to act as further safeguard i.e. marked to market.
- ✓ Existence of **regulatory authority**.
- ✓ Every day the transactions are **marked to market** till they are re-wound or matured.

**Q 7 What is insider trading practice?****Answer:**

The insider is any person who accesses the price sensitive information of a company before it is published to the general public. Insider includes corporate officers, directors, and owners of firm etc. who have substantial interest in the company. Even persons who have access to non public information due to their relationship with the company are an insider.

Insider trading practice is the act of buying or selling or dealing in securities by as a person having unpublished inside information with the intention of making abnormal profit's and avoiding losses. This inside information includes dividend declaration, issue or buy back of securities, amalgamation, mergers, takeover or major expansion plans.

Insider trading practices are lawfully prohibited. The regulatory bodies in general are imposing different fines and penalties for those who indulge in such practices. SEBI has framed various regulations implemented the same to prevent the insider trading practices.

**Q 8 Write short notes on the “Marking to Market”.****Answer:**

- ✓ Futures contracts **follow a practice** known as mark-to-market.
- ✓ At the end of each trading day, the exchange sets a **settlement price** based on the day's closing price range for each contract.
- ✓ Each trading account is credited or debited based on that day's profits or losses and checked to ensure that the trading account **maintains the appropriate margin** for all open positions.
- ✓ While the margin accounts of each party get adjusted at the end of each day, on the same time the **old futures contract gets replaced with the new one** at the new price.
- ✓ Thus each future contract is **rolled over** to the next day at **new price**.

**Q 9 Explain the term Intrinsic Value and Time Value of the option.****Answer:**

Intrinsic value of an option and time value of an option are primary determinants of an option's price.

Intrinsic value is the value that any given option would have if it is to be exercised immediately. This is defined as the difference between the options strike price and the stock's actual current price.

An option's intrinsic value can never be negative.

1. Say you bought a **call** option with strike price of ₹500 for ₹20 and two months later its market price is ₹515  
Here the intrinsic value of the option is  
= Spot (Market) Price – Strike Price = 515-500 = 15
2. Say you bought a **put** option with strike price of ₹500 for ₹20 and two months later its market price is ₹490  
Here the intrinsic value of the option is  
= Strike price – Spot Price = 500-490 = 10

**Time value (extrinsic value) is the difference between options premium and its intrinsic value.**

Considering the same example of call option we can compute the time value of the option

$$\begin{aligned}\text{Time Value} &= \text{Options Premium} - \text{Intrinsic Value} \\ &= 20-15 \\ &= 5\end{aligned}$$

**Q 10 Write short notes on Interest Swaps****Answer:**

- ✓ A swap is a contractual agreement between two parties to exchange or 'swap' future payment streams based on differences in the returns to different securities or changes in the price of some underlying item.
- ✓ In an Interest rate swap, the parties to the agreement, termed as swap counterparties, agree to exchange payments indexed to two different interest swaps.
- ✓ Financial intermediaries, such as banks, pension funds, and insurance companies as well as non financial firms use interest rate swaps to effectively change the maturity of outstanding debt or that of an interest bearing asset.
- ✓ Swaps grew out of parallel loan agreements in which firms exchange loans denominated in different currencies.

**Q 11 What is the significance of underlying in relation to derivative instrument?****Answer:**

The underlying may be a share, commodity or any other asset which has a marketable value which is subject to market risks. The importance of underlying in derivative instruments is as follows:

- ✓ All derivative instruments are dependent on an underlying to have value.
- ✓ The change in value in a forward contract is broadly equal to the change in value in the underlying.
- ✓ In the absence of a valuable underlying asset the derivative instrument will have no value.
- ✓ On maturity, the position of profit/loss is determined by the price of underlying instruments. If the price of the underlying is higher than the contract price the buyer makes a profit. If the price is lower, the buyer suffers a loss.

**Q 12 What is the difference between options and futures****Answer:**

| Basis                         | Futures                                                                               | Options                                                                               |
|-------------------------------|---------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------|
| <b>Obligation to perform</b>  | Both parties are obliged to perform.                                                  | Only the seller (Writer) is obliged to perform.                                       |
| <b>Premium</b>                | No premium is paid by any party.                                                      | Premium is paid by the buyer to the seller at the inception of the contract.          |
| <b>Potential of gain/loss</b> | There is potential/risk for unlimited gain/loss for the futures buyer.                | Loss is restricted while there is unlimited gain potential for the option buyer.      |
| <b>Exercise</b>               | A futures contract has to be honoured by both the parties only on the date specified. | An American option contract can be exercised any time during its period by the buyer. |

**Q 13 Explain Initial Margin & Maintenance Margin.****Answer:****Initial Margin**

Before a futures position can be opened, there must be enough available balance in the futures trader's margin account to meet the initial margin requirement. Upon opening the futures position, an amount equal to the initial margin requirement will be deducted from the trader's margin account and transferred to the exchange's clearing firm. This money is held by the exchange clearinghouse as long as the futures position remains open.

**Maintenance Margin**

The maintenance margin is the minimum amount a futures trader is required to maintain in his margin account in order to hold a futures position. The maintenance margin level is usually slightly below the initial margin.

If the balance in the futures trader's margin account falls below the maintenance margin level, he or she will receive a margin call to top up his margin account so as to meet the initial margin requirement.

**Example:**

Let's assume we have a speculator who has \$10000 in his trading account. He decides to buy August Crude Oil at \$40 per barrel. Each Crude Oil futures contract represents 1000 barrels and requires an initial margin of \$9000 and has a maintenance margin level set at \$6500.

Since his account is \$10000, which is more than the initial margin requirement, he can therefore open up one August Crude Oil futures position.

One day later, the price of August Crude Oil drops to \$38 a barrel. Our speculator has suffered an open position loss of \$2000 (\$2 x 1000 barrels) and thus his account balance drops to \$8000.

Although his balance is now lower than the initial margin requirement, he did not get the margin call as it is still above the maintenance level of \$6500.

Unfortunately, on the very next day, the price of August Crude Oil crashed further to \$35, leading to an additional \$3000 loss on his open Crude Oil position. With only \$5000 left in his trading account, which is below the maintenance level of \$6500, he received a call from his broker asking him to top up his trading account back to the initial level of \$9000 in order to maintain his open Crude Oil position.

This means that if the speculator wishes to stay in the position, he will need to deposit an additional \$4000 into his trading account.

Otherwise, if he decides to quit the position, the remaining \$5000 in his account will be available to use for trading once again.

#### Q 14 Write Short Notes on Put Call Parity Theory

**Answer:**

This theory was developed to explain the **relationship between the prices of the options and their underlying stock.**

Put-call parity is the relationship that must exist between the prices of European put and call options that both have the same underlier, strike price and expiration date. (Put-call parity does not apply to American options because they can be exercised prior to expiry.)

According to Put Call parity theory "The total of current price of the underlying stock and the price of the put option is exactly equal to the total of the price of the call option and present value of the exercise price of the underlying stock."

We can represent the above theory in following formula

$$S + P = C + PV \text{ of Exercise price of the stock}$$

Where,

S = Current price of the underlying asset

P= Price (Premium) of the put option

C= Price (Premium) of the call option

#### Q 15 Write Short Notes FRA's

**Answer: Forward Rate Agreement(future)** is an agreement between two parties to fix the future interest rate. Interest rate is based on agreed notional principal for a specified period.

On the agreed date if the market rate differs from the agreed FRA rate. A difference amount is paid by either of the party as settlement. The principal amount is not exchanged here and no party is obliged to borrow or lend money.

##### Users

- Those who wish **to hedge against future interest rate risk** by fixing the future interest rate today itself.
- Those who want **to make profit based on their expectation** on the future development of interest rate.
- Those who try **to take advantage of different prices of FRAs and other financial instruments.**

##### Characteristics

- It is an off balance sheet agreement as there is no exchange of principal amount.
- There is no need to pay initial margins or variation margins
- The existing FRA agreement can be closed any time by entering into new and opposite FRA at a new price.
- FRAs are customised to meet the specific requirements of the customer.
- FRAs offers highest liquidity and hence termed as money market instrument

## **Bond Valuation**

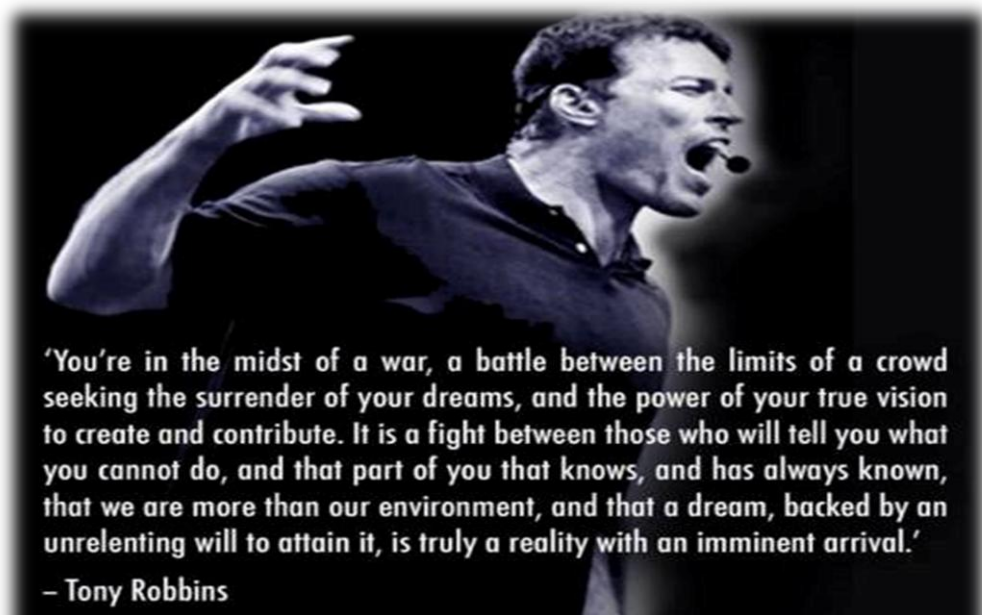
**Q 1 Why should the duration of a coupon carrying bond always be less than the time to its maturity?**

**Answer:** Duration is nothing but the average time taken by an investor to collect investment. If an investor receives a part of his/her investment over the time on specific intervals before maturity, the investment will offer him the duration which would be lesser than the maturity of the instrument. Higher the coupon rate lesser would be the duration.

**Q 2 Write short notes on 'Zero Coupon Bonds'.**

**Answer:**

- ✓ As the name indicates these bonds do not pay interest during the life of the bonds.
- ✓ Instead, zero coupon bonds are issued at discounted price to their face value, which is the amount a bond will be worth when it matures or comes due.
- ✓ When a zero coupon bond matures, the investor will receive one lump sum equal to the initial investment plus interest that has been accrued on the investment made.
- ✓ The maturity dates on zero coupon bonds are usually long term. These maturity dates allow an investor for a long range planning.
- ✓ Zero coupon bonds are issued by banks, government and private sector companies.
- ✓ However, bonds issued by corporate sector carry a potentially higher degree of risk, depending on the financial strength of the issuer and longer maturity period, but they also provide an opportunity to achieve a higher return.



## Portfolio Management

### Q 1 What are the objectives of portfolio management?

Answer:

#### 1. Security of the Principal Investment

Portfolio management not only involves keeping the investment intact but also contributes towards the growth of its purchasing power over the period. **The motive of a financial portfolio management is to ensure that the investment is absolutely safe.**

#### 2. Consistency of returns

Portfolio management also **ensures to provide the stability of returns** by reinvesting the same earned returns in profitable and good portfolios.

#### 3. Risk reduction

Portfolio management is purposely designed to reduce the risk of loss of capital and/or income by investing in different types of securities available in a wide range of industries. **The investors shall be aware of the fact that there is no such thing as a zero risk investment.**

#### 4. Capital growth

Portfolio management guarantees the growth of capital by reinvesting in growth securities or by the purchase of growth securities.

#### 5. Liquidity

Portfolio management is planned in such a way that it facilitates to take maximum advantage of various good opportunities upcoming in the market. The portfolio should always ensure that there are enough funds available at short notice to take care of the investor's liquidity requirements.

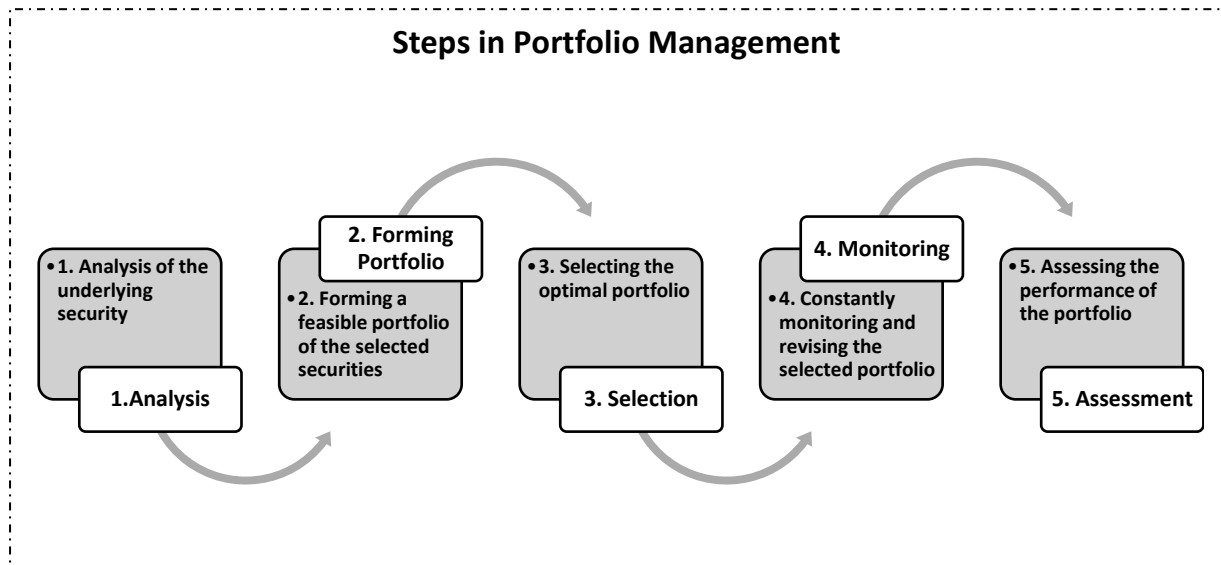
#### 6. Marketability

Portfolio management ensures the flexibility to the investment portfolio. A portfolio consists of such investment, which can be marketed and traded.

#### 7. Favourable tax treatment

Portfolio management is planned in such a way to increase the effective yield an investor gets from his surplus invested funds. By minimizing the tax burden, yield can be effectively improved.



**Q 2 What are the steps in Portfolio Management?****Answer:****Q 3 Distinguish between Systematic Risk and Unsystematic Risk?****Answer:**

| Particulars          | Systematic Risk                                                                                                                                         | Unsystematic Risk                                                                                             |
|----------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------|
| <b>Meaning</b>       | Risk inherent to the <b>entire market or entire market segment.</b>                                                                                     | Risk inherent to the <b>specific company or industry.</b>                                                     |
| <b>Control</b>       | <b>Uncontrollable</b> by an organisation                                                                                                                | <b>Controllable</b> by an organisation                                                                        |
| <b>Nature</b>        | <b>Macro</b> in nature                                                                                                                                  | <b>Micro</b> in nature                                                                                        |
| <b>Types</b>         | Interest rate risk, market risk, purchasing power / inflationary risk                                                                                   | Business/Liquidity risk, financial/credit risk                                                                |
| <b>Also known as</b> | Market risk, Non diversifiable risk                                                                                                                     | Diversifiable risk                                                                                            |
| <b>Example</b>       | <b>Recession and wars</b> all represent sources of systematic risk because they affect the entire market and cannot be avoided through diversification. | <b>Sudden strike by the employees</b> of a company you have shares in, is considered to be unsystematic risk. |

**Q 4 What is Diversification?****Answer:**

**Diversification** is a risk-management technique that mixes a wide variety of investments within a portfolio in order to minimize the impact that any one security will have on the overall performance of the portfolio. Diversification lowers the risk of your portfolio. Academics have complex formulas to demonstrate how this works, but we can explain it clearly with an example:

Suppose that you live on an island where the entire economy consists of only two companies: one sells umbrellas while the other sells sunscreen. If you invest your entire portfolio in the company that sells umbrellas, you'll have strong performance during the rainy season, but poor performance when it's sunny outside. The reverse occurs with the sunscreen company, the alternative investment; your portfolio will be high performance when the sun is out, but it will tank when the clouds roll in. Chances are you'd rather have constant, steady returns. The solution is to invest 50%



in one company and 50% in the other. Because you have diversified your portfolio, you will get decent performance year round instead of having either excellent or terrible performance depending on the season. There are three main practices that can help you ensure the best diversification:

1. Spread your portfolio among multiple investment vehicles such as cash, stocks, bonds, mutual funds and perhaps even some real estate.
2. Vary the risk in your securities. You're not restricted to choosing only blue chip stocks. In fact, it would be wise to pick investments with varied risk levels; this will ensure that large losses are offset by other areas.
3. Vary your securities by industry. This will minimize the impact of industry-specific risks.

Diversification is the most important component in helping you reach your long-range financial goals while minimizing your risk. At the same time, diversification is not an ironclad guarantee against loss. No matter how much diversification you employ, investing involves taking on some risk.

Another question that frequently baffles investors is how many stocks should be bought in order to reach optimal diversification. According to portfolio theorists, adding about 20 securities to your portfolio reduces almost all of the individual security risk involved. This assumes that you buy stocks of different sizes from various industries.

#### Q 5 What do you mean by Risk Reduction?

**Answer:** Risk reduction means actual risk ( $\sigma$ ) of the portfolio is less than the weighted average risk of the securities that constitutes the portfolio. This is the point where one can say that diversification has resulted into risk reduction.

#### Q 6 Write short notes on Capital Asset Pricing Model.

**Answer:**

The Capital Asset Pricing Model is used to determine a theoretically appropriate required rate of return of an asset, if that asset is to be added to an already diversified portfolio, given that assets non-diversifiable risk.

$R_j$  = Defined as the minimum expected return needed so that investor will purchase and hold asset.

SML is the graphical representation of the results of the CAPM.

##### Advantages of CAPM

1. Considers only systematic risk.
2. Better method to calculate cost of equity.
3. Can be used as risk adjusted discounted rate (RADR)

##### Limitations of CAPM

1. Unreliable Beta.
2. Hard to get the market information.

##### Return of security under CAPM

$$R_j = R_f + \beta(R_m - R_f)$$

Where,

$R_j$  = Return on Security

$R_f$  = Risk free rate of return

$R_m$  = Market return

$\beta$  = beta of the security

#### Q 7 What sort of investor normally views the variance (or Standard Deviation) of an individual security's return as the security's proper measure of risk?

**Answer:**

A rational risk-averse investor views the variance (or standard deviation) of her portfolio's return as the proper risk of her portfolio. If for some reason or another the investor can hold only one

security, the variance of that security's return becomes the variance of the portfolio's return. Hence, the variance of the security's return is the security's proper measure of risk.

While risk is broken into diversifiable and non-diversifiable segments, the market generally does not reward for diversifiable risk since the investor himself is expected to diversify the risk himself. However, if the investor does not diversify, he cannot be considered to be an efficient investor. The market, therefore, rewards an investor only for the non-diversifiable risk. Hence, the investor needs to know how much non-diversifiable risk he is taking. This is measured in terms of beta.

An investor therefore, views the beta of a security as a proper measure of risk, in evaluating how much the market reward him for the non-diversifiable risk that he is assuming in relation to a security. An investor who is evaluating the non-diversifiable element of risk, that is, extent of deviation of returns viz-a-viz the market therefore consider beta as a proper measure of risk.

**Q 8 What sort of investor rationally views the beta of a security as the security's proper measure of risk? In answering the question, explain the concept of beta.**

**Answer:**

If an individual holds a diversified portfolio, she still views the variance (or standard deviation) of her portfolio's return as the measure of the risk of her portfolio. However, she is no longer interested in the variance of each individual security's return. Rather she is interested in the contribution of each individual security to the variance of the portfolio.

Under the assumption of homogeneous expectations, all individuals hold the market portfolio. Thus, we measure risk as the contribution of an individual security to the variance of the market portfolio. The contribution when standardized properly is the beta of the security. While a very few investors hold the market portfolio exactly, many hold reasonably diversified portfolio. These portfolios are close enough to the market portfolio so that the beta of a security is likely to be a reasonable

"You don't get what you wish for; you get what you work for."

In other words, beta of a stock measures the sensitivity of the stock with reference to a broad based market index like BSE Sensex. For example, a beta of 1.3 for a stock would indicate that this stock is 30 per cent riskier than the Sensex. Similarly, a beta of 0.8 would indicate that the stock is 20 per cent (100 – 80) less risky than the Sensex. However, a beta of one would indicate that the stock is as risky as the stock market index.



## Mutual Funds

### Q 1 Explain Briefly the NAV of a Mutual Fund scheme.

**Answer:** NAV is the value of the fund's assets minus its liabilities. SEBI rules require funds to calculate the NAV daily. To calculate the NAV per share, simply subtract the fund's liabilities from its assets and then divide the result by the number of shares outstanding.

If the market value of a fund's portfolio increases, after deduction of expenses and liabilities, then the value (NAV) of the fund and its shares increases. The higher NAV reflects the higher value of your investment.

NAV of a Mutual Fund are published on a daily basis in the newspapers and electronic media and play an important role in investor's decision to enter or to exit. Analyst use the NAV to determine the yield on the schemes.

$$\text{NET ASSET VALUE} = \frac{\text{Net assets of the scheme}}{\text{Number of units outstanding}}$$

Where Net Assets of the scheme

| Particulars                     | Amount      |
|---------------------------------|-------------|
| Market value of the Investment  | XXXX        |
| + Receivables                   | XXX         |
| + Other Accrued Income          | XXX         |
| + Other Assets                  | XXX         |
| - Accrued Expenses              | (XXX)       |
| - Other Payables                | (XXX)       |
| - Other Liabilities             | (XXX)       |
| <b>Net assets of the scheme</b> | <b>XXXX</b> |

### Q 2 What are the advantages and drawbacks of investing in a Mutual Fund?

**Answer:**

#### Advantages

|                            |                    |                  |                 |
|----------------------------|--------------------|------------------|-----------------|
| 1. Professional management | 2. Diversification | 3. Affordability | 4. Convenience  |
| 5. Return Potential        | 6. Low Cost        | 7. Liquidity     | 8. Transparency |
| 9. Well Regulated          | 10. Flexibility    | 11. Tax Benefits |                 |

#### Drawbacks

|                         |                      |                    |                        |
|-------------------------|----------------------|--------------------|------------------------|
| 1. No Guaranteed Return | 2. Fees and Expenses | 3. Management Risk | 4. Unethical Practices |
|-------------------------|----------------------|--------------------|------------------------|

**Q 3 Explain Briefly what is Exchange Traded Funds.****Answer:**

An exchange-traded fund (ETF) is an investment fund traded on stock exchanges, much like stocks. An ETF holds assets such as stocks, commodities, or bonds, and trades close to its net asset value over the course of the trading day. Most ETFs track an index, such as a stock index or bond index. ETFs may be attractive as investments because of their low costs, tax efficiency, and stock-like features. ETFs are the most popular type of exchange-traded product.

*ETFs offer public investors an undivided interest in a pool of securities and other assets and thus are similar in many ways to traditional mutual funds, except that shares in an ETF can be bought and sold throughout the day like stocks on a securities exchange through a broker-dealer.*

Advantages of ETFs are the following:

- Buy and sell just like shares
- Buy and sell at real time prices
- One can put limit orders
- Delivery in your demat account
- Minimum trading lot is just one unit

**Q 4 Distinguish Between Open Ended and Close Ended Funds.****Answer:**

| PARAMETER            | OPEN ENDED FUNDS         | CLOSE ENDED FUNDS                   |
|----------------------|--------------------------|-------------------------------------|
| Fund Size            | Flexible                 | Fixed                               |
| Liquidity provider   | Fund itself              | Stock market                        |
| Sale Price           | At NAV plus load, if any | Significant premium/discount to NAV |
| Availability         | Fund itself              | Through exchange where listed       |
| Intra-Day Trading    | Not possible             | Expensive                           |
| NAV                  | Daily                    | Daily                               |
| Portfolio Disclosure | Monthly                  | Monthly                             |

**FAR AND AWAY  
THE BEST PRIZE  
THAT LIFE HAS TO OFFER  
IS THE CHANCE TO  
WORK HARD  
AT WORK WORTH DOING.**

## Money Market Operations

### Q 1 What is Call Money/Notice Money in the context of financial market?

Answer:

- ✓ Call money is a part of the money market where day to day surplus funds, mostly of banks are traded. Moreover, the call money market is most liquid of all short term money market instruments.
- ✓ The maturity period of call loans vary from 1 to 14 days. The money that is lend for one day in call money market is also known as 'overnight money'.
- ✓ Current and expected interest rates on call money are the basic rates to which other money markets and to some extent the Government securities market are anchored.
- ✓ In India, call money is lent mainly to even out the short term mismatches of assets and liabilities and to meet CRR requirements of banks that they should maintain with RBI every fortnight and is computed as a percentage of Net Demand and Time Liabilities (NDTL).

### Q 2 What is the distinction between Money Market and Capital Market?

| Basis                 | Money Market                                                                                                                                     | Capital Market                                                                                                                               |
|-----------------------|--------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Classification</b> | There is no distinction between primary and secondary market.                                                                                    | Capital market is classified into primary and secondary market.                                                                              |
| <b>Purpose</b>        | It deals for funds of short term requirement.                                                                                                    | It deals with funds of long term requirement.                                                                                                |
| <b>Instruments</b>    | Money market instruments include interbank call money, notice money, short term deposits upto 3 months, commercial paper, 91 days treasury bills | Capital market instruments are shares and debt instrument.                                                                                   |
| <b>Participants</b>   | Money Market participants are banks, financial institutions, RBI and Government.                                                                 | Capital Market participants include retail investors, institutional investors like mutual funds, financial institutions, corporate and banks |

### Q 3 Explain briefly what is Money Market Mutual Funds.

Answer:

A money market fund is a mutual fund that invests solely in money market instruments. Money market instruments are forms of debt like Commercial Papers (CPs), Certificate of Deposits (CDs) and Treasury Bills (TBs) that mature in less than one year and are very liquid. Treasury bills make up the bulk of the money market instruments. Securities in the money market are relatively risk-free.

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

Generally, money market instruments require huge amount of investments and it is beyond the capacity of an ordinary retail investor to invest such large sums. Money market mutual funds allow retail investors the opportunity of investing in money market instrument and benefit from the price advantage.

- The goal of a money-market fund is to preserve principal while yielding a modest return.
- Money-market mutual fund is akin to a high-yield bank account but is not entirely risk free.

In order to excel, you must be completely dedicated to what you have chosen. You must also be prepared to work hard and be willing to accept destructive criticism. Without 100% dedication, you won't be able to do this.

**Q 4 Write a short note on Inter Bank Participation Certificate.****Answer:**

Inter-Bank Participation Certificates are instruments issued by scheduled commercial banks only to raise funds or to deploy short term surplus. There will be two types of Participations:

- I. Inter-Bank Participations with Risk Sharing
- II. Inter-Bank Participations without Risk Sharing

The IBP with risk sharing can be issued for a period between 91 days to 180 days. The IBP without risk sharing is a money market instrument with a tenure not exceeding 90 days and the interest rate on such IBPs is left to be determined by the two concerned banks without any ceiling on interest rate.

**Q 5 Write short note on Commercial Bill.****Answer:**

A commercial bill is one which arises out of a genuine trade transaction i.e. credit transaction. As soon as goods are sold on credit, the seller draws a bill on the buyer for the amount due. The buyer accepts it immediately agreeing to pay amount mentioned therein after a certain specified date. Thus, a bill of exchange contains a written order from the creditor to the debtor, to pay a certain sum, to a certain person, after a certain period. A bill of exchange is a 'self liquidating' paper and negotiable; it is drawn always for a short period ranging between 3 months and 6 months.

**Q 6 What are the advantages of developed bill market?****Answer:**

A developed bill market is useful to borrowers, creditors and to financial and monetary system as a whole. The bill market scheme will go a long way to develop the bill market in the country. The following are various advantages of developed bill market

- i) Bill finance is better than cash credit. Bills are self liquidating and the date of repayment of banks loan through discounting or rediscounting is certain.
- ii) Bills provide greater liquidity to their holders because they can be shifted to others in the market in case of need for cash.
- iii) A developed bill market is also useful to the banks in case of emergency. In the absence of such market the banks in need of cash have to depend either on call money market or the Reserve Bank's loan window.
- iv) The commercial bill rate is much higher than the Treasury bill rate. Thus, the commercial banks and other financial institutions with short term surplus funds find in bills an attractive source of both liquidity as well as profit.
- v) A developed bill market will also makes the monetary system of the country more elastic.

**Q 7 Write short note on Certificate of Deposits.****Answer:**

A certificate of deposit (CD) is a fixed-deposit investment option offered by banks and lending institutions. It offers higher interest rates than conventional savings accounts because it requires investors to deposit funds for a specified term ranging from one month to more than five years. However, like savings accounts, CDs are a secure form of investment, as they are insured by government agencies.

A person can buy a certificate of deposit (CD) by depositing the minimum requisite amount. In general, the higher the deposited amount, the better will be the interest rate offered on it. The buyer of a CD receives a written declaration or certificate where the applicable interest rate, term of deposit and date of maturity are stated.

CDs can be issued by (i) scheduled commercial banks {excluding Regional Rural Banks and Local Area Banks}; and (ii) select All-India Financial Institutions (FIs) that have been permitted by RBI to raise short-term resources within the umbrella limit fixed by RBI.

**Minimum amount** of a CD should be Rs.1 lakh, i.e., the minimum deposit that could be accepted from a single subscriber should not be less than Rs.1 lakh, and in multiples of Rs. 1 lakh thereafter.

The **maturity period** of CDs issued by banks should not be less than 7 days and not more than one year, from the date of issue.

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

**[Master Circular dated July 01, 2013: Guidelines for Issue of Certificate of Deposit, RBI/2013-14/104, IDMD.PCD.05/14.01/03/2013-14]**

### Q 8 Write short note on Commercial Paper.

**Answer:**

**What is it?**

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

Corporate, primary dealers (PDs) and the All-India Financial Institutions (FIs) are eligible to issue CP.

It is generally issued at a discount freely determined by the market to major institutional investors and corporations either directly by issuing corporation or through a dealer bank.

Commercial paper represents a form of financing that allows the issuer of the paper to borrow money at relatively low interest rates. The availability of funding through the commercial paper market means the firm can negotiate to get bank loans, another source of financing, on better terms. From the issuer's point of view, the inability to retire debt before the end of its term without paying a penalty is a disadvantage. The firm may want to retire the debt early and save money on interest payments.

### Q 9 What is Repo Rates?

**Answer:**

- ✓ Repo rate is the rate at which RBI lends to commercial banks generally against government securities.
- ✓ Reduction in Repo rate helps the commercial banks to get money at a cheaper rate.
- ✓ Increase in Repo rate discourages the commercial banks to get money as the rate increases and becomes expensive.

### Q 10 What is Reverse Repo Rates?

**Answer:**

- ✓ Reverse Repo rate is the rate at which RBI borrows money from the commercial banks.
- ✓ The increase in the Repo rate will increase the cost of borrowing and lending of the banks which will discourage the public to borrow money and will encourage them to deposit.
- ✓ As the rates are high the availability of credit and demand decreases resulting to decrease in inflation.
- ✓ Increase in Repo Rate and Reverse Repo Rate is a symbol of tightening of the policy. As of August 2013, the repo rate is 7.25 % and reverse repo rate is 6.25%

"To me, the definition of focus is knowing exactly where you want to be today, next week, next month, next year, then never deviating from your plan. Once you can see, touch and feel your objective, all you have to do is pull back and put all your strength behind it, and you'll hit your target every time."

**Q 11 What is Cash Reserve Ratio (CRR)?****Answer:**

- ✓ **Definition:** Cash Reserve Ratio (CRR) is a specified minimum fraction of the total deposits of customers, which commercial banks have to hold as reserves either in cash or as deposits with the central bank. CRR is set according to the guidelines of the central bank of a country.
- ✓ **Description:** The amount specified as the CRR is held in cash and cash equivalents, is stored in bank vaults or parked with the Reserve Bank of India. The aim here is to ensure that banks do not run out of cash to meet the payment demands of their depositors. CRR is a crucial monetary policy tool and is used for controlling money supply in an economy.
- ✓ CRR specifications give greater control to the central bank over money supply. Commercial banks have to hold only some specified part of the total deposits as reserves. This is called fractional reserve banking.

**Q 12 What is Statutory Liquidity Ratio (SLR)?****Answer:**

- ✓ Statutory liquidity ratio refers to the amount that the commercial banks require to maintain in the form of gold or govt. approved securities before providing credit to the customers. Here by approved securities we mean, bond and shares of different companies.
- ✓ Statutory Liquidity Ratio is determined and maintained by the Reserve Bank of India in order to control the expansion of bank credit. It is determined as percentage of total demand and time liabilities.
- ✓ Time Liabilities refer to the liabilities, which the commercial banks are liable to pay to the customers after a certain period mutually agreed upon and demand liabilities are such deposits of the customers which are payable on demand.
- ✓ Example of time liability is a fixed deposits for 6 months, which is not payable on demand but after six months. Example of demand liability is deposit maintained in saving account or current account, which are payable on demand through a withdrawal form of a cheque.
- ✓ SLR is used by bankers and indicates the minimum percentage of deposits that the bank has to maintain in form of gold, cash or other approved securities. Thus, we can say that it is ratio of cash and some other approved liabilities (deposits). It regulates the credit growth in India.

**WHEN YOU WANT TO  
SUCCEED AS MUCH  
AS YOU WANT TO BREATHE,  
THAT'S WHEN YOU  
WILL BE SUCCESSFUL**

"If somebody is continuously trying to stop you from going forward, step backward, think again, plan again, this time with more hard work, with more dedication, with more passion and then attack once more. I am sure you will succeed in not only moving forward but also breaking them for coming in your way."



## Foreign Exchange Risk Management [FERM]

**Q 1 Operations in foreign exchange market are exposed to a number of risks. Explain**

**Answer:**

Firm dealing with foreign exchange may be exposed to foreign currency exposures. Following are the three types of exposure that a firm may face:

- **FX Exposures**

- 1. Transaction Exposure**

- A firm has transaction exposure whenever it has contractual cash flows (sales/purchases) whose values are subject to unanticipated changes in exchange rate due to contract being denominated in a foreign currency.
- Ex. Change in the value of Receivables on export on exchange rate fluctuation.

- 2. Economic/Operating Exposure**

- A firm has economic exposure to the degree that its market value is influenced by unexpected exchange rate fluctuations.
- Ex. Shift in exchange rate will affect demand of the product. This is economic exposure

- 3. Translation Exposure**

- A firm's translation exposure is the extent to which its financial reporting is affected by exchange rate movements
- Ex. Revaluation of debtors and creditors at balance sheet date for the exchange rate fluctuations.

**Q 2 Write short notes on:**

a. **Interest Rate Parity Theory**

b. **Purchasing Power Parity Theory**

**Answer:**

a. **Interest Rate Parity Theory**

Interest rate parity is a no-arbitrage condition representing an equilibrium state under which investors will be indifferent to interest rates available on bank deposits in two countries. The fact that this condition does not always hold allows for potential opportunities to earn riskless profits from covered interest arbitrage.

### **IRP theoretical formula**

$$\frac{1 + r_d}{1 + r_f} = \frac{F}{S}$$

Where,

$r_d$  = Rate of interest in domestic market

$r_f$  = Rate of interest in foreign market

$F$  = Forward rate of the foreign currency

$S$  = Spot rate of the foreign currency

When Interest rate parity exist then high interest in one country will be offset by the depreciation in the currency of that country.

IRP theory states that the size of the forward premium (discount) should be equal to the interest rate differential between the two countries in consideration.

**b. Purchasing Power Parity Theory**

Purchasing power parity (PPP) is an economic theory and a technique used to determine the relative value of currencies, estimating the amount of adjustment needed on the exchange rate between countries in order for the exchange to be equivalent to (or on par with) each currency's purchasing power.

It asks how much money would be needed to purchase the same goods and services in two countries, and uses that to calculate an implicit foreign exchange rate. Using that PPP rate, an amount of money thus has the same purchasing power in different countries.

Another interpretation is that the (difference in the rate of change in prices at home and abroad) – (the difference in the inflation rates), is equal to the percentage depreciation or appreciation of the exchange rate.

If PPP theory does not hold good and Actual spot rate at the end of the period offered by forex dealer is different than the theoretical spot rate for the end of the period calculated by us then arbitrage opportunities will open up.

**PPP theoretical formula**

$$F = S \times \frac{1 + i_d}{1 + i_f}$$

Where,

$i_d$  = Inflation rate in domestic market,  $i_f$  = Inflation rate in foreign market,  $F$  = Forward rate for foreign currency,  $S$  = Spot rate for foreign currency

**Q3 Write short notes on Nostro, Vostro and Loro accounts.**

Answer:

- i) **Vostro Account (Italian, English, 'yours'):** Account held by a foreign bank in a domestic bank is called Vostro account. A Vostro is our account of your money, held by us. A Vostro account with a credit balance (i.e. a deposit) is a liability, and a vostro with a debit balance (a loan) is an asset. For example Bank A (Barclays Bank of UK) opening an account in Bank B(ICICI Bank of India), this is Vostro account for Bank B(ICICI Bank of India).
- ii) **Nostro Account: (Italian, English, 'ours'):** Account held by a particular domestic bank in a foreign bank is called Nostro account. A Nostro is our account of our money, held by you. A bank counts a Nostro account with a credit balance as a cash asset in its balance sheet. Here in the above example given in Vostro account the same account is a Nostro account for Bank A(Barclays Bank of UK), or if Bank B(ICICI Bank of India) opens an account in Bank A(Barclays Bank of UK) then that account is a Nostro account for Bank B(ICICI Bank of India). Nostro accounts are usually in the currency of the foreign country. This allows for easy cash management because currency is not required to be converted.
- iii) **Loro Account (Italian, English, 'theirs'):** An account held by a domestic bank in itself on behalf of a foreign bank. The latter in turn would view this account as a Nostro account. **A Loro is our account of their money, held by you.** Loro account is a record of an account held by a second bank on behalf of a third party; i.e., my record of their account with you. In practice this is rarely used, the main exception being complex syndicated financing.

|                                                                                                                                                                                                                                      |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p style="text-align: center;"><b>Vostro</b></p> <p style="text-align: center;">“Our account of your money”</p> <p style="text-align: center;">Account of foreign<br/>bank(Barclays of UK) in<br/>domestic bank (ICICI of India)</p> |
| <p style="text-align: center;"><b>Nostro</b></p> <p style="text-align: center;">“Our account of our money”</p> <p style="text-align: center;">Account of domestic bank<br/>(Axis of India) in foreign bank<br/>(Barclays of UK)</p>  |

**Q 4 What is Exposure Netting? What are the advantages of Netting?****Answer**

Exposure Netting refers to offsetting exposures in one currency with exposures in the same or another currency, where exchange rates are expected to move in such a way that losses or gains on the first exposed position should be offset by gains or losses on the second currency exposure.

The objective of the exercise is to offset the likely loss in one exposure by likely gain in another. This is a manner of hedging forex exposures though different from forward and option contracts. This method is similar to portfolio approach in handling systematic risk.

**Advantages of Netting**

- **Reduces the number of cross border transactions** between subsidiaries thereby decreasing the overall administrative costs of such cash transfers.
- **Reduces the need for foreign exchange conversion** and hence decreases transaction costs associated with foreign exchange conversion.
- **Improves cash flow forecasting** since net cash transfers are made at the end of each period.
- **Gives an accurate report and settles accounts** through co-ordinated efforts among all subsidiaries.

**Q 5 What is Leading and Lagging?****Answer:**

**Leading:** Leading refers to prepaying import payments or receiving early payment for exports;

If the importer expects the foreign currency to appreciate beyond the cost of home currency funds then he will be willing to make an early payment by borrowing the amount. On the other hand if the exporter expects that the foreign currency to depreciate more than the cost of investment then he will be willing to receive early payments for the sales made by him.

**Lagging:** Lagging relates to delaying import payments or receiving late payment on exports.

If the importer expects the foreign currency to depreciate more than the interest charged by the vendor for delaying the payments then he will be willing to make delayed payment. On the other hand if the exporter expects that the foreign currency to appreciate more than the cost of investment then he will be willing to receive late payments for the sales made by him.

**Q 6 Write short notes on 'Arbitrage Operations'.****Answer:**

- ✓ Arbitrage is the buying and selling of the same commodity in different markets. A number of pricing relationships exists in the foreign exchange market, whose variation would imply the existence of arbitrage opportunities – the opportunity to make a profit without risk or investment. These transactions refer to advantage derived between two currencies at two different centres at the same time or of difference between cross rates and actual rates.
- ✓ For example, a customer can gain from arbitrage operation by purchase of dollars in the local market at cheaper price prevailing at a point of time and sell the same for sterling in the London market. The sterling will then be used for meeting his commitment to pay the import obligation from London.

**Q 7 Explain the significance of LIBOR in international financial transactions.****Answer:**

- ✓ LIBOR stands for London Inter Bank Offered Rate.
- ✓ It is the base rate of exchange with respect to which most international financial transactions are priced.
- ✓ It is used as the base rate for a large number of financial products such as options and swaps.
- ✓ Banks also use the LIBOR as the base rate when setting the interest rate on loans savings and mortgages.
- ✓ It is monitored by a large number of professionals and private individuals worldwide.

**Merger Acquisition & Restructuring****Q 1 What are the different types of Merger?****Answer:**

- **A Horizontal Merger** is usually between two companies in the same business sector. The example of horizontal merger would be if a health care system buys another health care system. This means that synergy can be obtained through many forms including such as; increased market share, cost savings and exploring new market opportunities.

- **A Vertical Merger** represents the buying of supplier of a business. In the same example as above if a health care system buys the ambulance services from their service suppliers is an example of vertical buying. The vertical buying is aimed at reducing overhead cost of operations and economy of scale.

- **Conglomerate Merger** is the third form of M&A process which deals the merger between two irrelevant companies. The example of conglomerate M&A with relevance to above scenario would be if the health care system buys a restaurant chain. The objective may be diversification of capital investment.

- **Congeneric Merger** is a merger where the acquirer and the related companies are related through basic technologies, production processes or markets. The acquired company represents an extension of product line, market participants or technologies of the acquirer. These mergers represent an outward movement by the acquirer from its current business scenario to other related business activities.

**Q 2 Write short notes on Friendly and Hostile takeover.****Answer:****Friendly takeover**

The acquisition of one firm by another where the owners of both firms agree to the terms of the takeover transaction is known as friendly takeover.

**Hostile takeover**

A hostile takeover of a corporation results from a takeover that is opposed by the target corporation's directors. In a tender offer, an acquiring entity offers the target corporation's shareholders cash in exchange for their shares. If the acquiring corporation obtains enough shares, it can approve a merger resolution or, alternatively, simply operate the corporation as its subsidiary by replacing its directors and officers with its own appointees and direct corporate affairs in this manner.

Whether a purchase is perceived as being a "friendly" one or a "hostile" depends significantly on how the proposed acquisition is communicated to and perceived by the target company's board of directors, employees and shareholders.

**Q 3 What are the various antitakeover strategies?  
or What do you mean by Defending against takeover bid?**

**Answer:**

Takeover defenses include actions by managers to resist having their firms acquired by other companies. There are several methods to defend a takeover.

1. **Crown Jewel Defense:** The target company has the right to sell off the entire or some of the company's most valuable assets when facing a hostile bid in the hope to make the company less attractive in the eyes of the acquiring company and to force a drawback of the bid.
2. **Poison Pill:** The logic behind the pill is to dilute the targeting company's stock in the company so much that bidder never manages to achieve an important part of the company without the consensus of the board.
3. **Poison Put:** Here the company issue bonds which will encourage the holder of the bonds to cash in at higher prices which will result in Target Company being less attractive.
4. **Greenmail:** Greenmail involves repurchasing a block of shares which is held by a single shareholder or other shareholders at a premium over the stock price in return for an agreement called as standstill agreement. In this agreement it is stated that bidder will no longer be able to buy more shares for a period of time often longer than five years.
5. **White Knight:** The target company seeks for a friendly company which can acquire majority stake in the company and is therefore called a white knight. The intention of the white knight is to ensure that the company does not lose its management. In the hostile takeover there are lots of chances that the company acquired changes the management.
6. **White squire:** A different variation of white knight is white squire. Instead of acquiring the majority stake in the target company white squire acquires a smaller portion, but enough to hinder the hostile bidder from acquiring majority stake.
7. **Golden Parachutes:** A golden parachute is an agreement between a company and an employee (usually upper executive) specifying that the employee will receive certain significant benefits if employment is terminated. This will discourage the bidders and hostile takeover can be avoided.
8. **Pac-man defense:** The target company itself makes a counter bid for the Acquirer Company and let the Acquirer Company defence itself which will call off the proposal of takeover.

**Q 4 What do you mean by Takeover by reverse bid or Reverse Bid or Reverse Merger?**

**Answer:**

"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 and/or longer-established company and retain the name of the latter for the post-acquisition combined entity. This is known as a **reverse takeover**. Another type of acquisition is the **reverse merger**, a form of transaction that enables a private company to be publicly listed in a relatively short time frame. A reverse merger occurs when a privately held company (often one that has strong prospects and is eager to raise financing) buys a publicly listed shell company, usually one with no business and limited assets.

**Three test requirement for takeover by reverse bid**

1. The assets of the transferor company are greater than the transferee company.
2. Equity capital to be issued by the transferee company for acquisition should exceed its original share capital.
3. There should be a change of control in transferee company by way of introduction of a minority holder or group of holders

**Q 5 Write short note on Chop Shop Method.****Answer:**

**Chop shop methods seeks to identify the companies having different segments of operations which if separated can fetch more value.**

**It's simple**

1. Find out the different business segments of the target company.
2. Calculate the value of the each of the basis (sales, assets etc.). It is the sum total of the (basis x applicable capitalisation ratio).
3. Average of the all the basis will be the average theoretical value of the target company.

**Q 6 Write short note on Leverage Buy Out (LBO).****Answer:**

A leveraged buyout (LBO) is an acquisition (usually of a company, but can also be single assets such as a real estate property) **where the purchase price is financed through a combination of equity and debt** and in which the cash flows or assets of the target are used to secure and repay the debt.

In other words, the acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. Since the debt always has a lower cost of capital than the equity, the returns on the equity increase with increasing debt. The debt thus effectively serves as a lever to increase returns which explains the origin of the term LBO.

**LBOs can have many different forms such as Management Buy-out (MBO), Management Buy-in (MBI), secondary buyout and tertiary buyout, among others, and can occur in growth situations, restructuring situations and insolvencies.**

**Q 7 Write short note on Management Buy Out (MBO).****Answer:**

A management buyout (MBO) is a form of acquisition where a company's existing manager acquires a large part or all of the company from either the parent company or from the private owners.

Management buyouts are similar in all major legal aspects to any other acquisition of a company. The particular nature of the MBO lies in the position of the buyers as managers of the company,

**An MBO can occur for a number of reasons**

1. The owners of the business want to retire and want to sell the company to the management team they trust (and with whom they have worked for years).
2. The owners of the business have lost faith in the business and are willing to sell it to the management (who believes in the future of the business) in order to get some value for the business.
3. The managers see a value in the business that the current owners do not see and do not want to pursue.

**Q 8 Write short note on Financial Restructuring.****Answer:**

Financial restructuring, is carried out internally in the firm with the consent of its various stakeholders. Financial restructuring is a suitable mode of restructuring of corporate firms that have incurred accumulated sizable losses for/over a number of years. As a sequel, the share capital of such firms, in many cases, gets substantially eroded/lost; in fact in some cases, accumulated losses over the years may be more than share capital, causing negative net worth. Given such a dismal state of financial affairs, a vast majority of such firms are likely to have a dubious potential for liquidation. Can some of these firms be revived? Financial restructuring is one such a measure for the revival of only those firms that hold promise/prospects for better financial performance in the years to come.

To achieve the desired objective, such firms warrant/merit a restart with a fresh balance sheet, which does not contain past accumulated losses and fictitious assets and shows share capital at its real/true worth.

### Q 9 Write short note on Demerger.

**Answer:**

Demerger: The word 'demerger' is defined under the Income-tax Act, 1961. It refers to a situation where pursuant to a scheme for reconstruction/restructuring, an 'undertaking' is transferred or sold to another purchasing company or entity. The important point is that even after demerger, the transferring company would continue to exist and may do business.

Demerger is used as a suitable scheme in the following cases:

- Restructuring of an existing business
- Division of family-managed business
- Management 'buy-out'.

While under the Income tax Act there is recognition of demerger only for restructuring as provided for under sections 391 – 394 of the Companies Act, in a larger context, demerger can happen in other situations also.

### Q 10 Write short note on 'Economic Value Added'.

**Answer:**

- ✓ Economic Value Added method (EVA): It is defined in terms of returns earned by the company in excess of the minimum expected return of the shareholders. EVA is calculated as follows:
- ✓  $EVA = EBIT - \text{Taxes} - \text{Cost of funds employed} = \text{Net operating profit after taxes} - \text{Cost of Capital employed}.$
- ✓ Where, net operating profit after taxes = Profit available to provide a return to lenders and the shareholders.
- ✓  $\text{Cost of Capital employed} = \text{Weighted average cost of capital} \times \text{Capital employed}.$
- ✓ EVA is a residual income which a company earns after capital costs are deducted. It measures the profitability of a company after having taken into account the cost of all capital including equity. Therefore, EVA represents the value added to the shareholders by generating operating profits in excess of the cost of capital employed in the business. EVA increases if:
  - (i) Operating profits grow without employing additional capital.
  - (ii) Additional capital is invested in projects that give higher returns than the cost of incurring new capital and
  - (iii) Unproductive capital is liquidated i.e. curtailing the unproductive uses of capital.
- ✓ In India, EVA has emerged as a popular measure to understand and evaluate financial performance of a company. Several Companies have started showing EVA during a year as a part of the Annual Report. Infosys Technologies Ltd. and BPL Ltd. are a few of them.

**Important Websites**

- i) Securities and Exchange Board of India- [www.sebi.gov.in](http://www.sebi.gov.in)
- ii) National Stock Exchange- [www.nseindia.com](http://www.nseindia.com)
- iii) Bombay Stock Exchange- [www.bseindia.com](http://www.bseindia.com)
- iv) Multi Commodity Exchange of India Ltd. - [www.mcxindia.com](http://www.mcxindia.com)
- v) Reserve Bank of India- [www.rbi.org.in](http://www.rbi.org.in)

**FAQ's on Secondary Market****1. What are the various types of financial markets?**

The financial markets can broadly be divided into money and capital market.

**Money Market:** Money market is a market for debt securities that pay off in the short term usually less than one year, for example the market for 90-days treasury bills. This market encompasses the trading and issuance of short term non equity debt instruments including treasury bills, commercial papers, bankers acceptance, certificates of deposits, etc.

**Capital Market:** Capital market is a market for long-term debt and equity shares. In this market, the capital funds comprising of both equity and debt are issued and traded. This also includes private placement sources of debt and equity as well as organized markets like stock exchanges. Capital market can be further divided into primary and secondary markets.

**2. What is meant by Secondary Market?**

Secondary Market refers to a market where securities are traded after being initially offered to the public in the primary market and/or listed on the Stock Exchange. Majority of the trading is done in the secondary market. Secondary market comprises of equity markets and the debt markets.

For the general investor, the secondary market provides an efficient platform for trading of his securities. For the management of the company, Secondary equity markets serve as a monitoring and control conduit—by facilitating value-enhancing control activities, enabling implementation of incentive-based management contracts, and aggregating information (via price discovery) that guides management decisions.

**3. What is the difference between the primary market and the secondary market?**

In the primary market, securities are offered to public for subscription for the purpose of raising capital or fund. Secondary market is an equity trading avenue in which already existing/pre- issued securities are traded amongst investors. Secondary market could be either auction or dealer market. While stock exchange is the part of an auction market, Over-the-Counter (OTC) is a part of the dealer market.

**SEBI and its Role in the Secondary Market****4. What is SEBI and what is its role?**

The SEBI is the regulatory authority established under Section 3 of SEBI Act 1992 to protect the interests of the investors in securities and to promote the development of, and to regulate, the securities market and for matters connected therewith and incidental thereto.

**5. What are the various departments of SEBI regulating trading in the secondary market?**

The following departments of SEBI take care of the activities in the secondary market.

| Sr.No. | Name of the Department                                                | Major Activities                                                                                                                                                                                                                                                                          |
|--------|-----------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1.     | Market Intermediaries Registration and Supervision department (MIRSD) | Registration, supervision, compliance monitoring and inspections of all market intermediaries in respect of all segments of the markets viz. equity, equity derivatives, debt and debt related derivatives.                                                                               |
| 2.     | Market Regulation Department (MRD)                                    | Formulating new policies and supervising the functioning and operations (except relating to derivatives) of securities exchanges, their subsidiaries, and market institutions such as Clearing and settlement organizations and Depositories (Collectively referred to as 'Market SROs'.) |
| 3.     | Derivatives and New Products Departments (DNPD)                       | Supervising trading at derivatives segments of stock exchanges, introducing new products to be traded, and consequent policy changes.                                                                                                                                                     |



## Products available in the Secondary Market

## 6. What are the products dealt in the secondary markets?

Following are the main financial products/instruments dealt in the secondary market:

**Equity:** The ownership interest in a company of holders of its common and preferred stock. The various kinds of equity shares are as follows:-

**Equity Shares:**

An equity share, commonly referred to as ordinary share also represents the form of fractional ownership in which a shareholder, as a fractional owner, undertakes the maximum entrepreneurial risk associated with a business venture. The holders of such shares are members of the company and have voting rights.

- **Rights Issue / Rights Shares:** The issue of new securities to existing shareholders at a ratio to those already held.
- **Bonus Shares:** Shares issued by the companies to their shareholders free of cost by capitalization of accumulated reserves from the profits earned in the earlier years.
- **Preferred Stock / Preference shares:** Owners of these kinds of shares are entitled to a fixed dividend or dividend calculated at a fixed rate to be paid regularly before dividend can be paid in respect of equity share. They also enjoy priority over the equity shareholders in payment of surplus. But in the event of liquidation, their claims rank below the claims of the company's creditors, bondholders / debenture holders.
- **Cumulative Preference Shares:** A type of preference shares on which dividend accumulates if remains unpaid. All arrears of preference dividend have to be paid out before paying dividend on equity shares.
- **Cumulative Convertible Preference Shares:** A type of preference shares where the dividend payable on the same accumulates, if not paid. After a specified date, these shares will be converted into equity capital of the company.
- **Participating Preference Share:** The right of certain preference shareholders to participate in profits after a specified fixed dividend contracted for is paid. Participation right is linked with the quantum of dividend paid on the equity shares over and above a particular specified level.
- **Security Receipts:** Security receipt means a receipt or other security, issued by a securitisation company or reconstruction company to any qualified institutional buyer pursuant to a scheme, evidencing the purchase or acquisition by the holder thereof, of an undivided right, title or interest in the financial asset involved in securitisation.
- **Government securities (G-Secs):** These are sovereign (credit risk-free) coupon bearing instruments which are issued by the Reserve Bank of India on behalf of Government of India, in lieu of the Central Government's market borrowing programme. These securities have a fixed coupon that is paid on specific dates on half-yearly basis. These securities are available in wide range of maturity dates, from short dated (less than one year) to long dated (up to twenty years).
- **Debentures:** Bonds issued by a company bearing a fixed rate of interest usually payable half yearly on specific dates and principal amount repayable on particular date on redemption of the debentures. Debentures are normally secured / charged against the asset of the company in favour of debenture holder.
- **Bond:** A negotiable certificate evidencing indebtedness. It is normally unsecured. A debt security is generally issued by a company, municipality or government agency. A bond investor lends money to the issuer and in exchange, the issuer promises to repay the loan amount on a specified maturity date. The issuer usually pays the bond holder periodic interest payments over the life of the loan. The various types of Bonds are as follows-
  - **Zero Coupon Bond:** Bond issued at a discount and repaid at a face value. No periodic interest is paid. The difference between the issue price and redemption price represents the return to the holder. The buyer of these bonds receives only one payment, at the maturity of the bond.

- **Convertible Bond:** A bond giving the investor the option to convert the bond into equity at a fixed conversion price.
- **Commercial Paper:** A short term promise to repay a fixed amount that is placed on the market either directly or through a specialized intermediary. It is usually issued by companies with a high credit standing in the form of a promissory note redeemable at par to the holder on maturity and therefore, doesn't require any guarantee. Commercial paper is a money market instrument issued normally for tenure of 90 days.
- **Treasury Bills:** Short-term (up to 91 days) bearer discount security issued by the Government as a means of financing its cash requirements.

## 7. What are the regulatory requirements specified by SEBI for corporate debt securities?

The term Corporate Bonds referred here includes all debt securities issued by institutions such as Banks, Public Sector Undertakings, Municipal Corporations, bodies corporate and companies having a tenure of more than 365 days. Such an issue of bonds, if offered to the public shall be required to comply with the SEBI (Disclosure and Investor Protection Guidelines), 2000. Also, a private placement of corporate bonds made by a listed company shall be required to comply with provisions contained in SEBI Circulars in this regard.

The SEBI Circulars dated September 30, 2003 and December 22, 2003 have laid out norms pertaining to the disclosure norms on issuance of such securities, which include compliance with Chapter VI of the SEBI (Disclosure and Investor Protection) Guidelines, 2000, Companies Act, 1956, listing agreement for debentures with the stock exchanges, rating to be obtained from a Credit Rating Agency registered with SEBI, requirement for appointing a debenture trustee registered with SEBI, mandatory trading in dematerialized form, etc.

In order to develop an exchange traded market for corporate bonds SEBI vide circulars dated December 12, 2006 and March 01, 2007 has authorized BSE and NSE to set up and maintain corporate bond reporting platforms to capture all information related to trading in corporate bonds as accurately and as close to execution as possible. Subsequently, FIMMDA has also been permitted to operate a reporting platform. As per the circulars, all issuers, intermediaries and contracting parties are granted access to the reporting platform for the purpose and transactions shall be reported within 30 minutes of closing the deal. The data reported on the platform is disseminated on websites of BSE, NSE and FIMMDA.

As a second phase of development, SEBI vide Circular dated April 13, 2007 has permitted BSE and NSE to have in place corporate bond trading platforms to enable efficient price discovery and reliable clearing and settlement in a gradual manner. To begin with, BSE and NSE have launched an order driven trade matching platform which retains essential features of OTC market where trades are executed through brokers. OTC trades however continue to be reported on the exchange reporting platforms. In order to encourage wider participation, the lot size for trading in bonds has been reduced to Rs.1lakh. Subsequently BSE and NSE may move towards anonymous order matching with clearing and settlement.

### Role of Broker and Sub-broker in the Secondary Market

#### 8. Whom should I contact for my Stock Market related transactions?

You can contact a broker or a sub broker registered with SEBI for carrying out your transactions pertaining to the capital market.

#### 9. Who is a broker?

A broker is a member of a recognized stock exchange, who is permitted to do trades on the screen-based trading system of different stock exchanges. He is enrolled as a member with the concerned exchange and is registered with SEBI.

#### 10. Who is a sub broker?

A sub broker is a person who is registered with SEBI as such and is affiliated to a member of a recognized stock exchange.

**11. How do I know if the broker or sub broker is registered?**

You can confirm it by verifying the registration certificate issued by SEBI. A broker's registration number begins with the letters "INB" and that of a sub broker with the letters "INS". For the brokers of derivatives segment, the registration number begins with the letters "INF". There is no sub-broker in the derivatives segment.

**12. Am I required to sign any agreement with the broker or sub-broker?**

Yes. For the purpose of engaging a broker to execute trades on your behalf from time to time and furnish details relating to yourself for enabling the broker to maintain client registration form you have to sign the "Member - Client agreement" if you are dealing directly with a broker. In case you are dealing through a sub-broker then you have to sign a "Broker - Sub broker - Client Tripartite Agreement". Model Tripartite Agreement between Broker-Sub broker and Clients is applicable only for the cash segment. The Model Agreement has to be executed on the non-judicial stamp paper. The Agreement contains clauses defining the rights and responsibility of Client vis-à-vis broker/ sub broker. The documents prescribed are model formats. The stock exchanges/stock broker may incorporate any additional clauses in these documents provided these are not in conflict with any of the clauses in the model document, as also the Rules, Regulations, Articles, Byelaws, circulars, directives and guidelines.

**13. What is Member –Client Agreement Form?**

This form is an agreement entered between client and broker in the presence of witness where the client agrees (is desirous) to trade/invest in the securities listed on the concerned Exchange through the broker after being satisfied of brokers capabilities to deal in securities. The member, on the other hand agrees to be satisfied by the genuineness and financial soundness of the client and making client aware of his (broker's) liability for the business to be conducted.

**14. What kind of details do I have to provide in Client Registration form?**

The brokers have to maintain a database of their clients, for which you have to fill client registration form. In case of individual client registration, you have to broadly provide following information:

- Permanent Account Number (PAN), which has been made mandatory for all the investors participating in the securities market.
- Your name, date of birth, photograph, address, educational qualifications, occupation, residential status(Resident Indian/ NRI/others)
- Bank and depository account details
- If you are registered with any other broker, then the name of broker and concerned Stock exchange and Client Code Number.

For proof of address (any one of the following):

- Passport
- Voter ID
- Driving license
- Bank Passbook
- Rent Agreement
- Ration Card
- Flat Maintenance Bill
- Telephone Bill
- Electricity Bill
- Insurance Policy

Each client has to use one registration form. In case of joint names /family members, a separate form has to be submitted for each person.

In case of Corporate Client, following information has to be provided:

- Name, address of the Company/Firm
- Date of incorporation and date of commencement of business.
- Registration number(with ROC, SEBI or any government authority)
- Details of PAN
- Details of Promoters/Partners/Key managerial Personnel of the Company/Firm in specified format.
- Bank and Depository Account Details
- Copies of the balance sheet for the last 2 financial years (copies of annual balance sheet to be submitted every year)

- Copy of latest share holding pattern including list of all those holding more than 5% in the share capital of the company, duly certified by the Company Secretary / Whole time Director/MD. (copy of updated shareholding pattern to be submitted every year)
- Copies of the Memorandum and Articles of Association in case of a company / body corporate, partnership deed in case of a partnership firm
- Copy of the Resolution of board of directors' approving participation in equity / derivatives / debt trading and naming authorized persons for dealing in securities.
- Photographs of Partners/Whole time directors, individual promoters holding 5% or more, either directly or indirectly, in the shareholding of the company and of persons authorized to deal in securities.
- If registered with any other broker, then the name of broker and concerned Stock exchange and Client Code Number.

#### 15. What is meant by Unique Client Code?

In order to facilitate maintaining database of their clients and to strengthen the know your client (KYC) norms; all brokers have been mandated to use unique client code linked to the PAN details of the respective client which will act as an exclusive identification for the client.

#### 16. What is MAPIN?

MAPIN (Market Participant Identification Number) is the Market Participants and Investors Integrated Database. The SEBI (Central Database of Market Participants) Regulations, 2003 were notified on November 20, 2003 under which, all the participants in the Indian Securities Market viz., SEBI registered intermediaries, listed companies and their associates and the investors were required to obtain a Unique Identification Number (UIN) in order to enable the regulator to establish the identity of person(s).

In the light of SEBI's order of making PAN the sole identification number for all participants transacting in the securities market, irrespective of the amount of transaction, it has been decided to discontinue with the requirement of Unique Identification Number (UIN) under the SEBI (Central Database of market Participants Regulations), 2005 (MAPIN regulations)/circulars. Accordingly, acceptance of MAPIN card as one of the documents for the purpose of Proof of Identity (POI) has been withdrawn.

#### 17. What is a risk disclosure document?

In order to acquaint the investors in the markets of the various risks involved in trading in the stock market, the members of the exchange have been required to sign a risk disclosure document with their clients, informing them of the various risks like risk of volatility, risks of lower liquidity, risks of higher spreads, risks of new announcements, risks of rumours etc.

#### 18. How do I place my orders with the broker or sub broker?

You can either go to the broker's / sub broker's office or place an order over the phone / internet or as defined in the Model Agreement given above.

#### 19. How do I know whether my order is placed?

The Stock Exchanges assign a Unique Order Code Number to each transaction, which is intimated by broker to his client and once the order is executed, this order code number is printed on the contract note. The broker member has also to maintain the record of time when the client has placed order and reflect the same in the contract note along with the time of execution of the order.

#### 20. What documents should be obtained from broker on execution of trade?

You have to ensure receipt of the following documents for any trade executed on the Exchange:

- a. Contract note in Form A to be given within stipulated time.
- b. In the case of electronic issuance of contract notes by the brokers, the clients shall ensure that the same is digitally signed and in case of inability to view the same, shall communicate the same to the broker, upon which the broker shall ensure that the physical contract note reaches the client within the stipulated time.

It is the contract note that gives rise to contractual rights and obligations of parties of the trade. Hence, you should insist on contract note from stock broker.

**21. What details are required to be mentioned on the Contract note issued by the Stock Broker?**

A broker has to issue a contract note to clients for all transactions in the form specified by the stock exchange. The contract note inter-alia should have following:

- Name, address and SEBI Registration number of the Member broker.
- Name of partner /proprietor /Authorized Signatory.
- Dealing Office Address/Tel No/Fax no, Code number of the member given by the Exchange.
- Unique Identification Number
- Contract number, date of issue of contract note, settlement number and time period for settlement.
- Constituent (Client) name/Code Number.
- Order number and order time corresponding to the trades.
- Trade number and Trade time.
- Quantity and Kind of Security brought/sold by the client.
- Brokerage and Purchase /Sale rate are given separately.
- Service tax rates and any other charges levied by the broker.
- Securities Transaction Tax (STT) as applicable.
- Appropriate stamps have to be affixed on the original contract note or it is mentioned that the consolidated stamp duty is paid.
- Signature of the Stock broker/Authorized Signatory.

Contract note provides for the recourse to the system of arbitrators for settlement of disputes arising out of transactions. Only the broker can issue contract notes.

**22. What is the maximum brokerage that a broker can charge?**

The maximum brokerage that can be charged by a broker has been specified in the Stock Exchange Regulations and hence, it may differ from across various exchanges. As per the BSE & NSE Bye Laws, a broker cannot charge more than 2.5% brokerage from his clients.

**23. What are the charges that can be levied on the investor by a stock broker?**

The trading member can charge:

1. Brokerage charged by member broker.
  2. Penalties arising on specific default on behalf of client (investor)
  3. Service tax as stipulated.
  4. Securities Transaction Tax (STT) as applicable.
- The brokerage, service tax and STT are indicated separately in the contract note.

**24. What is STT?**

Securities Transaction Tax (STT) is a tax being levied on all transactions done on the stock exchanges at rates prescribed by the Central Government from time to time. Pursuant to the enactment of the Finance (No.2) Act, 2004, the Government of India notified the Securities Transaction Tax Rules, 2004 and STT came into effect from October 1, 2004.

**25. What is an Account Period Settlement?**

An account period settlement is a settlement where the trades pertaining to a period stretching over more than one day are settled. For example, trades for the period Monday to Friday are settled together. The obligations for the account period are settled on a net basis. Account period settlement has been discontinued since January 1, 2002, pursuant to SEBI directives.

**26. What is a Rolling Settlement?**

In a Rolling Settlement, trades executed during the day are settled based on the net obligations for the day. Presently 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.

**27. What is the pay-in day and pay-out day?**

Pay in day is the day when the brokers shall make payment or delivery of securities to the exchange. Pay out day is the day when the exchange makes payment or delivery of securities to the broker. Settlement cycle is on T+2 rolling settlement basis w.e.f. April 01, 2003. The exchanges have to ensure that the pay out of funds and securities to the clients is done by the broker within 24 hours of the payout. The Exchanges will have to issue press release immediately after pay out.

**28. What are the prescribed pay-in and pay-out days for funds and securities for Normal Settlement?**

The pay-in and pay-out days for funds and securities are prescribed as per the Settlement Cycle. A typical Settlement Cycle of Normal Settlement is given below:

|                 | Activity                                  | Day              |
|-----------------|-------------------------------------------|------------------|
| Trading         | Rolling Settlement Trading                | T                |
| Clearing        | Custodial Confirmation                    | T+1 working days |
|                 | Delivery Generation                       | T+1 working days |
| Settlement      | Securities and Funds pay in               | T+2 working days |
|                 | Securities and Funds pay out              | T+2 working days |
| Post Settlement | Valuation Debit                           | T+2 working days |
|                 | Auction                                   | T+3 working days |
|                 | Bad Delivery Reporting                    | T+4 working days |
|                 | Auction settlement                        | T+5 working days |
|                 | Close out                                 | T+5 working days |
|                 | Rectified bad delivery pay-in and pay-out | T+6 working days |
|                 | Re-bad delivery reporting and pickup      | T+8 working days |
|                 | Close out of re-bad delivery              | T+9 working days |

**Note:** The above is a typical settlement cycle for normal (regular) market segment. The days prescribed for the above activities may change in case of factors like holidays, bank closing etc. You may refer to scheduled dates of pay-in/pay-out notified by the Exchange for each settlement from time-to-time.

**29. In case of purchase of shares, when do I make payment to the broker?**

The payment for the shares purchased is required to be done prior to the pay in date for the relevant settlement or as otherwise provided in the Rules and Regulations of the Exchange.

**30. In case of sale of shares, when should the shares be given to the broker?**

The delivery of shares has to be done prior to the pay in date for the relevant settlement or as otherwise provided in the Rules and Regulations of the Exchange and agreed with the broker/sub broker in writing.

**31. How long it takes to receive my money for a sale transaction and my shares for a buy transaction?**

Brokers were required to make payment or give delivery within two working days of the pay - out day. However, as settlement cycle has been reduced from T+3 rolling settlement to T+2 w.e.f. April 01, 2003, the pay out of funds and securities to the clients by the broker will be within 24 hours of the payout.

**32. Is there any provision where I can get faster delivery of shares in my account?**

The investors/clients can get direct delivery of shares in their beneficial owner accounts. To avail this facility, you have to give details of your beneficial owner account and the DP-ID of your DP to your broker along with the Standing Instructions for 'Delivery-In' to your Depository Participant for accepting shares in your beneficial owner account. Given these details, the Clearing Corporation/Clearing House shall send pay out instructions to the depositories so that you receive pay out of securities directly into your beneficial owner account.

**33. What is an Auction?**

The Exchange purchases the requisite quantity in the Auction Market and gives them to the buying trading member. The shortages are met through auction process and the difference in price indicated in contract note and price received through auction is paid by member to the Exchange, which is then liable to be recovered from the client.

**34. What happens if the shares are not bought in the auction?**

If the shares could not be bought in the auction i.e. if shares are not offered for sale in the auction, the transactions are closed out as per SEBI guidelines.

The guidelines stipulate that "the close out Price will be the highest price recorded in that scrip on the exchange in the settlement in which the concerned contract was entered into and up to the date of auction/close out OR 20% above the official closing price on the exchange on the day on which auction offers are called for (and in the event of there being no such closing price on that day, then the official closing price on the immediately preceding trading day on which there was an official closing price), whichever is higher.

Since, in the rolling settlement the auction and the close out takes place during trading hours, the reference price in the rolling settlement for close out procedures would be taken as the previous day's closing price.

**35. What is Margin Trading Facility?**

Margin Trading is trading with borrowed funds/securities. It is essentially a leveraging mechanism which enables investors to take exposure in the market over and above what is possible with their own resources. SEBI has been prescribing eligibility conditions and procedural details for allowing the Margin Trading Facility from time to time.

Corporate brokers with net worth of at least Rs.3 crore are eligible for providing Margin trading facility to their clients subject to their entering into an agreement to that effect. Before providing margin trading facility to a client, the member and the client have been mandated to sign an agreement for this purpose in the format specified by SEBI. It has also been specified that the client shall not avail the facility from more than one broker at any time.

The facility of margin trading is available for Group 1 securities and those securities which are offered in the initial public offers and meet the conditions for inclusion in the derivatives segment of the stock exchanges.

For providing the margin trading facility, a broker may use his own funds or borrow from scheduled commercial banks or NBFCs regulated by the RBI. A broker is not allowed to borrow funds from any other source.

The "total exposure" of the broker towards the margin trading facility should not exceed the borrowed funds and 50 per cent of his "net worth". While providing the margin trading facility, the broker has to ensure that the exposure to a single client does not exceed 10 per cent of the "total exposure" of the broker.

Initial margin has been prescribed as 50% and the maintenance margin has been prescribed as 40%.

In addition, a broker has to disclose to the stock exchange details on gross exposure including name of the client, unique identification number under the SEBI (Central Database of Market Participants) Regulations, 2003, and name of the scrip.

If the broker has borrowed funds for the purpose of providing margin trading facility, the name of the lender and amount borrowed should be disclosed latest by the next day.

The stock exchange, in turn, has to disclose the scrip-wise gross outstanding in margin accounts with all brokers to the market. Such disclosure regarding margin-trading done on any day shall be made available after the trading hours on the following day.

The arbitration mechanism of the exchange would not be available for settlement of disputes, if any, between the client and broker, arising out of the margin trading facility. However, all transactions done on the exchange, whether normal or through margin trading facility, shall be covered under the arbitration mechanism of the exchange.

**36. What is SEBI Risk Management System?**

The primary focus of risk management by SEBI has been to address the market risks, operational risks and systemic risks. To this effect, SEBI has been continuously reviewing its policies and drafting risk management policies to mitigate these risks, thereby enhancing the level of investor protection and catalyzing market development. The key risk management measures initiated by SEBI include:-

- Categorization of securities into groups 1, 2 and 3 for imposition of margins based on their liquidity and volatility.
- VaR based margining system.
- Specification of mark to Market margins
- Specification of Intra-day trading limits and Gross Exposure Limits
- Real time monitoring of the Intra-day trading limits and Gross Exposure Limits by the Stock Exchanges
- Specification of time limits of payment of margins
- Collection of margins on upfront basis
- Index based market wide circuit breakers
- Automatic de-activation of trading terminals in case of breach of exposure limits
- VaR based margining system has been put in place based on the categorization of stocks based on the liquidity of stocks depending on its impact cost and volatility. It addresses 99% of the risks in the market.
- Additional margins have also been specified to address the balance 1% cases.
- Collection of margins from institutional clients on T+1 basis

The liquid assets deposited by the broker with the exchange should be sufficient to cover upfront VaR margins, Extreme Loss Margin, MTM (Mark to Market Losses) and the prescribed BMC. The Mark to Market margin would be payable before the start of the next day's trading. The Margin would be calculated based on gross open position of the member. The gross open position for this purpose would mean the gross of all net positions across all the clients of a member including his proprietary position. The exchanges would monitor the position of the brokers' online real time basis and there would be automatic deactivation of terminal on any shortfall of margin.

**37. What is Short Selling and Securities Lending & Borrowing?**

Short Selling means selling of a stock that the seller does not own at the time of trade. Short selling can be done by borrowing the stock through Clearing Corporation/Clearing House of a stock exchange which is registered as Approved Intermediaries (AIs). Short selling can be done by retail as well as institutional investors. Naked short sale is not permitted in India, all short sales must result in delivery, and information on short sale has to be disclosed to the exchange by end of day by retail investors, and at the time of trade for institutional investors. The Securities Lending and Borrowing mechanism allows short sellers to borrow securities for making delivery. Securities in the F&O segment are eligible for short selling.

Securities Lending and Borrowing (SLB) is a scheme that has been launched to enable settlement of securities sold short. SLB enables lending of idle securities by the investors through the clearing corporation/clearing house of stock exchanges to earn a return through the same. For securities lending and borrowing system, clearing corporations/clearing house of the stock exchange would be the nodal agency and would be registered as the "Approved Intermediaries"(AIs) under the Securities Lending Scheme, 1997.

Under SLB, securities can be borrowed for a period of 7 days through a screen based order matching mechanism. Securities in the F&O segment are eligible for SLB.

**38. What happens if I do not get my money or share on the due date?**

In case a broker fails to deliver the securities or make payment on time, or if you have complaint against conduct of the stock broker, you can file a complaint with the respective stock exchange. The exchange is required to resolve all the complaints. To resolve the dispute, the complainant can also resort to arbitration as provided on the reverse of contract note /purchase or sale note. However, if the complaint is not addressed by the Stock Exchanges or is unduly delayed, then the complaints along with supporting documents may be forwarded to SEBI. Your complaint would be followed up with the exchanges for expeditious redressal.

In case of complaint against a sub broker, the complaint may be forwarded to the concerned broker with whom the sub broker is affiliated for redressal.



**39. What recourses are available to me for redressing my grievances?**

You have following recourses available:

- Office of Investor Assistance and Education (OIAE) : You can lodge a complaint with OIAE Department of SEBI against companies for delay, non-receipt of shares, refund orders, etc., and with Stock Exchanges against brokers on certain trade disputes or non receipt of payment/securities.
- Arbitration: If no amicable settlement could be reached, then you can make application for reference to Arbitration under the Bye Laws of concerned Stock Exchange.
- Court of Law

**40. What is Arbitration?**

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.

**41. What is the process for preferring arbitration?**

The byelaws of the exchange provide the procedure for Arbitration. You 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.

**42. Who appoints the arbitrators?**

Every exchange maintains a panel of arbitrators. Investors may choose the arbitrator of their choice from the panel. The broker also has an option to choose an arbitrator. The name(s) would be forwarded to the member for acceptance. In case of disagreement, the exchange shall decide upon the name of arbitrators.

**43. What happens if I am aggrieved by the award of the arbitrator?**

In case you are aggrieved by the arbitration award, you can take recourse to the appeal provisions as given in the bye-laws of the Exchange.

**44. What is Investor Protection Fund (IPF) / Customer Protection Fund (CPF) at Stock Exchanges?**

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.

**45. What is BSE IndoNext?**

Regional stock exchanges (RSEs) have registered negligible business during the last few years and thus small and medium-sized companies (SMEs) listed there find it difficult to raise fresh resources in the absence of price discovery of their securities in the secondary market. As a result, investors also do not find exit opportunity in case of such companies.

BSE IndoNext has been formed to benefit such small and medium size companies (SMEs), the investors in these companies and capital markets at large. It has been set up as a separate trading platform under the present BSE Online Trading (BOLT) system of the BSE. It is a joint initiative of BSE and the Federation of Indian Stock Exchanges (FISE).

**INTERNAL AUDIT OF STOCK BROKERS/ TRADING MEMBERS /CLEARING MEMBERS****46. Whether internal audit is applicable to all the brokers/trading members/clearing members including the inactive members?**

Internal audit is applicable to all the active brokers/trading members/clearing members. The in-active brokers/trading members/clearing members shall inform the respective stock exchange through a letter at the end of the respective inspection/audit period.

Definition of Active broker: A broker who had one or more trades during the inspection/audit period in the respective exchange is considered to be an active broker.

**47. What is the time-limit to submit the report? Where to submit the report?**

The internal auditor shall submit the report to the Proprietor / Partner / Board of the respective stockbroker/clearing member within 60 days from the end of the half year period.

The management of the respective stock broker/clearing member shall place the report before the board of directors / Proprietor / Partners who shall forward the same along with para-wise comments to the respective stock exchange within 3 months from the end of the half year period.

**48. Whether statutory auditor can do the internal audit of the same firm?**

Statutory auditor of the stock broker can not do the internal audit of the same stock broker/clearing member.

**49. Whether an auditor can do the internal audit of particular stock broker on continuous basis?**

Every 3 years the stock broker has to change the internal auditor. Further, where, in the opinion of the stock exchange, the quality of the report is not satisfactory or the audit has not been carried out as per the exchange guidelines, the stock exchange may advise the concerned member to change the auditor.

**50. Is there any assistance for data from Stock Exchanges/Depositories?**

Internal auditors are advised to collect all the required data from the respective stock broker/clearing members only.

**51. Does exchange/SEBI plans to have CA/CS/CMA empanelment?**

Currently, neither SEBI nor the exchanges have any plan to have CA/CS/CMA empanelment.

**52. What should be the format of the report?**

While no specific format is being prescribed, the internal auditor should cover all the areas mentioned in the scope/guidelines for the internal audit. Further the auditor should give a certificate of audit in the prescribed format.

### **Corporatisation and Demutualisation**

**53. What is the structure of the stock exchanges in India?**

There are 19 recognised stock exchanges in India. Mangalore Stock Exchange, Saurashtra Kutch Stock Exchange, Magadh Stock Exchange and Hyderabad Stock Exchange have been derecognised by SEBI.

In terms of legal structure, the stock exchanges in India could be segregated into two broad groups – 16 stock exchanges which were set up as companies, either limited by guarantees or by shares, and 3 stock exchanges which were set up as association of persons and later converted into companies, viz. BSE, ASE and Madhya Pradesh Stock Exchange. Apart from NSE, all stock exchanges whether established as corporate bodies or Association of Persons, were earlier non-profit making organizations. As per the demutualisation scheme mandated by SEBI, all stock exchanges other than Coimbatore stock exchange have completed their corporatisation and demutualisation process. Accordingly, out of 19 stock exchanges 18 are corporatised and demutualised and are functioning as for-profit companies, limited by shares.

**54. What is meant by corporatisation of stock exchanges?**

Corporatisation is the process of converting the organizational structure of the stock exchange from a non-corporate structure to a corporate structure.

Traditionally, some of the stock exchanges in India were established as "Association of persons", e.g. the Stock Exchange, Mumbai (BSE), Ahmedabad Stock Exchange (ASE) and Madhya Pradesh Stock Exchange (MPSE). Corporatisation of such exchanges is the process of converting them into incorporated Companies.

**55. What is demutualisation of stock exchanges?**

Demutualisation refers to the transition process of an exchange from a "mutually-owned" association to a company "owned by shareholders". In other words, transforming the legal structure of an exchange from a mutual form to a business corporation form is referred to as demutualisation. The above, in effect means that after demutualisation, the ownership, the management and the trading rights at the exchange are segregated from one another.

**56. How is a demutualised exchange different from a mutual exchange?**

In a mutual exchange, the three functions of ownership, management and trading are intervened into a single Group. Here, the broker members of the exchange are both the owners and the traders on the exchange and they further manage the exchange as well. A demutualised exchange, on the other hand, has

all these three functions clearly segregated, i.e. the ownership, management and trading are in separate hands.

**57. Currently are there any demutualised stock exchanges in India?**

18 stock exchanges are demutualised in India, viz. BSE, NSE, Ahmedabad Stock Exchange, Madhya Pradesh Stock Exchange, Madras Stock Exchange, Cochin Stock Exchange, Bhubhaneshwar Stock Exchange, Bangalore Stock Exchange, OTCEI, Inter-connected Stock Exchange, Ludhiana Stock Exchange, Guwahati Stock Exchange, Vadodara Stock Exchange, Delhi Stock Exchange, Calcutta Stock Exchange, Pune Stock Exchange, Jaipur Stock Exchange and Uttarpradesh Stock Exchange.

**General Questions**

**58. What are the relevant Rules and Regulations and where can I find them?**

You can browse through the "Legal Framework" section on the SEBI website <http://www.sebi.gov.in> for complete information relating to acts, rules, regulations, circulars, and guidelines relating to securities market.

**59. What is day trading?**

Day trading refers to buying and selling of securities within the same trading day such that all positions will be closed before the market close of the trading day. In the Indian securities market only retail investors are allowed to day trade.

**60. What are the main things an investor should be aware of while dealing with a broker/sub-broker?**

Good understanding of investment opportunities alone may not help the investor in the securities market to trade. It is also important that the investor understands the process of investing, such as finding an appropriate broker, handling buying and selling of securities and maintaining records.

Before choosing a broker/sub-broker the investor should be aware of the following things:-

- From where the broker/sub-broker has learnt the business?
- How long has he been serving the securities industry?
- Whether he has eligible qualifications as a broker?
- How many clients does he serve?
- What fees and expenses does he charge?

**61. What are the major obligations and responsibilities of a broker?**

- a) Entering into an agreement with his client or with sub broker and client
- b) Maintenance of separate books of accounts and records for clients
- c) Maintenance of money of clients in a separate account and their own money in a separate account.
- d) Issue of daily statement of collateral utilization to clients
- e) Appointment of compliance officer
- f) Issue of contract note to his client within 24hrs of the execution of the contract.
- g) Delivery / Payment to be made to the client within 24 hrs of pay-out.
- h) Other duties as specified in the SEBI (Stock Brokers and Sub-Brokers) Rules, 1992.

**62. What are the major rights and obligations of an investor?**

- a) Before entering into a contract with the broker, ensure that he is registered with SEBI.
- b) Satisfy yourself about the credentials of the broker by asking for information/documents supporting his claims.
- c) Keep a documentary proof of having made deposit of money or securities with the broker.
- d) Before activating your trading account, obtain clear idea from your broker about all brokerage, commissions, fees and other charges which will be levied on your trades.
- e) Furnish details in full as are required by the broker as required in "know your client" (KYC) norms.
- f) Ensure that a contract note is issued by the broker which contains complete records of every transaction within 24hrs of the execution of the contract.
- g) In case pay-out of money and / or securities is not received on the next working day after date of pay-out, follow up with the concerned broker for its release. If it is not released within five working days, ensure to lodge a complaint immediately with the Investors' Grievance Cell of the exchange.
- h) Ensure to receive a complete 'Statement of Accounts' for both funds and securities settlement every quarter.

**63. What are the various accounts an investor should have for trading in securities market?**

**Beneficial owner Account (B.O. account) / Demat Account:** It is an account opened with a depository participant in the name of client for the purpose of holding and transferring securities.

**Trading Account:** An account which is opened by the broker in the name of the respective investor for the maintenance of transactions executed while buying and selling of securities.

**Client Account / Bank Account:** A bank account which is in the name of the respective client and is used for debiting or crediting money for trading in the securities market.

**64. With whom should the investor file his complaint against an intermediary?**

In case an investor feels that his issue/problem/grievance is not being sorted out by concerned intermediary then he may take up the matter with the immediate/next higher level authority/SRO for the concerned intermediary. If the investor is not satisfied with the resolution of his complaint then he can escalate the matter to SEBI. Example: for complaint against sub-broker/broker you may approach stock exchange. For complaints against DPs, you may approach Depository.

In order to expedite the process of redressal of complaints and to make the process of lodging a complaint easier for the complainants, all SEBI registered intermediaries have been mandated to designate an e-mail ID of the grievance redressal division/compliance officer exclusively for the purpose of registering complaints. The intermediaries have also been advised to display the email ID and other relevant details prominently on their websites.

**65. Are all the investors mandated to comply with PAN requirement?**

Yes. With effect from July 02, 2007, PAN has been made mandatory for all the investors participating in the securities market. In order to strengthen the Know Your Client (KYC) norms and identify every participant in the securities market with their respective PAN to ensure sound audit trail of all the transactions, SEBI has mandated PAN as the sole identification number for all persons transacting in the securities market, irrespective of the amount of transaction.

**66. What is Trade for Trade Segment?**

In a Trade for Trade segment, settlement of trades is done on the basis of gross obligations for the day. No netting is allowed and every trade is being settled separately.

**67. How trading takes place and what is the process of trading?**

The normal course of online trading in the Indian market context is placed below:

**Step 1.** Investor / trader decides to trade

**Step 2.** Places order with a broker to buy / sell the required quantity of respective securities

**Step 3.** Best priced order matches based on price-time priority

**Step 4.** Order execution is electronically communicated to the broker's terminal

**Step 5.** Trade confirmation slip issued to the investor / trader by the broker

**Step 6.** Within 24 hours of trade execution, contract note is issued to the investor / trader by the broker

**Step 7** Pay-in of funds and securities before T+2 day

**Step 8.** Pay-out of funds and securities on T+2 day

In case of short or bad delivery of funds / securities, the exchange orders for an auction to settle the delivery. If the shares could not be bought in the auction, the transaction is closed out as per SEBI guidelines.

**68. What is Direct Market Access (DMA)?**

Direct Market Access (DMA) is a facility which allows brokers to offer clients direct access to the exchange trading system through the broker's infrastructure without manual intervention by the broker. Some of the advantages offered by DMA are direct control of clients over orders, faster execution of client orders, reduced risk of errors associated with manual order entry, greater transparency, increased liquidity, lower impact costs for large orders, better audit trails and better use of hedging and arbitrage opportunities through the use of decision support tools / algorithms for trading. Presently, DMA facility is available for institutional investors.

**Facts about the Indian Economy [Jan 2014]**

- 1) The great scriptures of India - including The Vedas and The Upanishads - were written when most developed nations did not even know how to read and write.
- 2) Diamonds were first recognized and mined in India. Until 1896, India was the only source for diamonds to the world, as per the Gemological Institute of America.
- 3) India has the fourth largest army, is the second largest producer of rice and tea, and the largest producer of mica, jute, pulses and milk.
- 4) As of today, India is one of the fastest growing economies in the world. By 2030, India will become the third largest economy, behind China and the USA, with projected GDP at \$30 Trillion.
- 5) The largest employer in the world is the Indian Railways, employing over 20 lakh staff.
- 6) India is one of only three countries that make supercomputers, after the USA and Japan. Moreover, India also has the second largest community of software developers after the USA.
- 7) With close to around 100 crore Hindus, India is not just the largest Hindu country. It is also the world's third largest Muslim populated country after Pakistan and Indonesia.
- 8) The average age in India today is 25.6 as opposed to 44.6 of Japanese, 36.9 of Americans and 40.5 of British people. This surely makes India the Young India!
- 9) The Indian Railways is the fifth largest rail network in the world, after US, Russia, China and Canada, with a track length of 114,500 kilometers.
- 10) As of Jan 2013, The National Stock Exchange of Delhi retained its position of being the world's largest bourse in terms of the number of equity trades, while China's Shenzhen Exchange was at second position.
- 11) India also has the world's third largest road network, covering more than 4.3 million kilometers and carrying 87 percent of passenger traffic.
- 12) The working-age population of India is said to be increasing by seven million people each year in India. In fact, India has the second largest pool of scientists and engineers in the world.
- 13) India ranks fifth in the Knight Frank's Wealth Report 2013 with the highest net-worth individuals (HNIs). It has 122 billionaires with net assets worth Rs 500 crore and above, as of December 2013. The number is likely to double over the next 10 years.
- 14) India is among the fastest growing and currently the ninth largest civil aviation market in the world. However, it is expected to become the third largest in the world by 2020 after the US and China, according to Civil Aviation Secretary K N Shrivastava.
- 15) India is the 19th largest exporter and the 10th largest importer in the world. During 2011-12, India's foreign trade grew by an enormous 30.6% to reach \$792.3 billion.
- 16) The six sigma certified Mumbai's Dabbawalla boasts of 16 million full-proof deliveries of lunchboxes every day. They have been into existence since the 1890s during the British rule. The management skills of the dabbawallas and the delivery mechanism have also been a Harvard Business Case Study.
- 17) The Indian Film Industry, which is concentrated in Mumbai and known as Bollywood, is the largest producer of films in the world. The industry is the largest in the world in terms of ticket sales and number of films produced and second largest in terms of revenue.

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## About the Author

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**CA Mayank Kothari** is an Associate Member of the Institute of Chartered Accountants of India. He has completed his graduation (BBA) from Nagpur University in 2010.

### Achievements

1. Qualified the Chartered Accountancy exam in May 2012 held by ICAI.
2. Secured All India 47th Rank in CA Final and was topper in Nagpur division of ICAI.
3. Also, he received Gold Medal for securing highest, 88 Marks in Indirect Tax paper in Nagpur division.
4. He was felicitated with the Best Student Award from the hands of Vice Chancellor of Nagpur University.
5. He has an experience of working with Big4 firm.
6. He is teaching CA Final SFM and CA IPCC FM to the students in Nagpur division.



## About the Book

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