BHARATHIDASAN UNIVERSITY CONSTITUENT COLLEGE OF ARTS AND SCIENCE

NAGAPATTINAM-611106

M.B.A

ELECTIVE COURSE – VI – FINANCE

MERCHANT BANKING

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Semester – IV 5 Hours / 4 Credit

B: FINANCE

ELECTIVE COURSE -VI: MERCHANT BANKING

Objecties: To help students to learn the various concepts in merchant banking and its role in appraisal of projects.To help the students to know about insurance industry.

Unit I

Introduction – An Over view of Indian Financial System – Merchant Banking in India – Recent Developments and Challenges ahead – Institutional Structure – Functions of Merchant Banking - Legal and Regulatory Frameworks – Relevant Provisions of Companies Act- SERA- SEBI guidelines- FEMA, etc. - Relation with Stock Exchanges, OTCEI and NSE.

Unit II

Role of Merchant Banker in Appraisal of Projects, Designing Capital Structure and Instruments – Issue Pricing – Pricing – Preparation of Prospectus Selection of Bankers, Advertising Consultants, etc. - Role of Registrars – Underwriting Arrangements - Dealing with Bankers to the Issue, Underwriters, Registrars, and Brokers – Offer for Sale – Book – Building – Green Shoe Option – E-IPO Private Placement – Bought out Deals – Placement with FIs, MFs, FIIs, etc.

Unit III

Mergers and Acquisitions – Portfolio Management Services – Credit Syndication – Credit Rating – Mutual Funds - Business Valuation.

UNIT-IV

Mutual Funds - Origin, Types of Mutual Funds, Importance, Mutual Funds Industry in India – SEBI’s directives for Mutual Funds, Private Mutual Funds, Asst- Management company – Unit Trust of India – Evaluation of Performance of Mutual Funds – Money Market Mutual Funds – RBI Guidelines – Venture Capital: Meaning, Origin, Importance, Methods, India Scenario.

UNIT-V

Insurance – Meaning, Types, Insurance Industry in India and related reforms – Other Financial Services – Credit Cards – Credit Rating: Regulatory framework – Credit Rating Agencies – Rating Process and Methodology – Rating symbols/Grades – Pension Plan.

References

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2. K.Sriram, 'Hand Book of Leasing, Hire Purchase & Factoring', ICFAI, Hyderabad.
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4. Bhalla. V.K. – 'Management of Financial Services' – Anmol, New Delhi.
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CONTENTS

CHAPTERS	Topic	Page No
1	An overview of financial system	
2	Merchant banking	
3	Security contract regulation act	
4	Role of merchant banking in appraisal of projects	
5	Preparation of prospectus	
6	Brokers to the issue of shares	
7	Private placement	
8	Merger and Acquisition	
9	Portfolio management services	
10	Mutual fund	
11	Unit Trust of India	
12	Venture Capital	
13	Insurance	
14	Other financial services	
15	Credit rating	
16	Pension plan	

UNIT – I

CHAPTER– 1

INTROUDUCTION OF FINANCIAL SYSTEM

1.1 Introduction

1.2 An overview of financial system

1.3 Financial system

1.4 Objectives of financial system

1.5 Functions of financial system

1.6 Components of financial system

1.7 Limitations of financial system in India

1.8 Conclusion

AN OVERVIEW OF FINANCIAL SYSTEM

1.1 Introduction

A financial system (within the scope of finance) is a system that allows the exchange of funds between lenders, investors, and borrowers. Financial systems operate at national, global, and firm-specific levels.[1] They consist of complex, closely related services, markets, and institutions intended to provide an efficient and regular linkage between investors and depositors.

Money, credit, and finance are used as media of exchange in financial systems. They serve as a medium of known value for which goods and services can be exchanged as an alternative to bartering. A modern financial system may include banks(operated by the government or private sector), financial markets, financial instruments, and financial services. Financial systems allow funds to be allocated, invested, or moved between economic sectors. They enable individuals and companies to share the associated risks.

1.2 An overview of Indian Financial System

The word system implies a set of complex and interrelated factors organized in aparticular form. These factors are mostly interdependent but not always mutually exclusive. The financial system of any country consists of several ingredients. It includes financial institutions,markets, financial instruments, services, transactions, agents, claims and liabilities in the economy. Financial system's a system to analyze the funds from the surplus units to the deficit Units. Deficit unitsare a case where current expenditure exceeds their current income. There are other entities whose current income exceeds current expenditure which is called as Surplus Units.

An efficient financial system not only encourages savings and investments, it also efficiently allocates resources in different investment avenues and thus accelerates the rate of economic development. The financial system of a country plays a crucial role of allocating scarce capital resources to productive uses. Its efficient functioning is of critical importance to the economy.

1.3 FINANCIAL SYSTEM

It is a system for the efficient management and creation of finance. According to Robinson, financial system provides a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the existing wealth.

According to Van Horne, financial system is defined as the purpose of financial markets to allocate savings efficiently in an economy to ultimate users – either for investment in real assets or for consumption.

Thus the financial system mainly stands on **three factors**

- Money
- Credit
- Finance

1. Money's the unit of exchange or medium of payment. It represents the value of financialtransactions in qualitative terms.

2. Credit, on the other hand, is a debt or loan which is to be returned normally with interest.

3. Finance' is monetary wealth of the state, an institution or a person. Comprising these factors in a systematic order forms a financial system.

1.4 Objectives of Financial system

The objectives of the financial system are

1. Accelerating the growth of economic development.
2. Encouraging rapid industrialization
3. Acting as an agent to various economic factors such as industry, agricultural sector,Government etc.
4. Accelerating rural development
5. Providing necessary financial support to industry
6. Financing housing and small scale industries
7. Development of backward areas, infrastructure and livelihood
8. Imposing price control in need
9. Protecting environment.

Functions of financial system are distributed from creation of money to efficient Management. It is the sum total of the functions of the various intermediaries.

1.5 The functions of financial system can be classified into two broad categories:

1. Controlling functions
2. Promotional functions.

1.6 Components of Financial System:

Financial system Institutions Markets Financial Institutions Instruments Services Structure of Financial Institutions:

Commercial Banks Classification of Commercial Banks

- ✓ Financial Institutions Banking
- ✓ Non-Banking Companies
- ✓ Non-Banking Financial companies
- ✓ Central Bank
- ✓ CommercialBanks
- ✓ Co-Operative Banks
- ✓ Non-Banking Financial Intermediaries
- ✓ Joint Stock companies

1.7 Limitations of the financial system in India

The following are the limitations of the Indian financial system.

• The Indian Financial system has failed to meet the financial needs of small scale Industries. It has rather patroned the big industrial houses who are already well off.

• The mushrooming of financial institutions has deteriorated the quality and effectiveness of the sector to some extent.

• In many cases, it could not impose adequate control towards financial irregularities and frauds, often influenced by politically and economically organized pressure groups.

• The Indian financial system fails to create a well-defined and organized capital market.

• It fails to motivate economically marginal or small entrepreneurs by providing micro credit to them.

• The Indian financial system is not flexible at the desired level. It takes abnormal time to cope with the changing situation.

- Factoring Asset Liability Management
- Leasing Housing Finance
- Forfeiting Portfolio Finance
- Hire Purchase Finance Underwriting

- Credit Card Credit rating
- Merchant Banking Interest and Credit Swap
- Book Building Mutual fund

1.8 Conclusion

Indian Financial System accelerates the rate and volume of savings through provision of various financial instruments and efficient mobilization of savings. It aids in increasing the national output of the country by providing funds to corporate customers to expand their respective business. It helps economic development and raising the standard of living of people and promotes the development of weaker section of the society through rural development banks and co-operative societies. These are the important facts about Indian Financial system.

Questions

1. Define financial system? What are the factors of financial system?
2. State the objectives of financial system.
3. What are the components of financial system?
4. Explain the limitation of financial system.

CHAPTER– 2

MERCHANT BANKING

2.1 Introduction

2.2 Securities and Exchange Board of India (Merchant Bankers) Rules, 1992

2.3 Objectives

2.4 Functions of Merchant banking

2.5 Merchant banking in India

2.6 Recent Developments in Merchant Banking and Challenges Ahead

2.7 The challenges faced by merchant bankers in India

2.8Merchant banking and Legal regulatory framework in India

2.9 Provisions under Companies Act

2.10 Conclusion

MERCHANT BANKING

2.1 Introduction

The term 'merchant banking' has been used differently in different parts of the world. While in U.K. merchant banking refers to the 'accepting and issuing houses', in U.S.A. it is known as 'investment banking'. The word merchant banking has been so widely used that sometimes it is applied to banks who are not merchants, sometimes to merchants who are not banks and sometimes to those intermediaries who are neither merchants not banks.

In India merchant banking services were started only in 1967 by National Grindlays Bank followed by Citi Bank in 1970. The State Bank of India was the first Indian Commercial Bank having set up separate Merchant Banking Division in 1972. In India merchant banks have been primarily operating as issue houses than full- fledged merchant banks as in other countries.

A merchant bank may be defined as an institution or an organisation which provides a number of services including management of securities issues, portfolio services, underwriting of capital issues, insurance, credit syndication, financial advices, project counseling etc.

There is a distinction between a commercial bank and a merchant bank. The merchant banks mainly offer financial services for a fee. While commercial

banks accept deposits and grant loans. The merchant banks do not act as repositories for savings of the individuals.

2.2Securities and Exchange Board of India (Merchant Bankers) Rules, 1992.

A merchant banker has been defined as any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, adviser or rendering corporate advisory services in relation to such issue management.

Random House Dictionary —Merchant banker is an organization that underwrites securities for corporations, advices such clients on mergers and is involved in the ownership of commercialventures. These organizations are sometime banks which are not merchants and sometimes merchants who are not banks and sometimes houses which are neither merchants nor banks.

Charles P. Kindleberger —Merchant banking is the development of banking from commercewhich frequently encountered a prolonged intermediate stage known in England originally asmerchant banking. The Notification of the Ministry of finance defines A merchant banker asany person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to the securities as manager, consultant, adviser orrendering corporate advisory service in relation to such issue management.

2.3 Objectives

- ❖ Channelizing the financial surplus of the general public into productive investments avenues
- ❖ Co-coordinating the activities of various intermediaries like the registrar, bankers,advertising agency, printers, underwriters, brokers, etc., to the share issue
- ❖ Ensuring the compliance with rules and regulations governing the securities market.

2.4 Functions of merchant Banking:

Merchant banking functions in India is the same as merchant banks in UK and other European countries. The following are the functions of merchant bankers in India.

i. Corporate counseling
ii. Project Counseling
iii. Capita l Structuring
iv. Portfolio Management
v. Issue Management
vi. Credit Syndication
vii. Working capital
viii. Venture Capital
ix. Lease Finance
x. Fixed Deposits

(i) Corporate counseling: Corporate counseling covers counseling in the form of project counseling, capital restructuring, project management, public issue management, loan syndication, working capital fixed deposit, lease financing, acceptance credit etc., The scope of corporate counseling is limited to giving suggestions and opinions to the client and help taking actions to solve their problems. It is provided to a corporate unit with a view to ensure better performance, maintain steady growth and create better image among investors.

(ii) Project counseling: Project counseling is a part of corporate counseling and relates to project finance. It broadly covers the study of the project, offering advisory assistance on the viability and procedural steps for its implementation.

a. Identification of potential investment avenues.
b. A general view of the project ideas or project profiles.
c. Advising on procedural aspects of project implementation
d. Reviewing the technical feasibility of the project

e. Assisting in the selection of TCO (Technical Consultancy Organizations) for preparingproject reports

f. Assisting in the preparation of project report

g. Assisting in obtaining approvals, licenses, grants, foreign collaboration etc., from government

h. Capital structuring

i. Arranging and negotiating foreign collaborations, amalgamations, mergers and takeovers.

j. Assisting clients in preparing applications for financial assistance to various national and state level institutions banks etc.,

k. Providing assistance to entrepreneurs coming to India in seeking approvals from the Government of India.

(iii) Capital Structure: Here the Capital Structure is worked out i.e., the capital required, raising of the capital, debt-equity ratio, issue of shares and debentures, working capital, fixed capital requirements, etc.,

(iv) Portfolio Management: It refers to the effective management of Securities i.e., the merchant banker helps the investor in matters pertaining to investment decisions. Taxation and inflation are taken into account while advising on investment in different securities. The merchant banker also undertakes the function of buying and selling of securities on behalf of their client companies. Investments are done in such a way that it ensures maximum returns and minimum risks.

(v) Issue Management: Management of issues refers to effective marketing of corporate securities viz., equity shares, preference shares and debentures or bonds by offering them to public. Merchant banks act as intermediary whose main job is to transfer capital from those who own it to those who need it.

The issue function may be broadly divided in to pre issue and post issue management.

a. Issue through prospectus, offer for sale and private placement.
b. Marketing and underwriting
c. pricing of issues

(vi) Credit Syndication: Credit Syndication refers to obtaining of loans from single development finance institution or a syndicate or consortium. Merchant Banks help corporate clients to raise syndicated loans from commercials banks. Merchant banks helps in identifying which financial institution should be approached for term loans. The merchant bankers follow certain steps before assisting the clients approach the appropriate financial institutions.

a.Merchant banker first makes an appraisal of the project to satisfy that it is viable
b. He ensures that the project adheres to the guidelines for financing industrial projects.
c. It helps in designing capital structure, determining the promoter's contribution and arriving at a figure of approximate amount of term loan to be raised.
d. After verifications of the project, the Merchant Banker arranges for a preliminary meeting with financial institution.
e. If the financial institution agrees to consider the proposal, the application is filled and submitted along with other documents.

(vii) Working Capital: The Companies are given Working Capital finance, depending upontheir earning capacities in relation to the interest rate prevailing in the market.

(viii)Venture Capital: Venture Capital is a kind of capital requirement which carries more risksand hence only few institutions come forward to finance. The merchant banker looks in to the technical competency of the entrepreneur for venture capital finance.

(ix). Fixed Deposit: Merchant bankers assist the companies to raise finance by way of fixed deposits from the public. However such companies should fulfill credit rating requirements.

(x)Other Functions

- Treasury Management- Management of short term fund requirements by client companies.
- Stock broking- helping the investors through a network of service units
- Servicing of issues- servicing the shareholders and debenture holders in distributing dividends, debenture interest.
- Small Scale industry counseling- counseling SSI units on marketing and finance
- Equity research and investment counseling – merchant banker plays an important role inproviding equity research and investment counseling because the investor is not in a position to take appropriate investment decision.
- Assistance to NRI investors - the NRI investors are brought to the notice of the various investment opportunities in the country.
- Foreign Collaboration: Foreign collaboration arrangements are made by the Merchant bankers.

2.5 Merchant Banking in India

The first merchant bank was set up in 1969 by Grind lays Bank. Initially they were issue mangers looking after the issue of shares and raising capital for the company.

But subsequently they expanded their activities such as working capital management; syndication of project finance, global loans, mergers, capital restructuring, etc., initially the merchant banker in Indiawas in the form of management of public issue and providing financial consultancy for foreign banks. In 1973, SBI started the merchant banking and it was followed by ICICI. SBI capital market was set up in August 1986 as a fully-fledged merchant banker. Between 1974 and 1985, the merchant banker has promoted lot of companies. However they were brought under the control of SEBI in 1992.

2.6 Recent Developments in Merchant Banking and Challenges :

The recent developments in Merchant banking are due to certain contributory factorsin India. They are

- ✓ The Merchant Banking was at its best during 1985-1992 being when there were many new issues. It is expected that 2010 that it is going to be party time for Merchant banks, as many new issues are coming up.
- ✓ The foreign investors – both in the form of portfolio investment and through foreign direct investments are venturing in Indian Economy. It is increasing the scope of Merchant bankers in many ways.
- ✓ Disinvestment in the government sector in the country gives a big scope to the Merchant banks to function as consultants.
- ✓ New financial instruments are introduced in the market time and again. This basically provides more and more opportunity to the merchant banks.
- ✓ The mergers and corporate restructuring along with MOU and MOA are giving immense opportunity to the merchant bankers for consultancy jobs.

2.7 The challenges faced by merchant bankers in India are

1. SEBI guideline has restricted their operations to Issue Management and Portfolio Management to some extent. So, the scope of work is limited.
2. In efficiency of the clients are often blamed on to the merchant banks, so they are into troublewithout any fault of their own.
3. The net worth requirement is very high in categories I and II specially, so many professionally experienced person/ organizations cannot come into the picture.
4. Poor New issues market in India is drying up the business of the merchant bankers. Thus the merchant bankers are those financial intermediary involved with the activity of transferring capital funds to those borrowers who are interested in borrowing. The activities of the merchant banking in India is very vast in the nature of
   - ⇨ The management of the customers securities
   - ⇨ The management of the portfolio
   - ⇨ The management of projects and counseling as well as appraisal
   - ⇨ The management of underwriting of shares and debentures
   - ⇨ The circumvention of the syndication of loans
   - ⇨ Management of the interest and dividend etc.

2.8 MERCHANT BANKING AND LEGAL REGULATORY FRAME WORK

1.Companies Act

(i). Company means a company formed and registered under this Act or an existing company as defined in clause (ii)

(ii). Existing company means a company formed and registered under any of the previous companies laws specified below

a. any Act or Acts relating to companies in force before the Indian Companies Act, 1866 (10 of 1866) and repealed by the Act;

b. The Indian Companies Act, 1866

c. The Indian Companies Act, 1882

d. The Indian Companies Act, 1913 i.e. the Registration of Transferred Companies Ordinance 1942.

iii) Private company means a company which has a minimum paid-up capital of one lakh rupees or such higher paid-up capital as may be prescribed, and by its articles,

a. Restricts the right to transfer its shares, if any;

b. Limits the number of its members to fifty not including

(i)Persons who are in the employment of the company

(ii)Persons who, having been formerly in the employment of the company were members of the company while in that employment and have continued to be members after the employment ceased

c. Prohibits any invitation to the public to subscribe for any shares in, or debentures of the company;

d. Prohibits any invitation or acceptance of deposits from persons other than its members,directors or their relatives Provided that where two or more persons hold one or more shares in a company jointly, they shall, for the purposes of this definition, be treated as a single member;

iv) Public company means a company which a. is not a private company; b. has a minimum paidup capital of five lakh rupees or such higher paid-up capital, s may be prescribed c. is a private company which is a subsidiary of a company which is not a private company.

In this Act, unless the context otherwise requires,

1. Abridged prospectus means a memorandum containing such salient features of a prospectus as may be prescribed

2. Banking company has the same meaning as in the Banking Companies Act, 1949

3. Company Law Board means the Board of Company Law Administration constituted under section 10E

4. Debenture includes debenture stock bonds and any other securities of a company, whetherconstituting a charge on the assets of the company or not;

5. Derivative has the same meaning as in clause (aa) of section 2 of the Securities Contracts (Regulation) Act, 1956

6. Hybrid means any security which has the character of more than one type of security, including their derivatives

7. Issued generally means, in relation to a prospectus, issued to persons irrespective of their being existing members or debenture-holders of the body corporate to which the prospectusrelates;

8. Prospectus means any document described or issued as a prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares in, or debentures of, a body corporate;

9. Recognized stock exchange means, in relation to any provision of this Act in which it occurs a stock exchange whether in or outside India, which is notified by the Central Government in the Official Gazette as a recognized stock exchange for the purposes of that provision;

10. Registrar means a Registrar, or an Additional, a Joint, a Deputy or an Assistant Registrar, having the duty of registering companies under this Act;

11. Securities means securities as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956

12. Securities and Exchange Board of India means the Securities and Exchange Board of India established under section 3 of the Securities and Exchange Board of India Act, 1992

13. Share means share in the share capital of a company, and includes stock except where a distinction between stock and shares is expressed or implied;

2.9 Provisions under Companies Act

The various regulations which govern the merchant bankers on the capital issue are prescribed bythe companies act, and the other enactments mentioned below.

1. Provisions of the Companies Act, 1956

a. Prospectus (Sec. 55 to 68A)

b. Allotment (Sec. 55 to 75)

c. Commissions and discounts (Sec. 76 & 77)

d. Issue of shares at premium and at discount (Sec. 78 & 79)

e. Issue and redemption of preference shares (Sec. 80 & 80A)

f. Further issues of capital (Sec. 81)

g. Nature, numbering and certificate of shares (Sec. 82 to 84)

h. Kinds of share capital and prohibition on issue of any other kind of shares (Sec. 85 & 86)

i. Matters to be specified in prospectus and reports to be set out therein (Schedule 11)

j. The Securities Contracts (Regulations) Act, 1957 regarding transactions in securities

k. The Securities Contracts (Regulation) Rules, 1957.

l. Their capital adequacy

m. Their track record, experience and general reputation

n. Adequacy and quality of personnel employed by them and also the available infrastructure.

2.10 Conclusion

The term 'merchant banking' has been used differently in different parts of the world. While in U.K. merchant banking refers to the 'accepting and issuing houses', in U.S.A. it is known as 'investment banking'. The word merchant

banking has been so widely used that sometimes it is applied to banks who are not merchants, sometimes to merchants who are not banks and sometimes to those intermediaries who are neither merchants not banks.

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Questions

1. State the recent developments in merchant banking in India.
2. What are the Challenges faced by merchant bankers in India?
3. State the merchant banking and legal regulatory framework.

CHAPTER– 3

3.1 Introduction

3.2 Security contract regulation Act (SCRA)

3.3 Definitions

3.4 Recognized stock exchanges

3.5 Grant of recognized of stock exchanges

3.6 Security exchange of Board of India

3.6.1. Regulatory

3.6.2. Development

3.7 Objectives

3.8Powers of SEBI as per the Act, SEBI has powers

3.9General obligations

3.10 Maintenance of books

3.11 Appointment of lead merchant bankers

3.12 Restriction on appointment of lead managers

3.13 Responsibilities of lead managers

3.14 Underwriting obligations

3.15 Submission of due diligence certificate

3.16 Documents to be furnished to the board

3.17 Payment of fees to the board

3.18 Appointment of compliance officer

3.19 Procedure for inspection board's right to inspect

3.20 Notice before inspection

3.21Obligations of merchant banker on inspection

3.22Submission of report to the board

3.23Suspension of registration

3.24 Cancellation or registration

3.24.1 Manner of making order of suspension or cancellation

3.24.2 Manner of holding enquiry before suspension or cancellation

3.24.3 Showcase notice and order

3.25 Effect of suspension and cancellation

3.26 Appeal to the securities appellate tribunal

3.27 Renewal fees

3.28 SEBI regulations on merchant bankers

3.29 Procedure where registration is not granted

3.30 Effect of refusal to grant certificate

3.31 Code of conduct for merchant bankers

3.32 SEBI Guidelines

3.33 Stock Exchanges

3.34 Objectives of stock exchanges

3.35 Functions of stock exchanges

3.36 Traditional structure of stock exchanges

3.37 Demutualization of stock exchanges

3.38 Methods of trading in a stock exchange

3.39Online trading

3.40 BSE Bolt system

3.41 OTCEI

3.42 Benefits to listed companies

3.43 Conclusion

SECURITY CONTRACT REGULATION ACT

3.1 Introduction

The Securities Contracts (Regulation) Act, 1956 "Act" was enacted in order to prevent undesirable transactions in securities and to regulate the working of stock exchanges in the country. The provision of the Act came into force with effect from 20th February, 1957 vide Notification No. SRO 528 dated 16th February, 1957.

3.2 SCRA (Security contract regulation Act):

The Securities Contracts (Regulations) Act was passed in 1956 by Parliament and it cameinto force in February 1957. An act to prevent undesirable

transactions in securities by regulatingthe business of dealing therein, by providing for certain other matters connected therewith.

1. This Act may be called the Securities Contracts (Regulation) Act, 1956.

2. It extends to the whole of India.

2. It shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint.

3.3 Definitions

a. Contract means a contract for or relating to the purchase or sale of securities;

b. Corporatization means the succession of a recognized stock exchange, being a Body of individuals or a society registered under the Societies Registration Act, 1860 (21 of 1860), by another stock exchange, being a company incorporated for The purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities carried on by such individuals or society;

c. demutualization means the segregation of ownership and management from the trading rights of the members of a recognized stock exchange in accordance with a scheme approved by the Securities and Exchange Board of India;

d. Derivative includes:

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

ii.A contract which derives its value from the prices, or index of prices, of underlying securities;

iii. Government security means a security created and issued, whether before or after the commencement of this Act, by the Central Government or a State Government for the purpose of raising a public loan and having one of the forms specified in clause (2) of section 2 of the Public Debt Act, 1944 (18 of 1944);

iv. Member means a member of a recognized stock exchange;

v. Option in securities means a contract for the purchase or sale of a right to buy or sell, or a right to buy and sell, securities in future, and includes a teji, a mandi, a tejimandi, a galli, a put, a call or a put and call in securities;

f. Recognized stock exchange means a stock exchange which is for the time being recognized by the Central Government under section 4;

g. Stock exchange which may provide for

(i) The issue of shares for a lawful consideration and provision of trading rights in lieu of membership cards of members of a recognized stock exchange;

(ii) The restrictions on voting rights;

(iii) The transfer of property, business, assets, rights, liabilities, recognitions, contracts of the recognized stock exchange, legal proceedings by, or against, the recognized stock exchange, whether in the name of the recognized stock exchange or any trustee or otherwise and any permission given to, or by, the recognized stock exchange;

(iv) Thetransfer of employees of a recognized stock exchange to another recognized stock exchange;

(v) Any other matter required for the purpose of, or in connection with, the corporatization or demutualization, as the case may be, of the recognized stock exchange

(h). Securities include (i.) shares, scrip‘s, stocks, bonds, debentures, debenture stock or othermarketable securities of a like nature in or of any incorporated company or other body corporate;

(j) Government securities;

i. Such other instruments as may be declared by the Central Government to be securities

ii. Rights or interest in securities

(k). Stock Exchange means a anybody of individuals, whether incorporated or not, constituted before corporatization and demutualization under sections 4A and 4B, or b. a body corporate incorporated under the Companies Act 1956

whether under a scheme of corporatization and demutualization or otherwise, for the purpose of assisting, regulating or controlling the business of buying.

3.4 RECOGNIZED STOCK EXCHANGES

Application for Recognition of Stock ExchangesAny stock exchange, which is desirous of being recognized for the purposes of this Act, may make an application in the prescribed manner to the Central Government. (2) Every application under sub-section 1. shall contain such particulars as may be prescribed, and shall be accompanied by a copy of the bye-laws of the stock exchange for the regulation and control of contracts and also a copy of the rules relating in general to the constitution of the stock exchange and in particular

a. the governing body of such stock exchange, its constitution and powers of management and the manner in which its business is to be transacted;

b. the powers and duties of the office bearers of the stock exchange; c. the admission into the stock exchange of various classes of members, the qualifications for membership, and the exclusion, suspension, expulsion and readmission of members there from or there into; d. the procedure for the registration of partnerships as members of the stock exchange in cases where the rules provide for such membership; and the nomination and appointment of authorized representatives and clerks.

3.5 Grant of Recognition of Stock Exchanges

1. If the Central Government is satisfied, after making such inquiry as may be necessary in this behalf and after obtaining such further information, if any, as it may require

- ✓ That the rules and bye-laws of a stock exchange applying for registration are inconformity with such conditions as may be prescribed with a view to ensure fair dealing and to protect investors;
- ✓ That the stock exchange is willing to comply with any other conditions (including conditions as to the number of members) which the Central Government, after consultation with the governing body of the stock

exchange and having regard to the area served by the stock exchange and its standing and the nature of the securities dealt with by it, may impose for the purpose of carrying out the objects of this Act

- ✓ That it would be in the interest of the trade and also in the public interest to grant recognition to the stock exchange; it may grant recognition to the stock exchange subject to the conditions imposed upon it as aforesaid and in such form as may be prescribed.

2. The conditions which the Central Government may prescribe under clause (a) of subsection

(1) for the grant of recognition to the stock exchanges may include, among other matters, conditions relating to,

- ✓ The qualifications for membership of stock exchanges;
- ✓ The manner in which contracts shall be entered into and enforced as between members.
- ✓ The representation of the Central Government on each of the stock exchange by such number of persons not exceeding three as the Central Government may nominate in this behalf
- ✓ The maintenance of accounts of members and their audit by chartered accountantswhenever such audit is required by the Central Government.

3. Every grant of recognition to a stock exchange under this section shall be published in the Gazette of India and also in the Official Gazette of the State in which the principal office as of the stock exchange is situate, and such recognition shall have effect as from the date of its publication in the Gazette of India.

4. No application for the grant of recognition shall be refused except after giving an opportunity to the stock exchange concerned to be heard in the matter; and the reasons for such refusal shall be communicated to the stock exchange in writing.
5. No rules of a recognized stock exchange relating to any of the matters specified in sub-section (2) of section 3 shall be amended except with the approval of the Central Government. Even though we have 23 stock exchanges in India, a major part of the transactions is controlled by Bombay Stock Exchange. This has led to enormous speculation, rigging and cornering of shares by a few speculators. To prevent these malpractices by companies, brokers and merchant bankers, the government constituted Securities Exchange Board of India in April 1988 for regulating and promoting the stock market in the country and effective from 1992.

3.6 SECURITY EXCHANGE BOARD OF INDIA (SEBI)

SEBI is a body corporate with head office at Bombay. The Chairman and the board members are appointed by the Central government. SEBI has two following major functions:

3.6.1. Regulatory and

3.6.2. Development

3.6.1. Regulatory

a). Registering the brokers and sub-brokers

b). Registration of mutual funds

c). Regulation of stock exchanges

d). Prohibition of fraudulent and unfair trade practice

e). Controlling insider trading, take-over bids and imposing penalties.

3.6.2. Development

a. Educating investors

b. Training intermediaries in stock market transactions

c. Promoting fair transactions

d. Undertaking research and publishing useful information to all

3.7Objectives:

- To deal with development and regulation of stock market in India.
- To promote fair dealings by the issue of securities and ensure a market place where they can raise funds.
- To provide protection to the investors.
- Regulate and develop a code of conduct for brokers, merchant bankers, etc.
- To have check on preferential allotment to promoters at a very low price.
- To prevent deviations and violations of rules prescribed by stock exchange.
- To verify listing requirements, listing procedures, and ensure compliance of the same by the companies, so that only financially sound companies are listed.
- To prescribe required standards for merchant bankers.
- To promote healthy growth of security market for the development of capital market in the country.

3.8 Powers of SEBI as per the Act, SEBI has powers

- To file complaints in a court
- To regulate companies in the issue and transfer of shares including bonus and rights shares.
- It can levy penalties on companies and on brokers for violating transactions.
- Power to summon any broker or intermediaries and call for documents.
- It can issue directions to all brokers for protecting the interests of investors.

In addition to the above powers:

- It can call for periodical returns from stock exchange.
- Seek any information from stock exchange.
- It can enquire into the functioning of stock exchange.

- It can grant permission for the change of bye-laws of any stock exchange.
- It can compel listing of securities of public company.
- It can control and regulate stock exchanges.
- Granting registration to market intermediaries, prohibit insider-trading and prohibit Fraudulent and unfair trade practices.
- Promoting investor-education, and trading of intermediaries in capital market.
- Regulating purchase of shares and take-over of companies.

3.9 GENERAL OBLIGATIONS

The 1992 regulations have enunciated the following general obligations and responsibilities for the merchant bankers.Sole Function Every merchant banker shall abide by the Code of Conduct as specified in Schedule III. They are as follows:

1. Merchant Banker not to associate with any business other than the securities market.

2. No merchant banker, other than a bank or a public financial institution, who has been granted certificate of registration under these regulations, shall after June 30th, 1998 carry on any business other than that in the securities market. However, a merchant banker who prior to the date of notification of the Securities and exchange board of India (Merchant Bankers)

Amendment Regulations, 1997, has entered into a contract in respect of a business other that of the securities market may, f he so desires, discharge his obligations under such contract.

Similarly, a merchant banker who has been granted certificate of registration to act as primary or satellite dealer by the Reserve Bank of India may carry on such business as may be permitted byReserve Bank of India.

3.10 Maintenance of Books

Every merchant banker shall keep and maintain the following books of accounts, records and documents:

1. A copy of balance sheet as at the end of each accounting period;
2. A copy of profit and loss account for that period;
3. A copy of the auditor's report on the accounts for that period; and
4. A statement of financial position.

Every merchant banker shall intimate to the Board the place where the books of accounts, record and documents are maintained. Every merchant banker shall, after the end of each accounting period furnish to the Board copies of the Balance sheet, profit and loss account and such other documents for any other preceding five accounting years when required by the Board.

Submission of Half-yearly Results:

Every merchant banker shall furnish to the Board half-yearly unaudited financial results when required by the Board with a view to monitor the capital adequacy of the merchant banker.

Preservation of Books of Account, Records: The merchant banker shall preserve the books of accounts and other records and documents maintained under regulation 14 for a minimum period of five years.

Report on Steps taken on Auditor's Report:

Every merchant banker shall within two months from the date of the auditor's report take steps to rectify the deficiencies, made out in the auditor's report.

3.11 Appointment of Lead Merchant Bankers:

All issues should be managed by at least one merchant banker functioning as the leadmerchant banker. In an issue of offer of rights to the existing members with or without the right of renunciation, the amount of the issue of the body corporate does not exceed rupees fifty lakh, the appointment of a lead merchant banker shall not be essential. Every lead merchant banker shall before taking up the assignment relating to an issue enter into an agreement with such body

corporate setting out their mutual right, liabilities and obligations relating to such issue an in particular to disclosures, allotment and refund.

3.12 Restriction on Appointment of Lead Managers:

The number of lead merchant bankers may not, exceed in case of any issue of the following:

3.13 Responsibilities of Lead Managers:

No lead manager shall agree to manage or be associated with any issue unless his responsibilities relating to the issue mainly, those of disclosures, allotment and refund are:

Size of Issue	Number of Merchant Bankers
Less than Rs. 50 Crores	Two Above
Rs. 50 Crores but less than Rs.100 Crores	Three Above
Rs. 100 Crores but less that Rs.200 Crores	Four Above
Rs.200 Crores but less that Rs.400 Crores	Five Above
Rs.400 Crores	Five or more

As agreed by SEBI clearly defined, allocated and determined and a statement specifying such responsibilities is furnished to the Board at least one month before the opening of the issue for subscription.

Where there are more than one lead merchant banker to the issue the responsibilities of each of such lead merchant banker shall clearly be demarcated and a statement specifying such responsibilities shall be furnished to the Board at least one month before the opening of the issue for subscription. No lead merchant banker shall, agree to manage the issue made by anybody corporate, if such body corporate is an associate of the lead merchant banker.

A lead merchant banker shall not be associated with any issue if a merchant banker who is not holding a certificate is associated with the issue.

3.14 Underwriting Obligations:

In respect of every issue to be managed, the lead merchant banker holding a certificate under Category I shall accept a minimum underwriting obligation of five percent of the total underwriting commitment or rupees twenty-five lakh whichever is less. If the lead merchant banker is unable to accept the minimum underwriting obligation, that lead merchant banker shall make arrangement for having the issue underwritten to that extent by a merchant banker associated with the issue and shall keep the board informed of such arrangement.

3.15 Submission of Due Diligence Certificate:

The lead merchant bankers, who is responsible for verification of the contents of aprospectus or the Letter of Offer in respect of an issue and the reasonableness of the views expressed therein, shall submit to the Board at least two weeks prior to the opening of the issue for subscription, a due diligence certificate in Form

3.16 Documents to be furnished to the Board:

The lead manager responsible for the issue shall furnish to the Board, the following documents

1. Particulars of the issue;
2. Draft prospectus or where there is an offer to the existing shareholders, the draft letter of offer;
3. Any other literature intended to be circulated to the investors, including the shareholders; and

4. Such other documents relating to prospectus or letter of offer as the case may be.

The documents shall be furnished at least two weeks prior to the date of filing of the draft prospectus or the letter of the offer, as the case may be, with the Registrar of Companies or with the Regional Stock Exchanges or with both. The lead manager shall ensure that the modifications and suggestions, if any, made by the Board on the draft prospectus or the Letter of Offer as the case may be, with respect to information to be given to the investors are incorporated therein.

3.17 Payment of fees to the Board:

The draft prospectus or draft letter of offer referred to in regulation 24 shall be submitted
along with such fees and in such manner as may be specified in Schedule IV.

Continuance of Association of Lead Manager:

The lead manager undertaking the responsibility for refunds or allotment of securities in respect of any issue shall continue to be associated with the issues till the subscriber have received the share or debenture certificates or refund of excess application money.

Where a person other than the lead manager is entrusted with the refund or allot of securities in respect of any issue the lead manager shall continue to be responsible for ensuring that such other person discharges the requisite responsibilities in accordance with the provisions of the Companies Act and the listing agreement entered into but the body corporate with the stock Exchange.

Acquisition of shares Prohibited: No merchant banker or any of its directors, partner manageror principal shall either on their respective accounts or through their associates or relative enter into transaction in securities of bodies corporate on the basis of unpublished price sensitive information obtained by them during the course of any professional assignment either from the clients or otherwise.

Information to the Board: Every merchant banker shall submit to the Board complete particulars of any transaction for acquisition of securities of anybody corporate whose issue is being managed by that merchant banker within fifteen days from the date of entering into such transaction.

Disclosures to the Board: A merchant banker shall disclose to the Board as and when required,
the following information:

1. His responsibilities with regard to the management of the issue; Any change in the information of particulars previously furnished, which have a bearing on the certificate granted to it;
2. The names of the body corporate whose issues he has managed or has been ass0oiciated with;
3. The particulars relating to breach of the capital adequacy requirement as specified in regulation 7;
4. Relating to his activities as a manager, underwriter, consultant or adviser to an issue as the case may be.

3.18 Appointment of Compliance Officer: Every merchant banker shall appoint a compliance officer who shall be responsible for monitoring the compliance of the Act, rules and regulations notifications, guidelines, instructions etc., issued by the board or the Central Government and for redressed of investors_ grievances. The compliance officer shall immediately and independently report to the Board any non-compliance observed by him and ensure that the observations made or deficiencies pointed out by the Board on/in the draft prospectus or the Letter of offer as the case may be, do not recur.

3.19 Procedure for Inspection Boards Right to inspect: The Board may appoint one or more persons as inspecting authority to undertake inspection of

the books of accounts, records and documents of the merchant banker for any of the purposes specified in sub-regulation(2).

The purposes referred to in sub-regulation (1) may be as follows:

1. To ensure that the books of account are being maintained in the manner required;

2. To ensure that the provisions of the Act, rules, regulations are being complied with;

3. To investigate into the complaints received from investors, other merchant bankers or any other person on any matter having a bearing on the activities of the merchant banker; and

4. To investigate suo-moto in the interest of securities business or investors interest in the affairs of the merchant banker.

3.20 Notice before Inspection:

Before undertaking an inspection under regulation 29 the Board shall give a reasonablenotice to the merchant banker for that purpose. Where the Board is satisfied that in the interest of the investors no such notice should be given, it may, by an order in writing directing that the inspection of the affairs of the merchant banker be taken up without such notice.

During the course of inspection, the merchant banker against whom an inspection is being carried out shall be bound to discharge his obligations as provided under regulation 31.

3.21 Obligations of Merchant Banker on Inspection:

It shall be the duty of every director, proprietor, partner, officer and employee of the merchant banker, who is being inspected, to produce to the inspecting authority such books, accounts and other documents in his custody or control and furnish him with the statements and information relating to his activities as a merchant banker within such time as the inspecting authority may require. The merchant banker shall allow the inspecting authority to have

reasonable access to the premises occupied by such merchant banker or by any other person on his behalf and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the merchant banker or any such other person and also provide copies of documents or other materials which, in the opinion of the inspecting authorityare relevant for the purposes of the inspection. The inspecting authority, in the course of inspection, shall be entitled to examine or record statements of any principal officer, director, partner, proprietor and employee of the merchant banker. It shall be the duty of every director, proprietor, partner, officer or employee of the merchant banker to give to the inspecting authority all assistance in connection with the inspection which the merchant banker may be reasonably expected to give.

3.22 Submission of Report to the Board:

The inspecting authority shall, as soon as possible submit, an inspection report to the Board.

3.23 Suspension of Registration

SEBI Regulations, 2002 published in the official Gazette of India dated 27.09.2002. A penalty for suspension of registration of a merchant banker may be imposed under the following circumstances:

• Where the merchant banker violates the provisions of the Act, rules or regulations; or

• Where the merchant banker fails to furnish any information relating to his activity as merchant banker as required by the Board; or furnishes wrong or false information, or does not submit periodical returns as required by the Board; or does not co-operate in any enquiry conducted by the Board; or

• Where the merchant banker fails to resolve the complaints of the investors or fails to give a satisfactory reply to the Board in this behalf; or

• Where the merchant banker indulges in manipulation or price rigging or cornering activities; or

• Where the merchant banker is guilty of misconduct or improper or unbusiness like or unprofessional conduct which is not in accordance with the Code of Conduct specified in Schedule III; or

• Where the merchant banker fails to maintain the capital adequacy requirement in accordance with provisions of regulation 7; or

• Where the merchant banker fails to pay the fees; or

• Where the merchant banker violates the conditions of registration; or

• Where the merchant banker does not carry out his obligations as specified in the regulation.

3.24 Cancellation or Registration

A penalty of cancellation of registration of a merchant banker may be imposed where;

• The merchant banker indulges in deliberate manipulation or price rigging or cornering activities affecting the securities market and the investor's interest;

• The financial position of the merchant banker deteriorates to such an extent that the Board is of the opinion that his continuance as merchant banker is not in the interest of investors;

• The merchant banker is guilty of fraud, or is convicted of a criminal offence;

• In case of repeated defaults of the nature mentioned in regulation 36 provided that the Board furnishes reasons for cancellation in writing.

3.24.1 Manner of Making Order of Suspension or Cancellation:

No order of penalty of suspension or cancellations the case may be shall be imposed except after holding an enquiry in accordance with procedure specified in regulation.

3.24.2 Manner of Holding Enquiry before Suspension or Cancellation:

For the purpose of holding an enquiry under regulation 38, the board may appoint an enquiry officer. The enquiry officer shall issue to the merchant banker a notice the registered office or the principal place of business of the merchant banker. The merchant banker may, within thirty days from the date of receipt of such notice, furnish to the enquiry officer a reply together with copies of documentary or other evidence relied on by him or sought by the Board from the merchant banker. The enquiry officer shall, give a reasonable opportunity or hearing to the merchant banker to enable him to make submissions in support of his reply made under subregulation (3). The merchant banker may either appear in person or through any duly authorized person. No lawyer or advocate shall be permitted to represent the merchant banker at the enquiry. Where a lawyer or an advocate has been appointed by the Board as a presenting officer under sub-regulation (6), it shall be lawful for the merchant banker to present its case through a lawyer or advocate. It is considered necessary that the enquiry officer may ask the Board to appoint a presenting officer to present its case. The enquiry officer shall, after taking into account all relevant facts and submissions made by the merchant banker, submit a report the Board and recommend the penalty to be imposed as also the grounds on the basis of which proposed penalty is justified.

3.24.3 Show case Notice and Order:

On receipt of the report from the enquiry officer, the Board shall consider the same and issue a show-cause notice as to why the penalty as proposed by the enquiry officer should not be imposed. The merchant banker shall within twenty-one days of the date of the receipt of the show-cause send a reply to the Board. The Board after considering the reply to the show-cause notice, if received, shall as soon as possible or not later than thirty days from the receipt of the reply, if any, pass such order as it deems fit. Every order passed under sub-regulation (3) shall be self-contained and give reasons for the conclusions stated therein including justification of the penalty imposed by that order. The Board shall send a copy of the order under sub-regulation (3) to the merchant banker.

3.25 Effect of Suspension and Cancellation:

On and from the date of the suspension of their merchant banker he shall cease to carry on any activity as a merchant banker during the period of suspension. On and from the date of cancellation the merchant banker shall with immediate effect cease to carry on any activity as a merchant banker. The order of suspension or cancellation of certificate passed under subregulation (3) of regulation 40 shall be published in at least two daily newspapers by the Board.

3.26 Appeals to the Securities Appellate Tribunal:

Any person aggrieved by an order of the board may, on and after the commencement of the /securities Laws (second amendment) Act, 1999, under these regulations may prefer an appeal to a Securities Appellate Tribunal having jurisdiction in the matter. Fees every merchant banker shall pay a sum of Rupees five lacks as registration fees at the time of the grant of certificate by the Board. The fee shall be paid by the merchant a banker within fifteen days from the date of receipt of the intimation from the Board under sub regulation (1) of regulation 8.

A merchant banker to keep registration in force shall pay renewal fee of Rs.2.5 lacs every three years from the fourth year from the date of initial registration. The fee shall be paid by the merchant banker within fifteen days from the date of receipt of intimation from the Board under sub-regulation (3) of regulation 9. The fees specified shall be payable by merchant banker by a demand draft in favor securities and Exchange Board of India‘ payable at Mumbai or at the respective regional office. Every Merchant banker shall pay registration fees as set out below:

1. Category I merchant banker; A sum of Rs. 2.5 lakhs to be paid annually for the first two years commencing from the date of initial registration and thereafter for the third year a sum of Rs. 1 lakh to keep his registration in force.

2. Category II merchant banker; A sum of Rs. 1.5 lakh to be paid annually for the first two years commencing from the date of initial registration and thereafter for the third year a sum of Rs. 50,000 to keep his registration in force.

3. Category III merchant bankers ; A sum of Rs.1 lakh to be paid annually for the first two years commencing from the date of initial registration and thereafter for the third year a sum of Rs.25,000 to keep his registration in force.

4. Category IV merchant bankers ; A sum of Rs.5,000/- to be paid annually for the first two years commencing from the date of initial registration and thereafter for the third year a sum of Rs.1000/- to keep his registration in force.

3.27 Renewal Fees:

1. Category I merchant bankers : A sum of Rs.1 lakh to be paid annually for the first two years commencing from the date of each renewal and thereafter for the third year a sum of Rs.20,000/-to keep his registration in force;

2. Category II merchant bankers : A sum of Rs.75,000/- to be paid annually for the first two years commencing from the date of each renewal and thereafter for the third year a sum of Rs.10,000/- to keep his registration in force

3. Category III merchant bankers : A sum of s.50,000/ to be paid annually for the first two years commencing from the date of each renewal and thereafter for the third year a sum of Rs.5,000/- to keep his registration in force

4. Category IV merchant bankers : A sum of Rs.5,000/- to be paid annually for the first two years commencing from the date of each renewal and thereafter for the third year a sum of Rs.2,500/- to keep his registration in force ; In addition, the merchant banker has to pay the following fees towards documentation

Size of the Issue	**Fee per Document (Rs.)**
Up to 5 crores	10,000
More than 5 crores and up to 10 crores	15,000
More than 10 crores and up to 50 crores	25,000
More than 50 crores and up to 100 crores	50,000
More than 100 crores and up to 500 crores	2, 50,000
More than 500 crores	5, 00,000

3.28 SEBI Regulations on merchant bankers:

SEBI has brought about a effective regulative measures for the purpose of discipliningthe functioning of the merchant bankers in India. The objective is to ensure an era of regulated financial markets and thus streamline the development of the capital market in India. The measures were introduced by the SEBI in the year 1992. The measures were revised by SEBI in
1997. The salient features of the regulative framework of merchant banking in India arediscussed below.

Registration of Merchant Bankers Application for Grant of Certificate

An application by a person for grant of a certificate shall be made to the Board in Form A. The application shall be made for any one of the following categories of the merchant banker namely:

1. Category I- To carry on any activity of the issue management, which will inter alliance consist of preparation of prospectus and other information relating to the issue, determining financial structure, tie-up of financiers and final allotment and refund of the subscription; and to act as adviser, consultant, manager, underwriter, portfolio manager.
2. Category II- To act as adviser, consultant, co-manager, underwriter, portfolio manager.
3. Category III- To act as underwriter, adviser, consultant to an issue.
4. Category IV- To act only as adviser or consultant to an issue. 5. With effect from 9th December, 1997, an application can be made only for carrying on the activities mentioned in category I. An applicant can carry on the activity as underwriter only if he contains separate certificate of registration under the provisions of Securities and Exchange Board of India (Underwriters) Regulations, 1993, and as portfolio manager only if he obtains separate certificate of registration under the provisions of Securities and Exchange Board of India (Portfolio Manager) Regulations, 1993.

5. Conformance to Requirements:Subject to the provisions of the regulations, any application, which not complete in all respects and does not conform to the instructions specified in the form, shall be rejected. However, before rejecting any such application, the applicant will be given an opportunity to remove within the time specified such objections and may be indicated by the board.

6. Furnishing of Information:The Board may require the applicant to furnish further information or clarification regarding matter relevant to the activity of a merchant banker for the purpose of disposal of the application. The applicant or its principal officer shall, if so required, appear before the Board for personal representation.

7. Consideration of Application: The Board shall take into account for considering the grant of a certificate, all matters, which are relevant to the activities relating to merchant banker and in particular whether the applicant complies with the following requirements;

1. That the applicant shall be a body corporate other than a non-banking financial company as defined by the Reserve Bank of India Act, 1934.
2. That the merchant banker who has been granted registration by the Reserve Bank of India to act as Primary or Satellite Dealer may carry on such activity subject to the condition that it shall not accept or hold public deposit.
3. That the applicant has the necessary infrastructure like adequate office space, equipments, and manpower to effectively discharge his activities.
4. That the applicant has in his employment minimum of two persons who have the experience to conduct the business of the merchant banker.
5. That a person (any person being an associate, subsidiary, inter-connected or group Company of the applicant in case of the applicant being a body corporate) directly or indirectly connected with the applicant has not been granted registration by the Board.
6. That the applicant fulfills the capital adequacy as specified.

7. That the applicant, his partner, director or principal officer is not involved in any litigation connected with the securities market which has an adverse bearing on the business of the applicant.
8. That the applicant, his director, partner or principal officer has not at any time been convicted for any offence involving moral turpitude or has been found guilty of any economic offence.
9. That the applicant has the professional qualification from an institution recognized by theGovernment in finance, law or business management.
10. That the applicant is a fit and proper person.
11. That the grant of certificate to the applicant is in the interest of investors.

8. Capital Adequacy Requirement:According to the regulations, the capital adequacy requirement shall not be less than the net worth of the person making the application for grant of registration. For this purpose, the net worth shall be as follows:

Category	**Minimum Amount**
Category I	Rs.5, 00, 00,000
Category II	Rs.50, 00,000
Category III	Rs.20, 00,000
Category IV	Nil

For the purpose of this regulation net worth means in the case of an applicant which is a partnership firm or a body corporate, the value of the capital contributed to the business of such firm or the paid up capital of such body corporate plus free reserves as the case may be at the time of making application.
Procedure for Registration:The Board on being satisfied that the applicant is eligible shall grant a certificate in Form B. On the grant of a certificate the applicant shall be liable to pay the fees in accordance with Schedule II.

Renewal of Certificate: Three months before expiry of the period of certificate, the merchant banker, may if he so desired, make an application for renewal in Form A. The application for renewal shall be dealt with in the same manner as if it were a fresh application for grant of a certificate. In case of an application for renewal of certificate of registration, the provisions of clause (a) of regulation 6 shall not be applicable up to June 30th, 1998. The Board on being satisfied that the applicant is eligible for renewal of certificate shall grant a certificate in form B and send intimation to the applicant. On the grant of a certificate the applicant shall be liable to pay the fees in accordance with Schedule II.

3.29 Procedure where Registration is not granted:

Where an application for grant of a certificate under regulation 3 or of renewal under regulation 9, does not satisfy the criteria set out in regulation 6, the Board may reject the application after giving an opportunity of being heard. The refusal to grant registration shall becommunicated by the Board within thirty days of such refusal to the applicant stating therein the grounds on which the application has been rejected. Any applicant may, being aggrieved by the decision of the Board, under sub regulation (1), apply within a period of thirty days from the date of receipt of such intimation to the Board for reconsideration for its decision. The Board shall reconsider an application made under sub-regulation (3) and communicate its decision as soon as possible in writing to the applicant.

3.30 Effect of Refusal to Grant Certificate:

Any merchant banker whose application for a certificate has been refused by the Board shall on and from the date of the receipt of the communication under sub-regulation (2) of regulation 10 cease to carry on any activity as merchant banker.

Payment of Fees:Every applicant eligible for grant of a certificate shall pay such fees insuch manner and within the period specified in Schedule II. Where a

merchant banker fails to any annual fees as provided in sub-regulation (1), read with Schedule II, the Board may suspend the registration certificate, whereupon the merchant banker shall cease to carry on any activity as
a merchant banker for the period during which the suspension subsists.

3.31 CODE OF CONDUCT FOR MERCHANT BANKERS

The SEBI regulations have outlined the following code of conduct for the merchant bankers operation in India;

• A merchant banker shall make all efforts to protect the interests of investors.

• A Merchant Banker shall maintain high standards of integrity, dignity and fairness in the conduct of its business.

• A Merchant Banker shall fulfill its obligations in a prompt, ethical, and professional manner.

• A Merchant Banker shall at all times exercise due diligence, ensure proper care and exercise independent professional judgment.

• A Merchant Banker shall Endeavour to ensure that enquiries from the investors are adequately dealt with, grievances of investors are redressed in a timely and appropriate manner, where a complaint is not remedied promptly, the investor is advised of any further steps which may be available to the investor under the regulatory system.

• A Merchant Banker shall ensure that adequate disclosures are made to the investors in a timely manner in accordance with the applicable regulations and guidelines so as to enable them to make a balanced and informed decision.

• A Merchant Banker shall endeavor to ensure that the investors are provided with true and adequate information without making any misleading or exaggerated claims or any misrepresentation and are made aware of the attendant risks before taking any investment decision.

• A Merchant Banker shall endeavor to ensure that copies of the prospectus, offer document, letter of offer or any other related literature is made available to the investors at the time of issueof the offer.

• A Merchant Banker shall not discriminate amongst its clients, save and except on ethical and commercial considerations.
• A Merchant Banker shall not make any statement, either oral or written, which would misrepresent the services that the Merchant Banker is capable of performing for any client or has rendered to any client.
• A Merchant Banker shall avoid conflict of interest and make adequate disclosure of its interest. • A Merchant Banker shall put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, shall take reasonable steps to resolve the same in an equitable manner.
• Merchant Banker shall make appropriate disclosure to the client of its possible source or potential areas of conflict of duties and interest while acting as Merchant Banker which would impair its ability to render fair, objective and unbiased services.
• A Merchant Banker shall always endeavor to render the best possible advice to the clients having regard to their needs.
• A Merchant Banker shall not divulge to anybody either oral or in writing, directly or indirectly, any confidential information about its clients which has come to its knowledge, without taking prior permission of its client, except where such disclosures are required to be made in compliance with any law for the time being in force.
• A Merchant Banker shall ensure that any change in registration status/any penal action taken by the Board or any material change in the Merchant Banker‗s financial status, which may adversely affect the interests of clients/investors is promptly informed to the clients and any business remaining outstanding is transferred to another registered intermediary in accordance with any instructions of the affected clients.
• A Merchant Banker shall not indulge in any unfair competition, such as weaning away the

clients on assurance of higher premium or advantageous offer price or which is likely to harm the interests of other Merchant Bankers or investors or is likely to place such other Merchant Bankers in a disadvantageous position while competing for or executing any assignment.

- A Merchant Banker shall maintain arm's length relationship between its merchant banking activity and any other activity.
- A Merchant Banker shall have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients, investors and other registered entities from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.
- A Merchant Banker shall not make untrue statement or suppress any material fact in any documents, reports or information furnished to the Board.
- A Merchant Bankers shall maintain an appropriate level of knowledge and competence andabide by the provisions of the Act, regulations made there under, circulars and guidance, which may be applicable and relevant to the activities carried on by it. The merchant banker shall also comply with the award of the Ombudsman passed under Securities and Exchange Board of India (Ombudsman) Regulations, 2003.
- A Merchant Banker shall ensure that the Board is promptly informed about any action, legal proceedings etc., initiated against it in respect of material breach or non-compliance by it, of any law, rules, regulations, directions of the Board or of any other regulatory body.
- A Merchant Banker or any of its employers shall not render, directly or indirectly, any investment advice about any security in any publicly accessible media, whether real-time, unless a disclosure of his interest including a long or short position, in the said security has beenmade, while rendering such advice. In the event of an employee of the Merchant Banker rendering such advice, the merchant banker shall ensure that such employee shall also disclose the interests,

if any, of himself, his dependent family members including their long or short position in the said security, while rendering such advice.

• A Merchant Banker shall demarcate the responsibilities of the various intermediaries appointed by it clearly so as to avoid any conflict or confusion in their job description.

• A Merchant Banker shall provide adequate freedom and powers to its compliance officer forthe effective discharge of the compliance officer's duties.

• A Merchant Banker shall develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in carrying out their duties. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance or resolution of conflict of interests, disclosure of shareholdings and interests etc.

• A Merchant Banker shall ensure that good corporate policies and corporate governance are in place.

• A Merchant Banker shall ensure that any person it employs or appoints to conduct business is fit and proper and otherwise qualified to act in the capacity so employed or appointed

• A Merchant Banker shall ensure that it has adequate resources to supervise diligently and does supervise diligently persons employed if appointed by it in the conduct of its business, in respect of dealings in securities market.

• A Merchant Banker shall be responsible for the acts or omissions of its employees and agents in respect of the conduct of its business.

• A Merchant Banker shall ensure that the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.

• A Merchant Banker shall not be a party to or instrumental for creation of false market; price rigging or manipulation; or passing of unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange to any person or intermediary in the securities market.

3.32 SEBI Guidelines

Operational Guidelines

SEBI has pronounced the following guidelines for merchant bankers:

1. Submission of offer document:

The offer documents of issue size up to Rs. 20 crores shall be filed by lead merchant bankers with the concerned regional office of the Board under the jurisdiction of which the registered office of the issuer company falls. The jurisdiction of regional offices/head office shall be as per Schedule XXII. According to Clause 5.6 of Chapter V of the Guidelines, the draft offer document filed with the Board shall be made public.

The lead merchant banker shall make available 10 copies of the draft offer document to the Board and 25 copies to the stock exchange(s) where the issue is proposed to be listed. Copies of the draft offer document shall be made available to the public by the lead merchant bankers/Stock Exchange. The lead merchant banker and the Stock Exchange(s) may charge a reasonable charge for providing a copy of the draft offer document. The lead merchant banker shall also submit to the Board the daft offer document on a computer floppy in the format specified in Schedule XXIII. The Lead Merchant Banker shall submit two copies of the printed copy of the final offer document to dealing offices of the Board within three days of filing offer document with Registrar of companies/concerned Stock Exchange(s) as the case may be.

The lead merchant banker shall submit one printed copy of the final offer document to the Primary Market Department, SEBI, Head Office, within three days of filing the offer document with Registrar of Companies/concerned Stock Exchange(s) as the case may be. The lead merchant banker shall submit a computer floppy containing the final prospectus/letter of offer to the Primary Market Department, SEBI, Head Office, as specified in Schedule XXIII within three days of filing the final prospects/letter of offer with the Registrar of Companies/concerned Stock Exchange(s). Along with the floppy, the lead

manager shall submit an undertaking to SEBI certifying that the contents of the floppy are in HTML, format, and are identical to the printed version of the proposes/letter of offer filed with the registrar of Companies/concerned Stock Exchange, as the case may be. Wherever offer documents (for public/rights issues, takeovers or for any other purpose) are filed with any Department/Office of the Board, the following details —certified as correct shall be given by the lead merchant banker in the forwarding letters:

a. Registration number

b. Date of registration/Renewal of registration

c. Date of expiry of registration

d. If applied for renewal, date of application

e. Any communication from the Board prohibiting them from acting as a

f. merchant banker

g. Any inquiry/investigation being conducted by the Board

h. Period up to which registration/renewal fees has been paid

i. Whether any promoter/group and/or associate company of the issuer company is associated with securities-related business and registered with SEBI

j. If any one or more of these persons/entities are registered with SEBI, their respective registration numbers

k. If registration has expired, reasons for non-renewal

l. Details of any enquiry/investigation conducted by SEBI at any time

m. Penalty imposed by SEBI

n. Outstanding fees payable to SEBI by these entities, if any Offer documents not accompanied by the information as contained above may be rejected. Lead merchant bankers shall obtain similar information from other intermediaries to ensure that they comply with these guidelines and are eligible to be associated with the concerned issue. The intermediaries shall also indicate in their letters that they have obtained such information from other intermediaries.

2. Dispatch of issue material:

Lead merchant bankers shall ensure that whenever there is a reservation for NRIs, 10copies of the prospectus together with 1000 application forms are dispatched in advance of the issue opening date, directly along with a letter addressed in person to Adviser (NRI), IndianInvestment Centre, JeevanVihar Building SansadMarg, and New Delhi. Twenty copies of the prospectus and application forms shall be dispatched in advance of the issue opening date to the various Investors Associations.

3. Underwriting while selecting underwriters and finalizing underwriting arrangement, lead merchant bankers shall ensure that the underwriters do not overexpose themselves so that it becomes difficult to fulfill their underwriting commitments.

The overall exposure of underwriter(s) belonging to the same group or management in an issue shall be assessed carefully by the lead merchant banker. OTC Dealers registered with the Board under SEBI (Stock Brokers and Sub-Brokers) Rules and Regulations, 1992 shall be treated at par with the brokers of other stock exchanges in respect of underwriting arrangement.

4. Compliance obligations: The merchant banker shall ensure compliance with the followingpost-issue obligations

a. Association of resource personnel: In terms of Clause 7.1 of Chapter VII of these Guidelines, in case of over-subscription in public issues, a Board nominated public representative shall be associated in the process of finalization of the basis of allotment. The lead merchant banker shall intimate to the person so nominated the date, time, venue etc. regarding the process of finalization of the basis of allotment. The expenses of the public representatives associated in the allotment process of oversubscribed issues shall be borne by the lead merchant bankers, and recovered from the issues. Honorarium at a minimum of Rs.500/- per day,

plusnormal conveyance charges shall be paid to them, and the Board's Regional Managers at New Delhi, Chennai and Calcutta shall be associated with them.

b. Redressal of investor grievances: The merchant bankers shall assign high priority to investor grievances, and take all preventive steps to minimize the number of complaints. The lead merchant banker shall set up a proper grievance monitoring and redressal system in coordination with the issuers and the Registrars to Issue.. They shall take all necessary measures to resolve the grievances quickly. They shall actively associate with post-issue refund and allotment activities and regularly monitor investor grievances arising there from.

c. Submission of post issue monitoring reports: The concerned lead merchant banker shall submit, in duplicate, the Post Issue Monitoring Reports specified in Clause 7.2 of Chapter VII of these Guidelines, within 3 working days from the due dates, either by registered post or deliver them at the respective regional offices/head office give in Schedule XXII. Where the offer documents have been dealt with by any of the regional offices of the Board, a copy of the report shall be sent to the Board's Head office, Mumbai. The Lead Merchant Banker(s) shall informthe Board on important developments about the particular issues being lead managed by them during the period intervening the reports.

d. Issue of No objection Certificate (NOC): In accordance with the Listing Agreement of the Stock Exchanges, the issuer companies shall deposit 1% of the amount of securities offered to the public and/or to the holders of the existing securities of the company, as the case may be, with the regional Stock Exchange. These securities can be related by the concerned Stock Exchange only after obtaining an NOC from the Board. An application for NOC shall be submitted by the issue company to the Board in the format specified in Schedule XXIV. The following conditions shall be complied with before submitting the application for the issue of NOC.

• Completion of 4 months from the date of obtaining the listing permission from the concerned Regional Stock Exchange, or the last date when the listing

permission was obtained from any ofthe other Stock Exchanges, where the securities are proposed to be listed, whichever is later

• Satisfactory Redressal of all complaints received by the Board against the company

• Certificate from the Regional Stock Exchange to the issuer company to the effect thatunderwriting/brokerage commission as well as the Registrars/Lead merchant bankers fees been duly paid by the company.

Application for issue of NOC shall be filed with the concerned regional office of the Board, under the jurisdiction in which the registered office of the issuer company falls, as specified in Schedule XXII.. In cases where issues fail, and the investors' monies are fully refunded, an NOC from the Board may not be required, and the concerned regional Stock Exchange can refund the 1% security deposit after duly verifying that the refund orders have actually been dispatched. The complaints with respect to non-receipt of underwriting/brokerage commission and Registrars/Lead merchant banker's fees may be filed with the concerned regional Stock Exchanges. Responses to complaints forwarded by the Board to the concerned companies shall be submitted to the Board in the proforma specified in Schedule XXV for updating of records.

e. Registration of merchant bankers: Application for renewal of Certificate of Registration shall be made by the merchant bankers according to Regulation 9 of SEBI (Merchant Bankers) Rules and Regulations, 1992. While filing the renewal application for the certificate of registration as merchant banker, it shall provide a statement highlighting the changes that have taken place in the information that was submitted to the Board for the earlier registration, and a declaration stating that no other changes besides those mentioned in the above statement have taken place. Merchant Bankers, while forwarding the renewal application in Form A of the SEBI (Merchant Bankers) Rules and Regulations, 1992, shall also forward the additional information as specified in Schedule XXVI. Registered Merchant

Bankers shall inform the Board of their having become a member of AMBI, with the relevant details.

f. Reporting requirements: In terms of Regulation 28 of SEBI (Merchant Bankers Regulation) 1992, the merchant bankers shall send a half yearly report, in the format specified in Schedule XXVII, relating to their merchant banking activities. The report referred to in sub-clause (a) shall be submitted twice a year, on March 31 and September 30, and it should reach the Board withinthree months from the close of the period to which it relates.

g. Impositions of penalty points: Penalty points may be imposed on the merchant banker for violation of any of the provisions for operational guidelines. The merchant banker, on whom penalty points of four or more has been imposed, may be restrained from filing any offer document or associating or managing any issues for a particular period. The Board may initiate action under the SEBI (Merchant Bankers) Regulations against the merchant bankers, irrespective of whether any penalty point is imposed or not. Imposition of penalty point is not a precondition for initiation of proceedings against the merchant banker under the SEBI (Merchant Bankers) Regulations.

Guidelines on Advertisement Following are the guidelines applicable to the lead merchant banker who shall ensure due compliance by the issuer company:

1. Factual and truthful: An issue advertisement shall be truthful, fair and clear, and shall notcontain any statement that is untrue or misleading. Any advertisement reproducing, or purportingto reproduce, any information contained in an offer document shall reproduce such information in full and disclose all relevant facts. It should not be restricted to select extracts relating to that item. An issue advertisement shall be considered to be misleading, if it contains:

a. Statements made about the performance or activities of the company in the absence of necessary explanatory or qualifying statements, which may give an exaggerated picture of the performance or activities.

b.An inaccurate portrayal of past performance, or its portrayal in a manner which implies that past gains or income, will be repeated in the future.

2. Clear and concise: An advertisement shall be set forth in a clear, concise and understandable language. Extensive use of technical, legal terminology or complex language and the inclusion ofexcessive details, which may distract the investor, shall be avoided.

3. Promise or profits: An issue advertisement shall not contain statements which promise or guarantee rapid increase in profits. An issue advertisement shall not contain any information that is not contained in the offer document.

4. Mode of advertising: No models, celebrities, fictional characters, landmarks, caricatures or the likes shall be displayed on or form part of the offer documents or issue advertisements. Issue advertisements shall not appear in the form of crawlers (the advertisements which run simultaneously with the program in a narrow strip at the bottom of the television screen) ontelevision. Similarly, no advertisement shall include any issue slogans or brand names for theissue, except the normal commercial name of the company or commercial brand names of its products already in use. No slogans, expletives or non-factual and unsubstantiated titles shall appear in the issue advertisements or offer documents.

5. Financial data: If any advertisement carries any financial data, it shall also contain data for
the past three years and shall include particulars relating to sales, gross profit, not profit, share capital, reserves, earnings per share, dividends, and book values.

6. Risk factors: All issue advertisements carried in the print media such as newspapers, magazines, brochures or, pamphlets shall contain highlights relating to any issue, besides containing detailed information on the risk factors. The print size of highlights and risk factors inissue advertisements shall not be less than point 7 sizes. It shall contain the names of Issuer Company, address of its registered office, names of the main lead merchant bankers and Registrars to the Issue. No issue advertisement shall be released without giving ―Risk Factors in

respect of the concerned issue, provided that an issue opening/closing advertisement which does not contain the highlights need not contain risk factors.

7. Issue date No corporate advertisement of Issuer Company shall be issued after 21 days of filing of the offer document with the Board until the closure of the issue, unless the risk factors which are required to be mentioned in the offer document, are mentioned in the advertisement.

8. Product advertisement No product advertisement of the company shall contain any reference, directly or indirectly, to the performance of the company during the period.

9. Subscription No advertisement shall be issued stating that the issue has been fully subscribed or oversubscribed during the period the issue is open for subscription, except to the effect that the issue is open or closed.

10. Issue closure No announcement regarding closure of the issue shall be made except on the closing date. If the issue is fully subscribed before the closing date stated in the offer document, the announcement should be made only after the issue is fully subscribed and such announcement is made on the date on which the issued is to be closed. Announcements regarding closure of the issue shall be made only after the lead merchant banker is satisfied that at least 90% of the issue has been subscribed, and a certificate has been obtained to that effect from the Registrar to the issue.

11. Incentives No incentives, apart from the permissible underwriting commission and brokerage, shall be offered through advertisements to anyone associated with marketing theissue.

12. Reservation In case there is a reservation for NRIs, the issue advertisement shall specify the same, and also indicate the place in India from where the individual NRI applicant can procure application forms.

13. Undertaking: An undertaking has to be obtained from the issuer as part of the MoU between the lead merchant banker and the issue company to the effect that the issuer company shall not directly or indirectly release, during any

conference or at any other time, any material or information which is not contained in the offer documents.

14. Availability of copies: To ensure that the issuer company obtains approval for all issue advertisements and publicity materials from the lead merchant banker responsible for marketing the issue and also ensure the availability of copies of all issue related materials with the lead merchant banker, at least until the allotment is completed by the SEBI.

3.33 STOCK EXCHANGES:

• It is the market for exchange of stocks.

• Stock refers to the old securities i.e., those which have been already issued and listed on a stock exchange.

• These securities are purchased and sold continuously among investors without the involvement of companies.

• Stock exchange provides not only free transferability of shares but also makes continuous evaluation of securities traded in the market.

It is also called a Secondary Market‘ for securities. It is considered to be sine- quinoa for the primary market. In fact, the success of the issues taking place in the primary market depends much on the soundness and the depth of the secondary market. It provides the investor, the facility of disposing off their holdings as and when the need for it arises.

According to Hastings, Stock exchange or securities market comprises all the places where buyers and sellers of stocks and bonds or their representatives undertake transactions involving the sale of securities.

According to Section 2(3) of the Securities Contract Regulation Act 1956.bThe stock exchange has been defined as anybody of individuals whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities.

The following securities can be traded at the stock exchange a. Shares, scrip‘s, stock,bonds, debentures, debentures stocks or other marketable securities

of a like nature in or of any incorporated company or other body corporate b. Government securities; and c. Rights or interests in securities

3.34 Objectives of Stock Exchanges

The Objectives of stock exchanges are

1. Assisting in buying and selling of securities
2. Regulating the business of buying and selling or dealing in securities.

3.35 Functions of Stock Exchanges

The stock market occupies a pivotal position in the financial system. It performs several economic functions and renders invaluable services to the investors, companies, and to the economy as a whole. They may be summarized as follows:

1. Liquidity and marketability of Securities:

Stock exchanges provide liquidity to securities since securities can be converted into cash at any time according to the discretion of the investor by selling them at the listed prices. They facilitate buying and selling of securities at listed prices by providing continuous marketability to the investors in respect of securities they hold or intend to hold. Thus, they create a ready outlet for dealing in securities.

2. Safety of Funds:

Stock exchanges ensure safety of funds invested because they have to function under strict rules and regulations and the bye laws are meant to ensure safety of investible funds. Over trading, illegitimate speculation etc., are prevented through carefully designed set of rules. This would strengthen the investor's confidence and promote larger investment.

3. Supply of Long term funds:

The Company is assured of long term availability of funds because the security is transacted one investor is substituted by another.

4. Flow of Capital to Profitable Ventures:

The profitability and popularity of companies are reflected in stock prices. The prices quoted indicate the relative profitability and performance of companies.

Funds tend to be attracted towards securities of profitable companies and this facilitates the flow of capital into profitable channels.

5. Motivation for improved performance:

The performance of a company is reflected on the prices quoted in the stock market. These prices are more visible in the eyes of the public. Stock market provides room for this price quotation for those securities listed by it. This public exposure makes a company conscious of its status in the market and it acts as a motivation to improve its performance further.

6. Promotion of Investment:

Stock exchanges mobilize the savings of the public and promote investment through capital formation. But for these stock exchanges, surplus funds available with individuals and institutions would not have gone for productive and remunerative ventures.

7. Reflection of Business Cycle:

The changing business conditions in the economy are immediately reflected on the stock exchanges. Booms and depressions cane be identified through the dealings on the stock exchanges and suitable monetary and fiscal policies can be taken by the government. Thus a stock market portrays the prevailing economic situation instantly to all concerned so that suitable actions can be taken.

8. Marketing of New Issues:

If the new issues are listed, they are readily acceptable to the public, since, listing presupposes their evaluation by concerned stock exchange authorities. Costs of underwriting such issues would be less. Public response to such new issues would be relatively high. Thus, a stock market helps in the marketing of new issues also.

9. Miscellaneous Services:

Stock exchange supplies securities of different kinds with different maturities and yields. It enables the investors to diversity their risks by a wider portfolio of investment. It also inculcates saving habits among the community and paves the ways for capital formation.

It guides the investors in choosing securities by supplying him daily quotation of listed securities and by disclosing the trends of dealings on the stock exchange. It enables companies and the Government to raise resources by providing a ready market for their securities.

Organization of Stock Exchanges:

The first organized stock exchange in India was started in Bombay in 1875 with the formation of the ‗Native share and Stock Brokers Association‗. Thus the Bombay Stock Exchange is the oldest one in the country. With the growth of Joint stock companies, the stock exchanges also made a steady growth and at present these are 23 recognized stock exchanges with about 6000 stock brokers.

3.36 Traditional Structure of stock Exchanges

The stock exchanges in India can be classified into two broad groups on the basis of their legal structure. They are;

1. Three stock exchanges which are functioning as association of person‗s viz., BSE, ASE and Madhya Pradesh Stock Exchange.

2. Twenty stock exchanges which have been set up as companies, either limited by guarantees or by shares. They are

- ❖ Bangalore Stock Exchange
- ❖ Bhubaneswar Stock exchange
- ❖ Calcutta Stock Exchange
- ❖ Cochin Stock Exchange
- ❖ Coimbatore Stock Exchange
- ❖ Delhi Stock Exchange
- ❖ Gauhati Stock Exchange
- ❖ Hyderabad Stock Exchange
- ❖ Interconnected Stock Exchange
- ❖ Jaipur Stock Exchange
- ❖ Ludhiana Stock Exchange
- ❖ Madras Stock Exchange
- ❖ Magadh Stock Exchange

- ❖ Mangalore Stock Exchange
- ❖ National Stock Exchange
- ❖ Pune Stock Exchange
- ❖ OTCEI

3.37 Demutualization of Stock Exchanges

• The transition process of an exchange from a mutually-owned association to a company owned by Shareholders‖ is called demutualization.

• Demutualization is transforming the legal structure, of an exchange from a mutual form to a business corporation form. In a mutual exchange, the three functions of ownership, management and trading are intervened into a single group. It means that the broker members of the exchange are owners as well as traders on the exchange and further they themselves manage the exchange.

These three functions are segregated from one another after demutualization.

The demutualised stock exchanges in India are;

1. The National Stock Exchange (NSE)
2. Over the Counter Exchange of India (OTCEI)

Corporatization of Stock Exchanges

The process of converting the organizational structure of the stock exchange from a non-corporate structure to a corporate structure is called Corporatization of stock exchanges. Asstated earlier, some of the stock exchanges were established as ―Association of persons in India like BSE, ASE and MPSE. Corporatization of these exchanges is the process of converting them into incorporated companies.

Management:

The recognized stock exchanges are managed by ― Governing Boards‗. The governing boards consist of elected member directors from stock broker members, public representatives and government nominees nominated by the SEBI.

The government has also powers to nominate Presidents and Vice-presidents of stock exchanges and to approve the appointment of the chief Executive and public representatives. The major stock exchanges are managed by the Chief Executive Director and the smaller stock exchanges are under the control of a Secretary.

Membership:

To become a member of a recognized stock exchange, a person must possess the following qualifications:

- He should be a citizen of India,
- He should not be less than 21 years of age,
- He should not have been adjudged bankrupt or insolvent,
- He should not have been convicted for an offence involving fraud or dishonesty,
- He should not be engaged in any other business except dealing in securities,
- He should not have been expelled by any other stock exchange or declared a defaulter by any other stock exchange.

3.38 Methods of Trading in a Stock Exchange:

The stock exchange operation at follow level is highly technical in nature. Nonmembers are not permitted to enter into the stock market. Hence, various stages have to be completed in executing a transaction at a stock exchange. The steps involved in the methods of trading have been given below:

1. Choice of Broker:

The prospective investor who wants to buy shares or the investor who wants to sell his shares cannot enter into the hall of exchange and transact business. They have to act through only member brokers. They can also appoint their bankers for this purpose, since; bankers can become members of the stock exchange as per the present regulations. So, the first task in transacting business on a stock exchange is to choose a broker of repute or a banker. Such persons alone can ensure prompt and quick execution of a transaction at the best possible and profitable price.

2. Placement of Order:

Placement of order refers to the purchase or sale of securities with the broker. The order is usually placed by telegram, telephone, letter, fax etc., or in person.

3. Execution of Orders:

The Orders are executed through their authorized clerks. Small one carries out their business personally. Orders are executed in Trading ring of a stock exchange which works from 12 noon to 2 p.m. on all working days from Monday to Friday and a special one hour session on Saturday. Trading outside the trading hours is called kerb dealings.

(1) Preparation of Contract Notes:

A contract note is a written agreement between the broker and his client for the transactions executed. It contains the details of the contract made for the purchase/sale of securities, the brokerage chargeable, name of the company, number of shares bought/ sold, net rate, etc., it is prepared in a prescribed from and a copy of it is also sent to the client.

(2) Settlement of Transactions:

The settlement of transactions is made by means of delivering the share certificates along with the transfer deed. The transfer deed is duly signed by the transferor, i.e., the seller. It bears the stamp of the selling broker. The buyer then fills up the particulars in the transfer deed. At present, the settlement can be made by any one of the following methods;

- **Spot delivery settlement:**i.e., the delivery of securities and payment for these are affected on the date of the contract itself or on the next day.
- **Hand Delivery Settlement:**i.e., the delivery of securities and payment are affected within the time stipulated in the agreement or within 14 days from the date of the contract whichever is earlier.
- **Clearing Settlement:**i.e., the transactions are cleared and settled through the clearing house. Usually those securities which are frequently traded and are usually in demand are cleared through the clearing house. These transactions are also referred to as the transaction for the account.

• **Special Delivery Settlement:**i.e., the delivery of securities and payment may take place at any time exceeding 14 days following the date of the contract as specified in the contract and permitted by the governing board.

3.39 ONLINE TRADING

• It is the trading over the net i.e., E-trading

To overcome the wastage of time consumed and inefficient operations of the traditional method and the limits on trading volumes the NSE has introduced a nation-wide on line fully automated Screen Based Trading System (SBTS). Now, other stock exchanges have been forced to adopt SBTS and today India can boast that almost 100% trading take place through electronic order matching. Under SBTS, a member can punch into the computers quantities of securities and the prices at which he likes to transact the transaction. It is executed as soon as it finds a matching sale or buys order from a counter party; Thus, technology is used to carry the trading platform from the trading hall of the exchanges to the premises of the brokers. NSE has carried the trading platform further to the PCs at the residence of the investors through the internet and the hand held devices through WAP for the convenience of the mobile investors. This system also provides complete market information on-line. The market screens at any point of time provide complete information as to

(1). Total order depth in a security

(2). The best five buys and sells in the market

(3). The quantity traded during the day in that security

(4). The high and the low price for each security

(5). The last traded price for a security etc.,

3.40 BSE BOLT SYSTEM:

Bombay on line Trading (BOLT) has been introduced in the Bombay Stock Exchange. All the scrip‘s are being traded through BOLT. Many small companies in India are finding it difficult to rise adequate capital through stock exchanges as the conditions stipulated by them could not be fulfilled.

The companies must have run for minimum three years and they must have earned profit and the minimum capital requirement for listing is also quite high which is at present is Rs.5 Crores. Hence, promoting a new stock exchange with flexible conditions, the small and medium companies in India will be able to raise sufficient capital, once these companies enlarge their resources, they can list themselves in the regular stock exchanges.

3.41 OTCEI (Over the Counter Exchange of India)

It is a Stock Exchange without proper trading floor all stock exchanges have a specific place for trading their securities through counters. But, OTCEI is connected through a computer network and the transactions are taking place through computer operations. Thus, the development in information technology has given scope for starting this type of stock exchange.

This stock exchange is recognized under the Securities Contract (Regulation) Act and so all the stocks listed in this exchange enjoy the same benefits as other listed securities enjoy.

OTCEI has been incorporated under Section 25 of the companies Act. As a result of which the word limited‘need not be used since it is promoted for a common case of promoting the interest of small and medium companies. This privilege has been given to the company by the Central government. This company was promoted by a group of financial institutions owned by Government of India, consisting of UTI, ICICI, IDBI, SBI Capital Market, IFCI, LIC, GIC and CAN BANK financial Services.

FEATURES OF OTCEI

(1) Use of Modern Technology: It is an electronically operated stock exchange.

(2) Restrictions for other stocks: Stocks and shares listed in other stock exchanges will not be listed in the OTCEI and similarly, stock listed in OTCEI will not be listed in other stock exchanges.

(3) Minimum issued capital requirements: Minimum issued equity capital should be Rs.30 lakhs, out of which minimum public offer should be Rs.20 lakhs.

(4) Restrictions for large companies: No company with the issued equity share capital of more than Rs.25 crores is permitted for listing.

(5) Base Capital requirement for members: Members will be required to maintain a minimumbase capital of Rs. 4 lakhs to trade on the permitted or on listed segment.

(6) All India network: The network of counters links OTCEI members, located in different parts of the country.

(7) Satellite facility: The satellite required for OTCEI for its operations is jointly held with Press

Trust of India

(8) Computerization of transactions: Computers at each counter enable the dealers to enter various transactions or queries or quotes through a central OTCEI computer, using telecommunication links.

Objectives of OTCEI:

The following are the objectives of OTCEI

1. Assisting and guiding small companies to raise funds from the capital market in a costeffective manner
2. Providing a convenient and an efficient avenue of capital market investments for smallinvestors
3. Strengthening investors 'confidence in the financial market by offering them the two-way best prices to them
4. Ensuring transparency, redressing investor's complaints and unifying the country's securities market to cover even those places which do not have a stock exchange
5. Acting as a launch pad to an IPO
6. Providing liquidity advantage to the securities traded
7. Promoting organized trading in Unlisted Securities
8. Providing a source of valuation for securities traded OTCEI offers the following benefits:

3.42 Benefits to Listed Companies

The benefits that are offered to companies listed with OTCEI are as follows:

1. Negotiability: The Company can negotiate the issue price with the sponsors who have to market the issue. It provides an opportunity for fair pricing of an issue through negotiation with the sponsors.

2. Fixation of premium: In consultation with the sponsors, the company can fix an optimum level of premium on issue with minimum risk of non-subscription of the issue.

3. Savings in costs: Lots of costs associated with public issue of capital are saved through this mode. It provides an opportunity to companies to raise funds through capital market instruments at an extremely low cost as compared to a public issue. The method of sponsors placing the scrip's with members who in turn will offload the scrip's to public will obviate the need for a public issue and its associated costs.

4. No take-over threat: OTCEI lists scrip's even with 40 percent of the capital offered for public trading. The limit has now been brought down to 20 percent in the case of closely held companies and new companies. As a result, the present management of the companies is saved of threats of takeover if they restrict public offer.

5. Large access: Accessing a large pool of captive investor base through the OTCEIs computerized network is made possible for companies. Though nationwide network for servicingof investors, companies listed on OTC Exchange can have a larger investor base.

6. Other benefits:

a. Helpful to small companies

b. Shares of all unlisted companies can now be traded on OTCEI

c. Platform for issuers and first-level investors like financial institutions, state level financial corporations, Foreign Institutional Investors, etc.

d. System for defining benchmark for securities

e. Increasing business for the market constituents

Benefits to Investors

OTCEI offers the following benefits for investors:

1. Safety: OTCEIs ring less and scrip less electronic trading ensure safety of transactions of the investor. For instance, every investor in a OTCEI is given an Invest-OTC-Card free. This code is allotted on a permanent basis and should be used in all OTC transactions and applications of OTC issues. This card provides for the safety and security of the investors investments. The mechanism offers greater security to investors as the sponsors investigate into the company and he projects, before accepting sponsorship thus building up much needed greater investor confidence.

2. Transparency: OTC screens at every OTC counter display the best buy/sell prices. The exact trading prices are printed in the trading documents for confirmations. This protects the investor interest and there by minimize disputes.

3. Liquidity: A great advantage of the OTC is that the scrip‘s traded are liquid. This is because there are at least two market-makers who indulge in continuous buying and selling. This enables investors to buy and sell the scrip‘s any time.

4. Appraisal: OTC members sponsor each scrip listed in an OTC counter. The sponsor makes an appraisal of the scrip‘s for investor worthiness. This ensures quality of investments.

5. Access: Every OTC counter serves as a single window to the entire OTC exchange throughout the country and throughout the world too. Therefore, buying and selling may be resorted to from any part of the world. It offers the facility of faster deal settlement for investors across the counters spread over the entire country.

6. Transfer: It is important that OTC shares are transferable within 7 days, where theconsolidated holdings of the scrip‘s do not exceed 0.5 percent of the issued capital of the company.

7. Allotment: There is not much waiting for the investors when it comes to allotment of scrip‘s. Allotment is completed in all respects within a matter of 35 days and trading begins immediately thereafter.

8. Other benefits:(a.) Derivatives such as futures and options, forward contracts on stock, and other forms of forward transactions and stock lending are allowed on OTCEI (b.) Scrip less trading makes dealings simper and easier (c.) Market-making system in OTC Exchange gives sufficient opportunities for the investors to exit (d.)Acts as a benchmark to value securities (e.)Creating an exit option for illiquid stocks/venture capitalists (f.) Shuffling portfolios for the investors (g.) Organizing and broad-basing trading in the existing market

Benefits to Financial System

The OTCEIs role has been laudable in as far as it helps contribute improving the financial system of India in the following ways:

1. National network of OTCEI operations facilitates the integration of capital market in the country.
2. Boon to closely-held companies as they are encouraged to go public because scrip's can be listed even if only 40 percent of capital (now a minimum of 20 percent in case of closely held and new companies) is offered for public trading.
3. Facilities wider dispersal of economic activities by encouraging small companies and small investors.
4. Promoting savings and investments by offering easier avenues for raising capital.
5. Providing over-all stimulation to venture capital activities thereby promoting entrepreneurship.
6. Market-making assistance by the sponsors on the OTCEI that helps in making appraised future projections in the issue documents which in turn helps prospective investors in determining the usefulness of the issues for investment purposes, promoting investment environment in general.
7. Those members of the OTCEI who did not have multiple memberships can now have an opportunity to trade in some of the large capital index stocks.
8. Encourage venture capital activities and boost entrepreneurship
9. Spread of stock exchange operations geographically all over India

Securities Traded Following are the securities that are traded on the OTCEI:

1. Listed equity (exclusive): These are equity shares of the companies listed exclusively on the OTCEI. The shared can be bought or sold at any of the member/ dealer's office all over India.

The securities, which are listed exclusively on the OTCEI, cannot be traded on other stock exchanges.

2. Listed debt: These are the debentures/bonds that are issued through a public issue or a private placement and are listed on OTCEI. Any entity holding the entire series of a particular debt instrument can also offer them for trading on the OTCEI, by appointing an OTCEI member/dealer to carry out compulsory market making in those securities.

3. Gilts: The securities issued by the Central and State Governments are called gilts. Government of India Dated Securities, Treasury Bills and special securities are traded in this segment. Banks, Foreign Investors, Foreign Institutional Investors, NBFCs and Provident Fundscan trade in these securities through OTCEI designated members/dealers. PSU Bonds, Commercial Paper, and Certificates of Deposit will also be traded in this segment.

4. Permitted securities: These are the securities listed on other exchanges, which are permitted for trading on OTCEI. Securities of Blue Chip companies like ACC, Reliance Industries Ltd., State Bank of India, ITC, etc. are traded in this segment.

5. Listed mutual funds: Listed mutual funds are units of mutual funds that are listed on OTCEI. Mutual fund units like units of Unit-64, Monthly Income Plan, and IISFUS 97 are also listed under this category. To counter the influence of Bombay Stock Exchange and reduce the influence of certain powerful intermediaries in the stock market.

A new stock market waspromoted in which both securities of companies and debt instruments are traded, namely the National Stock Exchanges. NSE takes into account the screen based trading and so it is the most advanced. The success of this stock exchange is quite evident that within a few years of its promotion the volume and the value of transactions have surpassed the BSE.

3.43 Conclusion

The Securities Contract (Regulation) Act, 1956 deals with stock exchanges, contracts in securities, and listing of securities on stock exchanges, and keeps a vigil over all the stock exchanges of India and prevents undesirable contracts in Securities market through a process of recognition and continued supervision.

Questions

1. Define SERA?
2. List out the recognized stock exchanges?
3. Explain the general obligations and responsibilities of merchant banker.
4. State SEBI regulations on merchant bankers.
5. State the Code of conduct for merchant banker.
6. Explain the Guidelines of SEBI for merchant banker.
7. What is stock exchange? State the objectives of stock exchange.
8. What is secondary market?
9. What are the functions of stock exchange?
10. What are the Traditional structure of stock exchange
11. What is Demutualization of stock exchange ?
12. Who will be the members of recognized stock exchange
13. What are the Methods of trading in a stock exchange?
14. What is online trading?
15. What is BSE BOLT system?
16. What is OTCEI? State the features and objectives of OTCEI.
17. What are the benefits that are offered to companies listed with OTCEI
18. What are the benefits of investors in OTCEI?
19. Explain the benefits of financial system by OTCEI.
20. List out the Securities that are traded on OTCEI

UNIT – II

CHAPTER – 4

4.1 Introudction

4.2 Merchant bankers and capital issues management

4.3 Merchant bankers functions

4.4 Factors affecting capital structure decisions

4.5 Capital market instruments

4.6 Types of capital market instruments

4.7 Kinds of debentures

4.8 Issue pricing

4.9 Book building

4.10Advantages of book building

4.11 Conclusion

ROLE OF MERCHANT BANKING IN APPRAISAL OF PROJECTS

4.1 Introduction

Merchant Banking, as a commercial activity, took shape in India through the management of Public Issues of capital and Loan Syndication. It was originated in 1969 with the setting up of the Merchant Banking Division by ANZ Grind lays Bank. The main service offered at that time to the corporate enterprises by the merchant banks included the management of public issues and some aspects of financial consultancy.

The early and mid-seventies witnessed a boom in the growth of merchant banking organizations in the country with various commercial banks, financial institutions, and broker‘s firms entering into the field of merchant banking. Reform measures were initiated in the capital market from 1992, starting with the conferring of statutory powers on the Securities and Exchange Board of India (SEBI) and the repeal of Capital Issues. Control Act and the abolition of the office of the Controller of Capital Issue.

4.2Merchant Bankers and Capital Issues Management

Merchant Banker has been defined under the Securities & Exchange Board of India (Merchant Bankers) Rules, 1992 as any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering corporateadvisory service in relation to such issue management.

The capital issue management comprises of the effective management of market related factors. They are:

- Transition to rolling settlement on the equity market
- Impact on different classes of market users
- Obtaining a liquid bond market
- Impact of reforms of 1990s
- Law and taxation
- Taxation of capital
- Legal reforms
- Politicaleconomy of financial sector reforms
- Market design, market inefficiencies, and trading profits.

Issue Management

The management of issues for raising funds through various types of instruments by companies is known as issue management. The function of capital issues management in India is carried out by merchant bankers. The Merchant Bankers have the requisite skill and competence to carry out capital issues management. The funds are raised by companies to finance new projects, expansion / modernization/ diversification of existing units etc.

The definition of merchant banker as contained in SEBI (Merchant Banker) Rules and Regulations, 1992 clearly brings out the significance of Issue Management as,

"Any person who is engaged in the business of issue management either by making arrangement regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering corporate advisory services in relation to such issue management".

Merchants of Public Issue Management Classification of Securities Issue

- Public Issue
- Right Issue

- Private Placement

4.3 Merchant Bankers Functions

The different functions of merchant bankers towards the capital issues management are as follows:

1) Designing Capital Structure

2) Capital Market Instruments

3) Issue Pricing

4) Book Building

5) Preparation of Prospectus

6) Selection of Bankers

7) Advertising Consultants

8) Role of Registrar

9) Bankers to the Issue

10)Underwriters to the Issue

11)Brokers to the Issue

DESIGNING CAPITAL STRUCTURE

The term capital structure refers to the proportionate claims of debt and equity in the total long-term capitalization of a company.

According to Weston and Brigham, "Capital structure is the permanent financing of the firm, represented primarily by long-term-debt, preferred stock and common equity, but excluding all short-term credit. Common equity includes common stock, capital surplus and accumulated retained earnings".

Decisions on Capital Structure:

The decisions regarding the use of different types of capital funds in the overall long term capitalization of a firm are known as capital structure decisions. Any decisions on Capital Structure are based on different principles.

a) Cost Principle

b) Control Principle

c) Return Principle

d) Flexibility Principle

e) Timing Principle

4.4 Factors affecting Capital Structure Decisions:

The major developments taking place in the economy affect the capital structure of firms. In order words, the way the economy of a country is managed determines the way the capital structure of a firm will be determined. Factors that are active in the economy are:

1. Business Activity:
2. Stock Market:
3. Taxation:
4. Regulations:
5. Credit Policy:
6. Financial Institutions:

4.5 CAPITAL MARKET INSTRUMENTS

Financial instruments that are used for raising capital resources in the capital market are known as Capital Market Instruments. The changes that are sweeping across the Indian capital market especially in the recent past are something phenomenal. It has been experiencing metamorphic in the last decade, thanks to a host of measures of liberalization, globalization, and privatization that have been initiated by the Government. Pronounced changes have occurred in the realm of industrial policy such as Licensing policy, Financial services, Interest rates, etc. The competition has become very intense and real in both industrial sector and financial services industry.

As a result of these changes, the financial services industry has come to introduce a number of instruments with a view to facilitate borrowing and lending of money in the capital market by the participants.

4.6 Types of Capital Market Instruments:

The various capital market instruments used by corporate entities for raising resources are as follows:

1. Equity Shares
2. Non-voting Equity shares
3. Preference Shares
4. Cumulative Convertible Preference Shares
5. Company Fixed Deposits
6. Warrants
7. Debentures and Bonds

1.Equity Shares:

Equity shares, also known as ordinary shares are the shares held by the owners of a corporate entity. Since equity shareholders face greater risks and have no specified preferential rights, they are given larger share in profits through higher dividends than those given to preference shareholders, provided the company's performance is excellent.

2.Non-voting Equity Shares:

Consequent to the recommendations of the AbidHussain Committee and subsequent to the amendment to the Companies Act, corporate managements are permitted to mobilize additional capital without diluting the interest of existing shareholders with the help of a new instrument called non-voting equity shares. Such shares will be entitled to all the benefits except the right to vote in general meetings.

3.Preference Shares:

Shares that carry preferential rights in comparison with ordinary shares are called 'Preference Shares'. The preferential rights are the rights regarding payment of dividend and the distribution of the assets of the company in the event of its winding up, in preference to equity shares.

Types of Preference Shares

- ✓ Cumulative preference shares
- ✓ Non-cumulative preference shares
- ✓ Participating preference shares
- ✓ Redeemable preference shares
- ✓ Fully convertible cumulative preference shares
- ✓ Preference shares with warrants attached

4. Cumulative convertible preference share

Cumulative Convertible Preference Share are 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.

5.Company Fixed Deposits

Fixed deposits are the attractive source of short-term capital both for the companies and investors as well. Corporate favour fixed deposits as an ideal form of working capital mobilization without going through the process of mortgaging assets. Investors find fixed deposits a simple avenue for investment in popular companies at attractively reasonable and safe interest rates.

6.Warrants

An option issued by a company whereby the buyer is granted the right to purchase a number of shares of its equity share capital at a given exercise price during a given period is called a 'warrant'. Although trading in warrants are in vogue in the U.S. Stock markets for more than 6 to 7 decades, they are being issued to meet a range of financial requirements by the Indian corporate.

7.Debentures and Bonds: A document that either creates a debt or acknowledges it is known as a debenture. Accordingly, any document that fulfills either of these conditions is a debenture. A debenture, issued under the common seal of the company, usually takes the form of a certificate that acknowledges indebtedness of the company. A document that shows on the face of it that a company hasborrowed a sum of money from the holder thereof upon certain terms and conditions is called a debenture.

4.7 Kinds of Debentures:

Innovative debt instruments that are issued by the public limited companies are described below:

1. Participating Debentures
2. Convertible Debentures
3. Debt-equity Swaps
4. Zero-coupon Convertible Notes
5. Secured Premium Notes (SPN) with detachable Warrants
6. Non-Convertible Debentures (NCDs) with detachable Equity Warrant
7. Zero-interest Fully Convertible Debentures (FCDs)
8. Secured Zero-interest Partly Convertible Debentures (PCDs) with detachable and separately tradable warrants
9. Fully Convertible Debentures (FCDs) with interest (optional)
10. Floating Rate Bonds (FRB)

4.8 ISSUE PRICING

A listed company can freely price equity shares/convertible securities through public/ rights issues. An unlisted company eligible to make a public issue and desirous of getting its securities listed on a recognized stock exchange can also freely price shares and convertible securities. The free pricing of equity shares by an infrastructure company is subject to the compliance with disclosure norms as specified by the SEBI from time to time. While freely pricing their initial public issue of share/convertibles, all banks require approval by the Reserve Bank of India (RBI).

Differential Pricing: Listed/unlisted companies may issue shares/convertible securities to applicants in the firm allotment category (i.e. Allotment on a firm basis made to Indian and multilateral development finance institutions, Indian mutual funds, foreign institutional investors including non-resident Indians/overseas corporate bodies and permanent/regular employees of the issuing company) at a price different from the price at which the net offer to the

public (i.e. the Indian public, excluding firm allotments/reservations/ promoters contribution) is made, provided the price at which the security is offered to the applicants in firm allotment category is higher than the price at which securities are offered to the public.

Price Band: The issuer/issuing companies can mention a price band of 20 percent (cap in the price band should not exceed 20 percent of the floor price) in the offer document filed with the SEBI and the actual price can be determined at a later date before filing it with the ROCs (Registrar of Companies). If the Board of Directors (BOD) of the issuing company has been authorized to determine the offer price within a specified price band, a resolution would have to be passed by them to determine such a price.

Payments of Discounts/Commissions: Any direct/indirect payment in the nature of discount/commission/allowance or otherwise cannot be made by the issuer company/promoters to any firm allotted in a public issue.

Denomination of Shares: Public/rights issue of equity shares can be made in any denomination in accordance with Section 13(4) of the Companies Act and in compliance with norms specified by the SEBI from time to time. The companies that have already issued shares in the denominations of Rs.10 or Rs.100 may change their standard denomination by splitting/consolidating them.

4.9 BOOK BUILDING

A method of marketing the shares of a company whereby the quantum and the price of the securities to be issued will be decided on the basis of the bids received from the prospective shareholders by the lead merchant bankers is known as Book-Building method.

Under the book-building method, share prices are determined on the basis of real demand for the shares at various price levels in the market. For discovering the price at which issue should be made, bids are invited from prospective

investors from which the demand at various price levels is noted. The merchant bankers undertake full responsibility for the same.

The option of book-building is available to all body corporate, which are otherwise eligible to make an issue of capital to the public. The initial minimum size of issue through book-building route was fixed at Rs.100 Crores. However, beginning from December 9, 1996 issues of any size will be allowed through the book-building route. Book-building facility is available as an alternative to firm allotment. Accordingly, a company can opt for book-building route for the sale of shares to the extent of the percentage of the issue that can be reserved for firm allotment as per the prevailing SEBI guidelines. It is therefore possible either to reserve securities for firm allotment or issue them through the book-building process.

The book-building process involves the following steps:

1) Appointment of Book-Runners
2) Drafting Prospectus
3) Circulating Draft Prospectus
4) Maintaining Offer Records
5) Intimation about Aggregate Orders
6) Bid Analysis
7) Mandatory Underwriting
8) Filling with ROC
9) Bank Accounts
10) Collection of Completed Applications
11) Allotment of Securities
12) Payment Schedule and Listing
13) Under-subscription

4.10 Advantages of Book Building:

Book-building process is of immense use in the following ways:

a. Reduction in the duration between allotment and listing

b. Reliable allotment procedure

c. Quick listing in stock exchanges possible

d. No price manipulation as the price is determined on the basis of the bids received

4.11 Conclusion

This type of reforms has gaining more importance as financial intermediaries and also helps in opening new opportunity for growth and development of various financial services. As a result of these new reforms there is a shift in financial services from quantitative to qualitative services. Financial institution is highly competitive due to which many financial institutions comes with new and modern services and its best example is Merchant Banking as almost all the banks are providing this type of services.

Question

1. What is capital issue management?
2. What are the factors affecting the effective management in capital issue management?
3. What is issue management
4. Explain the functions of merchant banker
5. How do you decide capital structure?
6. What is capital market investment? Explain its types.
7. What is issue pricing? State the types of issue pricing.
8. What is a book building step? What are the advantages of book building?

CHAPTER– 5

5.1 Introduction

5.2 Regular Prospectus

5.3 Abridged Prospectus

5.4 Selection of bankers

5.5 Advertising consultants

5.6 Role of registrars

5.7 General obligations and responsibilities code of conduct for register to an issue and share transfer agents

5.8 Maintenance of records

5.9 Bankers to the issue

5.10 Inspection

5.11 Underwriters

5.12 SEBI's general obligations and responsibilities

5.13 Conclusion

PREPARATION OF PROSPECTUS

5.1 Introduction

Prospectus is defined a document through which public are solicited to subscribe to the share capital of a corporate entity. Its purpose is inviting the public for the subscription/purchase of any securities of a company.

Prospectus for public offer

a) Regular Prospectus

b) Abridged Prospectus

c) Prospectus for Rights Issue

d) Disclosures in Prospectus

e) Disclosures in Abridged Prospectus and Letter of Offer

5.2 Regular Prospectus: The regular prospectus is presented in three parts:

PART I

a. General Information about the company e.g. Name and address of the registered office consent of the Central Government for the issue and names of regional stock exchanges etc.,
b. Capital Structure such as authorized, issued, subscribed and paid up capital etc.,

c. Terms of the issue like mode of payment , rights of instruments holders etc.,
d. Particulars of the issue like project cost , means of financing etc.,
e. Company, Management and project like promoters for the project, location of the project etc.,
f. Disclosures of public issues made by the Company, giving information about type of issue, amount of issue, date of closure of issue, etc.,
g. Disclosure of Outstanding Litigation, Criminal Prosecution and Defaults
h. Perception of risk factors in marketing the products, of raw materials etc.,

PART II

a. General Information
b. Financial Information like Auditor's Report, Chartered Accountant's Report etc.,
c. Statutory and Other Information

PART III

a. Declaration i.e., by the directors that all the relevant provisions of the companies Act, 1956 and guidelines issued by the Government have been complied with.
b. Application with prospectus

5.3 Abridged Prospectus

The concept of abridged prospectus was introduced by the Companies (amendment) Act of 1988 to make the public issue of shares an inexpensive proposition. A memorandum containing the salient features of a prospectus as prescribed is called as Abridged Prospectus.

5.4 SELECTION OF BANKERS

Merchant bankers assist in selecting the appropriate bankers based on the proposals or projects. Because the commercial bankers are merely financiers and their activities are appropriately arrayed around credit proposals, credit appraisal and loan sanctions. But merchant banking include services like project counseling, corporate counseling in areas of capital restructuring amalgamations, mergers, takeover etc., discounting and rediscounting of short term paper in money markets, managing, underwriting and supporting public issues in new issue market and acting as brokers and advisers on portfolio management in stock exchange.

5.5 ADVERTISING CONSULTANTS

Merchant bankers arrange a meeting with company representatives and advertising agents to finalize arrangements relating to date of opening and closing of issue, registration, of prospectus, launching publicity campaign and fixing date of board meeting to approve and sign prospectus and pass the necessary resolutions. Publicity campaign covers the preparation of all publicity material and brochures, prospectus, announcement, advertisement in the press, radio, TV, investors conference etc.

The merchant bankers help choosing the media, determining the size and publications in which the advertisement should appear. The merchant Bankers role is limited to deciding the number of copies to be printed, checking accuracy of statements made and ensure that the size of the application form and prospectus conform to the standard prescribed by the stock exchange.

The Merchant banker has to ensure that the material is delivered to the stock exchange at least 21 days before the issue opens and to brokers to the issue, branches of brokers to the issue and underwriter in time. Securities issues are underwritten to ensure that in case of under subscription the issues are taken up by the underwriters.

SEBI has made underwriting mandatory for issues to the public. The underwriting arrangement should be filed with the stock exchange. Particulars of

underwriting arrangement should be mentions in the prospectus. The various activities connected with pre issue management are a time bound program which has to be promptly attended to. The execution of the activities with clockwork efficiency would lead to a successful issue.

5.6 ROLE OF REGISTRARS

Role of Registrars to an Issue (and Share Transfer Agents):

The registrars to an issue, as an intermediary in the primary market, carry on activities such as collecting application from the investors, keeping a proper record of applications and money received from investors or paid to the seller of securities and assisting companies in determining the basis of allotment of securities in consultation with stock exchanges, finalizing the allotment of securities and processing/dispatching allotment letters, refund orders, certificates and other related documents in respect of issue of capital.

The share transfer agents maintain the records of holders of securities or on behalf of companies, and deal with all matters connected with the transfer/redemption of its securities. To carry on their activities, they must be registered with the SEBI which can also renew the certificate of registration.

They are divided into two categories:

- Category I – To carry on the activities as a registrar to an issue and share transfer agent;
- Category II – To carry on the activity either as a registrar or as a share transfer agent.

The registration is granted by the SEBI on the basis of consideration of all relevant matters and, in particular, the necessary infrastructure, past experience and capital adequacy. It also takes into account the fact that any connected person has not been granted registration and any director/partner/principal officer has not been convicted for any offence involving moral turpitude or has been found guilty of any economic offence.

Capital Adequacy Fee:

- The capital adequacy requirement in terms of net worth (capital and free reserves) was Rs.6 lakh and Rs.3 lakh for Category I and Category II of registrars and share transfer agents respectively.
- However, the capital adequacy requirements are not applicable since November 1999 for a department/division of a body corporate maintaining the records of holders of securities issued by them and deal with all matters connected with transfer/ redemption of securities.
- The two categories of registrars and transfer agents had to pay an annual fee respectively of Rs.15,000 and Rs.10,000 for initial registration a well as renewal.
- With effect from November 1999, while Category I is required to pay a registration fee of Rs.50,000 and a renewal fee of Rs.40,000 every three years, Category II has to pay Rs.30,000 and Rs.25,000 respectively.

5.7 General obligations and responsibilities code of conduct for register to an issue and share transfer agents:

A registrar to an issue and share transfer agent should:

1) Maintain high standards of integrity in the conduct of its business.

2) Fulfill its obligations in a prompt, ethical and professional manner.

3) At all times exercise due diligence, ensure proper care and exercise independent professional judgment.

4) Exercise adequate care, caution and due diligence before dematerialization of securities by confirming and verifying that the securities to be dematerialized have been granted listing permission by the stock exchange(s).

5) Make reasonable efforts to avoid misinterpretation and ensure that the information provided to the investors is not misleading.

6) Not reject the dematerialization/dematerialization requests on flimsy grounds. Such requests could be rejected only on valid and proper grounds and supported by relevant documents.

7) Avoid conflict of interest and make adequate disclosure of its interest.

8) Put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, should take reasonable steps to resolve the same in an equitable manner.
9) Make appropriate disclosure to the client of its source or potential areas of conflict of duties and interest which would impair its ability to render fair, objective and unbiased services.
10) Always endeavour to render the best possible advice to the clients having regard to their needs.

5.8 Maintenance of Records:

The registrars and share transfer agents have to maintain records relating to all applications received from investors in respect of an issue, all rejected applications together with reasons, basis of allotment of securities in consultation with the stock exchanges, terms and conditions of purchase of securities, allotment of securities, list of allottees and non-allotees, refund orders, and so on.

Inspection: The SEBI is authorized to undertake the inspection of the books of accounts, other records, and documents of the registrars and share transfer agents to ensure that they are being maintained in a proper manner and the provisions of the SEBI Act, rules, regulations and the provisions of the SCRA.

Action in Default: A registrar/share transfer agent who fails to comply with any condition subject to which registration is granted, or contravenes any of the provisions of the SEBI Act/SCRA, rules/regulations and stock exchange bye-laws, rules and regulations is liable to suspension or cancellation of registration.

5.9 BANKERS TO THE ISSUE

The bankers to an issue are engaged in activities such as acceptance of applications along with application money from the investors in respect of issues of capital and refund of application money. Registration: To carry on activity as a banker to issue, a person must obtain a certificate of registration from the SEBI. The SEBI grants registration on the basis of all the activities relating to banker to an issue in particular with reference to the requirements:

The applicant has the necessary infrastructure, communication and data processing facilities and manpower to effectively discharge his activities,

a) The applicant/any of the directors of the applicant is not involved in any litigation connected with the securities market/has not been convicted of any economic offence;
b) The applicant is a scheduled bank and
c) Grant of a certificate is in the interest of the investors.

A banker to an issue can apply for the renewal of his registration three months before the expiry of the certificate.

General Obligations and Responsibilities furnish Information

When required, a banker to an issue has to furnish to the SEBI the following information;

a. The number of issues for which he was engaged as a banker to an issue;
b. The number of application/details of the application money received,
c. The dates on which applications from investors were forwarded to the issuing company /registrar to an issue;
d. The dates/amount of refund to the investors.

Books of Account/Record/Documents

A banker to an issue is required to maintain books of accounts/records/documents for a minimum period of three years in respect of, inter-alia, the number of applications received, the names of the investors.

The time within which the applications received were forwarded to the issuing company/registrar to the issue and dates and amounts of refund money to investors.

Disciplinary action by the RBI

If the RBI takes any disciplinary action against a banker to an issue in relation to issue payment, the latter should immediately inform the SEBI. If the banker is prohibited from carrying on his activities as a result of the disciplinary action, the SEBI registration is automatically deemed as suspended/cancelled.

5.10 Inspection

Such inspection is done by the RBI upon the request of the SEBI. The purpose of inspection is largely to ensure that the required books of accounts are maintained and to investigate into the complaints received from the investors against the bankers to an issue.

The foregoing rules and regulations have brought the bankers to an issue under the regulatory framework of the SEBI with a view to ensuring greater investor protection.

On the basis of the inspection report, the SEBI can direct the banker to an issue to take such measures as it may deem fit in the interest of the securities market and for due compliance with the provision of the SEBI Act.

5.11 UNDERWRITERS

Another important intermediary in the new issue/primary market is the underwriters to issues of capital who agree to take up securities which are not fully subscribed. They make a commitment to get the issue subscribed either by others or by themselves. Though underwriting is not mandatory after April 1995, its organization is an important element of the primary market. Underwriters are appointed by the issuing companies in consultation with the lead managers/merchant bankers to the issues. A statement to the effect that in the opinion of the lead manager, the underwriters' assets are adequate to meet their obligation should be incorporated in the prospectus.

Registration: To act as underwriter, a certificate of registration must be obtained from the SEBI. In granting the certificate of registration, the SEBI considers all matters relevant/relating to the underwriting and in particular.

Fee: Underwriters, had to, for grant or renewal of registration, pay a fee to the SEBI from the date of initial grant of certificate, Rs. 2 lakhs for the first and second years and Rs.1 lakh for the third year. A fee of Rs.20,000 was payable every year to keep the certificate in force or for its renewal. Since 1999, the

registration fee has been raised to Rs.5 lakhs. To keep the registration in force, renewal fee of Rs.2 lakhs every three years from the fourth year from the date of initial registration is payable. Failure to pay the fee would result in the suspension of the certificate of registration.

Agreement with Clients: Every underwriter has to enter into an agreement with the issuing company. The agreement, among others, provides for the period during which the agreement is in force, the amount of underwriting obligations, the period within which the underwriter has to be subscribe to the issue after being intimated by/on behalf of the issuer, the amount of commission/brokerage, and details of arrangements, if any, made by the underwriter for fulfilling the underwriting obligations.

Inspection and Disciplinary Proceedings: The framework of the SEBI‘s right to undertake the inspection of the books of accounts, other records and documents of the underwriters, the procedure for inspection and obligations of the underwriters is broadly on the same pattern as applicable to the lead managers.

5.12 SEBI's General Obligations and Responsibilities

Code of Conduct for Underwriters:

1) Make all efforts to protect the interests of its clients.
2) Maintain high standards of integrity, dignity and fairness in the conduct of its business.
3) Ensure that it and its personnel will act in an ethical manner in all its dealings with a body corporate making an issue of securities (i.e. the issuer).

4) Endeavour to ensure all professional dealings are effected in a prompt, efficient and effective manner.
5) At all times render high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgment.
6) Not make any statement, either oral or written, which would misrepresent

(a) the services that the underwriter is capable of performing for its client, or has rendered to any other issuer company;

(b) his underwriting commitment.

7) Avoid conflict of interest and make adequate disclosure of his interest.
8) Put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, should take reasonable steps to resolve the same in any equitable manner.
9) Make appropriate disclosure to the client of its possible source or potential in areas of conflict of duties and interest while acting as underwriter.
10) Not discriminate amongst its clients, save and except on ethical and commercial considerations.

Action in Case of Default: The liability for action in case of default arising out of

i. non-compliance with any conditions subject to which registration was granted.

ii. contravention of any provision of the SEBI Act/rules/regulations, by an underwriter involves the suspension/cancellation of registration, the effect of suspension/ cancellation are on the lines followed by the SEBI in case of lead managers.

5.13 Conclusion

Several legislation was enacted in Indian capital market to create a healthy and efficient atmosphere and to protect the interest of investors. The primary object of this legislation is to protect the interest of investors and to inspire the confidence in the mind of those who actively involved in it by controlling fraudently and unfair trade practices.

The legislation also regulated various financial intermediaries like mutual funds, venture capital, underwriters, merchant banker etc.

Question

1. What do you mean by preparation of prospectus in issue pricing? Explain the regulation of prospectus.
2. How do you select a merchant banker?
3. What is the role of registration to an issue of shares?
4. What are the general obligation and responsibilities code of conduct for registration to an issue and share transfer agent?
5. Who are called underwriters?

CHAPTER -6

6.1 Introduction

6.2 Offer for sale

6.3 Green shoe option

6.4 E-IPO

6.5 Conclusion

BROKERS TO THE ISSUE OF SHARE

6.1 Introduction

Brokers are the persons mainly concerned with the procurement of subscription to the issue from the prospective investors. The appointment of

brokers is not compulsory and the companies are free to appoint any number of brokers. The managers to the issue and the official brokers organize the preliminary distribution of securities and procure direct subscriptions from as large or as wide a circle of investors as possible.

The permission granted by the stock exchange is also subject to other stipulations which are set out in the letter of consent. Brokerage may be paid within the limits and according to other conditions prescribed. The brokerage rate applicable to all types of public issue of industrial securities is fixed at 1.5 percent, whether the issue is underwritten or not. The mailing cost and other out-of-pocket expenses for canvassing of public issues have to be borne by the stock brokers and no payment on that account is made by the companies.

The issuing company is expected to pay brokerage within two months from the date of allotment and furnish to the broker, on request, the particulars of allotments made against applications bearing their stamp, without any charge. The Cheques relating to brokerage on new issues and underwriting commission, if any, should be made payable at par at all Centre where the recognized stock exchanges are situated. The rate of brokerage payable must be is enclosed in the prospectus.

- ❖ Banking
- ❖ Issuing and underwriting
- ❖ Corporate Finance
- ❖ Management Services
- ❖ Product Knowledge

Marketing the public issue arises because of the highly competitive nature of the capital market. Moreover, there is a plethora of companies, which knock at the doors of investors seeking to sell their securities. Above all the media bombards the modern investors with eye catching advertisement to sell their concepts to prospective investors.

6.2 OFFERS FOR SALE

Where the marketing of securities takes place through intermediaries, such as issue houses, stockbrokers and others, it is a case of 'Offer for Sale Method'. Under this method, the sale of securities takes place in two stages:

1) In the first stage, the issuer company makes an en-block sale of securities to intermediaries such as the issue houses and share brokers at an agreed price.

2) Under the second stage, the securities are re-sold to ultimate investors at a market-related price. The difference between the purchase price and the issue price constitutes profit for the intermediaries. The intermediaries are responsible for meeting various expenses such as underwriting commission, prospectus cost, advertisement expenses, etc.

The issue is also underwritten to ensure total subscription of the issue. The biggest advantage of this method is that it saves the issuing company the hassles involved in selling the shares to the public directly through prospectus. This method is, however, expensive for the investor as it involves the offer of securities by issue houses at very high prices.

6.3 GREEN SHOE OPTION

Definition of 'Greenshoe Option': A provision contained in an underwriting agreement that gives the underwriter the right to sell investors more shares than originally planned by the issuer.

This would normally be done if the demand for a security issue proves higher than expected. It is legally referred to as an over-allotment option.

A 'Greenshoe option' can provide additional price stability to a security issue because the underwriter has the ability to increase supply and smooth out price fluctuations if demand surges.

Greenshoe options typically allow underwriters to sell up to 15% more shares than the original number set by the issuer, if demand conditions warrant such action.

However, some issuers prefer not to include Greenshoe options in their underwriting agreements under certain circumstances, such as if the issuer wants

to fund a specific project with a fixed amount of cost and does not want more capital than it originally sought.

The term is derived from the fact that the Green Shoe Company was the first to issue this type of option.

Before investing in an IPO, we go through the offer document of the company to know more about it. A listed company is legally bound to abide by commitments made in the document. Besides providing information about the company's competitive strengths, industry regulation, corporate structure, main objects, subsidiary details, risk factors, etc. the offer document also mentions a technical word called “Green shoe option”.

Origin of the Greenshoe: The term "Greenshoe" came from the Green Shoe Manufacturing Company (now called Stride Rite Corporation), founded in 1919. It was the first company to implement the Greenshoe clause into their underwriting agreement.

Green Shoe Option in India: Green shoe options or over-allotment options were introduced by the Securities and Exchange Board of India (SEBI) in 2003 to stabilise the aftermarket price of shares issued in IPOs.

Greenshoe Option in Action It is very common for companies to offer the Greenshoe option in their underwriting agreement.

In 2009, most realty companies in India, who were planning to raise funds from the primary market, had opted for green shoe option in their IPOs to stem volatility in share prices following their listing on the exchanges.

Companies such as Sahara Prime City, DB Realty, Lodha Developers and Ambience had opted for the green shoe option, which helped them stabilise share prices in the event of extreme volatility or prices moving below offer price.

6.4 E-IPO

What is an e-IPO?: A company proposing to issue capital to public through the on-line system of the stock exchange for offer of securities can do so if it complies with the requirements under Chapter 11A of DIP Guidelines. The appointment of various intermediaries by the issuer includes a prerequisite that

such members/registrars have the required facilities to accommodate such an online issue process.

Initial Public Offering (IPO):

Initial Public Offering (IPO), also referred to simply as a "Public Offering" is the first sale of stock by a private company to the public. IPOs are often issued by smaller, younger companies seeking capital to expand, but can also be done by large privately- owned companies looking to become publicly traded.

In a IPO, the issuer may obtain the assistance of an underwriting firm, which helps it determine what type of security to issue (common or preferred), best offering price and time to bring it to market.

The Securities and Exchange Board of India will consider this week wide-ranging reforms in its regulations for mutual funds and initial public offers (IPOs), including a 'safety net' guarantee and tax incentives for new investors.

Various proposals expected to be discussed and approved at SEBI's upcoming board meeting on August 16 also include introduction of e-IPO, which would allow investors to bid for IPO shares electronically and without any physical paperwork.

• The Securities and Exchange Board of India (SEBI) has decided to introduce electronic IPOs from January 1, 2013.

• "The facility to submit the application forms would be available in more than 1000 locations which are part of the nationwide broker network of the stock exchanges and where there is a presence of the brokers' terminals (broker centre)," said SEBI in a circular to market participants.

• In the first phase, around 400 broker centres would be covered by January 1, 2013 and the remaining centres would be covered by March 1, 2013.

• Accordingly, details of locations including name of the broker, contact details such as name of the contact person, postal address, telephone number and e- mail address of the broker, where the application forms shall be collected, will be disclosed by the stock exchanges on their websites at least 15 days before the dates specified by SEBI for introduction of electronic IPO.

• SEBI also asked stock exchanges to ensure that the details disclosed on their websites are regularly updated.

6.5 Conclusion

One of the most important investment decisions you will make has nothing to do with which stock, bond or mutual fund you buy. We're talking about selecting a broker. Hopefully the information in this tutorial will assist you in your studies.

Question

1. How the brokers to issue the shares?
2. What is offer for sale methods? Write the stages.
3. What is Greeshoe – option?
4. What is E-IPO?
5. What is IPO?

CHAPTER – 7

7.1 Introduction

7.2 Advantages of private placement

7.3 Disadvantages of private placement

7.4 Bought-out deals

7.5 Characteristics of bought –out deals

7.6 Benefits of bought-out deals

7.7 PLACEMENT WITH FIs, MFs, FIIs

7.8 OFF-SHORE ISSUES

7.9 ISSUE MARKETING

7.10 ADVERTISING STRATEGIES

7.11 Code of Advertisements - Capital Issues

7.12 NRI Marketing

7.13 Investment in money market mutual funds

7.14 Post issue activities

7.15 Conclusion

PRIVATE PLACEMENT

7.1 Introduction

A method of marketing of securities whereby the issuer makes the offer of sale to individuals and institutions privately without the issue of a prospectus is known as Private Placement Method. This is the most popular method gaining momentum in recent times among the corporate enterprises.

Under this method, securities are offered directly to large buyers with the help of shares brokers. This method works in a manner similar to the Offer for Sale Method whereby securities are first sold to intermediaries such as issues houses, etc. They are in turn placed at higher prices to individuals and institutions. Institutional investors play a significant role in the realm of private placing. The expenses relating to placement are borne by such investors.

7.2 Advantages of Private Placement

- Less expensive as various types of costs associated with the issue are borne by the issue houses and other intermediaries.
- Less troublesome for the issuer as there is not much of stock exchange requirements connecting contents of prospectus and its publicity etc. to be complied with.
- Placement of securities suits the requirements of small companies.

The method is also resorted to when the stock market is dull and the public response to the issue is doubtful.

7.3 Disadvantages of Private Placement

• Concentration of securities in a few hands.

• Creating artificial scarcity for the securities thus jacking up the prices temporarily and misleading general public.
• Depriving the common investors of an opportunity to subscribe to the issue, thus affecting their confidence levels.

7.4 BOUGHT-OUT DEALS

A method of marketing of securities of a body corporate whereby the promoters of an unlisted company make an outright sale of a chunk of equity shares to a single sponsor or the lead sponsor is known as 'bought-out deals'.

7.5 Characteristics of Bought out deals

- ✓ **Parties:** There are three parties involved in the bought-out deals. They are promoters of the company, sponsors and co-sponsors who are generally merchant bankers and investors.
- ✓ **Outright Sale:** Under this arrangement, there is an outright sale of a chunk of equity shares to a single sponsor or the lead sponsor.
- ✓ **Syndicate:** Sponsor forms syndicate with other merchant bankers for meeting the resource requirements and for distributing the risk.
- ✓ **Sale Price:** The s ale price is finalized through negotiations between the issuing company and the purchaser, the sale being influenced by such factors as project evaluation, promoter's image and reputation, current market sentiments, prospects of off-loading these shares at a future date, etc.
- ✓ **Fund-based:** Bought-out deals are in the nature of fund-based activity where the funds of the merchant bankers get locked in for at least the prescribed minimum period.
- ✓ **Listing:** The investor-sponsors make a profit, when at a future date, the shares get listed and higher prices prevail. Listing generally takes place at a time when the company is performing well in terms of higher profits and larger cash generations from projects.

- ✓ **OTCEI:** Sale of these shares at Over-the-Counter Exchange of India (OTCEI) or at a recognized stock exchanges, the time of listing these securities and off- loading them simultaneously are being generally decided in advance.

7.6 Benefits of Bought-out Deals:

Bought-out deals provide the following benefits:

1. Speedy sale
2. Freedom
3. Investor protection
4. Quality offer

7.7 PLACEMENT WITH FIs, MFs, FIIs

Listed companies have been allowed by SEBI to make preferential allotment to registered FIIs subject to certain conditions. A company desiring to make a preferential allotment should obtain the shareholders' consent. The allotment should be in accordance with ceilings of 10% of total issued capital for individual FII and 30% of all FIIs and nonresident Indian investors.

The preferential allotment should be made at a price not less than the highest price during the last 26 weeks on all stock exchanges where the company securities are listed.

FIIs (Foreign Institutional Investors): Guidelines of Government of India Government of India through Guidelines issued on September 14, 1992 has allowed reputed foreign Institutional Investors (FIIs) including pension funds, mutual funds, asset management companies, investment trusts, nominee companies and incorporated or institutional portfolio managers to invest in the India capital market subject to the condition that they register with the Securities and Exchange Board of India and obtain RBI approval under FERA.

The different forms in which the portfolio investment flows into the country are global depository receipts (GDR‘s), investment in primary and secondary market, offshore funds and government securities. At the end of March 2000, 506 FIIs were registered with SEBI. Their total cumulative investment in

securities market was Rs.57,038 crores as at March 2002. Of the FIIs only 205 were active and 10 % accounted for 70% of transactions. There is no restriction on amount of investment and there is no lock in period.

FII and SEBI Regulations, 1995: The regulations stipulate that foreign institutional investors have to be registered with SEBI and obtain a certificate from SEBI. For the purpose of grant of the certificate SEBI takes into account,

1. The applicant's track record, professional competence, financial soundness, experience, general reputation of fairness and integrity
2. Whether the applicant is regulated by appropriate foreign regulatory authority
3. Whether the applicant has been granted permission by RBI under Foreign Exchange Regulating Act for making investments in India as a foreign institutional investor and
4. Where the applicant is,

a. an institution established or incorporated outside India as a pension fund, mutual fund or investment trust ; or

b. an asset management company or nominee company or bank or institutional portfolio manager, established or incorporated outside India and proposing to make investments in India on behalf of broad based funds; or

5. A trustee or power of attorney holder established or incorporated outside India and proposing to make investments in India on behalf of broad based funds.
6. The certificate is granted in Form B subject to payment of prescribed fees which is valid for 5 Years and can be renewed thereafter.

7.8 OFF-SHORE ISSUES

Off Shore Finance: Merchant bankers help their clients in Long term foreign currency loan, Joint venture abroad, Financing exports and imports, Foreign collaboration arrangement.

Banks Providing Merchant Banking Services In India:

- Commercial banks, Foreign banks like National Grindlays Bank, Citibank, HSBC bank etc.
- Development banks like ICICI, IFCI,IDBI etc.

- ❖ SFC, SIDCs Private firms like JM Financial and Investment service ,
- ❖ DSP Financial Consultants, CEAT Financial Services, Kotak Mahindra, VMC Project Technologies, Morgan Stanley, Jardie Fleming, Klienwort Benson etc.

7.9 ISSUE MARKETING

Merchant Banking and Marketing of New Issues:

Following are the steps involved in the marketing of the issue of securities to be undertaken by the lead manager:

- ✓ Target Market
- ✓ Target Concentration
- ✓ Pricing
- ✓ Mobilizing Intermediaries
- ✓ Information Contents
- ✓ Launching Advertisement Campaign
- ✓ Brokers and Investors Conferences

A critical factor that could make or break the proposed public issue is its timing. The market conditions should be favorable. Otherwise, even issues from a company with an excellent track record, and whose shares are highly priced, might flop. Similarly, the number and frequency of issues should also be kept to a minimum to ensure success of the public issue.

7.10 ADVERTISING STRATEGIES

SEBI issued Guidelines in 1993 to ensure that the advertisement are truthful fair and clear and do not contain statements to mislead the investors to imitate their judgment. All lead managers are expected to ensure that issuer companies strictly observe the code of advertisement set-out in the guidelines.

For the purpose of these guidelines the expression advertisement, means notices, brochures, pamphlets, circulars show cards, catalogues, hoardings, placards, posters, insertions in newspapers, pictures, films, radio/television program or through any electronic media and would also include the cover pages of the offer documents.

7.11 Code of Advertisements - Capital Issues

1. An issue advertisement shall be truthful fair and clear and shall not contain any statement which is untrue or misleading.

2. An issue advertisement shall be considered to be misleading, It contains

a. Statements made about the performance or activities of the company in the absence of necessary explanatory or qualifying statements, which may give an exaggerated picture of the performance or activities than what it really is?

b. An inaccurate portrayal of a past performance in a manner which implies that past gains or income will be repeated in the future.

3. As investors may not be well versed in legal or financial matter, care should be taken to ensure that the advertisement is set forth in a clear, concise and understandable language. Extensive use of technical, legal terminology or complex languages and the inclusion of excessive details which may distract the investor should be avoided.

4. An issue advertisement shall not contain statements which promise or guarantee an appreciation or rapid profits.

5. An issue advertisement shall not contain any inform or language that not contained in the offer documents.

6. All issue advertisement in newspapers, magazines, brochures, pamphlets containing highlights relating to any issue should also contain risk factors with the same print size. It should mention the names of lead Managers, Registers to the issue.

7. No corporate advertisement except product advertisements shall be issued between the date of opening and closing of subscription of any public issue. Such product advertisement shall not make any reference directly or indirectly on the performance of the company during the said period.

8. No advertisement shall be issued stating that the issue has been fully subscribed or oversubscribed during the period the issue is open for subscription, except to the effect that the issue is open or closed. No announcement regarding closure of the issue shall be made except on closing date. If the issue is fully subscribed

before the last closing date as state in the prospectus, the announcement should be made only after the issue is fully subscribed and such announcement is made on the date on which the issue is to be closed.

9. No model, celebrities, fictional characters, landmarks or caricatures or the like shall be displayed on or form part of the offer documents or issue advertisements.

10.No slogans, expletives or non-factual and unsubstantiated titles should appear in the issue advertisement or offer documents.

11.If any advertisements carries any financial data it should also contain data for last three years and shall include particulars relating to sales, gross profits, net profit share capital reserves, earning per share, dividends and book values.

12.No incentives, apart from the permissible underwriting commission and brokerages, shall be offered through any advertisements to anyone associated with marketing the issue.

7.12 NRI MARKETING

The term NRI includes the following categories of persons:

- Indian national holding Indian passports with non-resident status (INNR),
- Person of Indian origin, foreign nationals of Indian origin, living in foreign countries including such persons of Indian origin as is in the status of stateless, because no foreign country has as yet accepted them as their national and they are not Indian national either by birth or residence, (FNIO).
- The term NRI also includes companies, partnership firms, trusts, societies and other corporate bodies called OCBs where 60% of the equity is owned by the NRIs.

Avenues for Investment by NRIs

• NRIs can have three different types of bank accounts, buy securities in the primary and secondary markets, and do business on non-reparable basis as well as reparable basis.

• NRI‘s have also made in the past large investments in specific bonds.

• Development Bond in 1991, the Resurgent India Bond in 1998 and India Millennium Deposits in 2000.

Foreign Direct Investment under New Industrial Policy (1991)

a) Repatriable Basis

b) Non Repatriable Basis

Investment in New Issues (Primary Market)

1) **Forty percent scheme -** Indian companies engaged in industry and manufacturing, Hotel (3,4, and 5 star category), hospitals and diagnostic centers, shipping companies, development of computer software and oil exploration services are allowed by RBI to issue shares/debentures to NRIs with repatriation benefits to the extent of 40% of new issue.
2) No permission for investment is required in cases where the company has obtained permission from RBI. This is generally granted in the green field project (e.g. Chambal Fertilizers, Mangalore Refineries). NRI has to obtain permission from RBI even if the sale is to be effected after 12 month. Blanket permission can be obtained before completing 12 months of each investment.
3) Generally RBI does not permit NRI investment at issue prices in case of
    a. Right issues of existing companies (excluding existing NRI shareholders)
    b. Public issues of an existing profit making company.
4) NRI can repatriate original investment, profit and dividend provided they are held for a minimum period of one year. On long term capital gains a rate of 10% is applicable.
5) If the investment is sold before one year the investment and all related receipts become non-repatriable unless RBI permission is taken in advance with clearance from Income
6) Tax department, with long term capital gains (LTCG) provisions as applicable to resident assesses.
7) In the case of non-allotment or allotment of less than requested amount, refunds can be credited to NRE accounts.

8) In case of debentures, long term capital gains (LTCG) provisional apply after three years (in place of one year for equity issues). But the proceeds are fully repatriable. For investment and sale through secondary market blanket permission valid for 5 years is to be obtained through an NRE banker. RBI permission stipulates that such investments be routed through any one bank branch to facilitate control/monitoring. There is a ceiling for NRI investment in each company. For an individual NRI it is one percent of paid up capital and five percent for all NRI‘s and it could be raised to 24 % for all NRI‘s wherever the company passes a special resolution at is annual general meeting.

   Repatriation of original investment, profits and dividends is allowed. The lock- in period has been removed on 12.10.1994.

7.13 Investment in Money Market Mutual Funds (MMFs)

NRIs are permitted to invest on non – repatriation basis in MMFs floated by commercial banks and public/private sector financial institutions. The concerned bank/ institution should get authorization from RBI/SEBI. NRIs do not need separate permission. Purchase of Share by Private Arrangement NRIs/OCBs requires permission of RBI for purchasing shares of Indian companies by private arrangement.

7.14 POST ISSUE ACTIVITIES

Post-Issue: The public issue closes on the stipulated closing date. Subsequently, the BRLM and the issuing company finalize the price. The prospectus will be updated with the mention of the final price of the shares. The finalized prospectus will be issued to QIBs. After making allotment to the QIBs on the discretionary portion, basis of allotment for the retail investors will be finalized by the issuer, Registrar, BRLM, stock exchange and a public representative. The basis of allotment is communicated to the stock exchange.

After this, the refund orders are sent to the applicants. Arrangements for crediting the allotted shares are done with the depositories. The merchant banker

who acts as the lead manager is responsible till this final stage of listing of shares. Finalization of Basis of Allotment: If the public issue is oversubscribed to the extent of greater than five times, a SEBI nominated public representative is required to participate in the finalization of Basis of allotment (BoA).

- ✓ **Dispatch of Share Certificates:** Immediately after finalizing the Boa, share certificates are dispatched to the eligible allottees, and refund orders made to unsuccessful applications. In addition, a 78 days report is to be filed with SEBI. Permission for listing of securities is also obtained from the stock exchange.
- ✓ **Advertisement:** An announcement in the newspaper has to be made regarding the basis of allotment, the number of applications received and the date of dispatch of share certificates and refund orders, etc.

Law Relating To Issue Management: It is important that the lead managers take into account the regulations of the capital issue as prescribed by the various enactments mentioned below: 1) Provisions of the Companies Act, 1956 2) The Securities Contracts (Regulations) Act, 1957 regarding transactions in securities 3) The Securities Contracts (Regulation (Rules, 1957)

7.15 Conclusion

Different rules under Regulation are providing stipulations for offering a Private Placement, such as required financial criteria for investors or solicitation allowances.Private placements may typically consist of offers of common stock or preferred stock or other forms of membership interests, warrants or promissory notes (including convertible promissory notes), bonds, and purchasers are often institutional investors such as banks, insurance companiesor pension funds. Common exemptions from the Securities Act of 1933 allow an unlimited number of accredited investors to purchase securities in an offering. In most cases, all investors must have sufficient financial knowledge and experience to be capable of evaluating the risks and merits of investing in a company.

Questions

1. What is private placement? Discuss the advantages and disadvantages of private placement.
2. What is bough – out deals? What are the characteristics of bought – out deals
3. What are the benefitsof bought – out deals?
4. What do you mean by FIIs?
5. What is off – shore issue?
6. What is NBI marketing
7. What do you mean by MMIs?
8. What is post – issue activities

UNIT – III

CHAPTER - 8

8.1 Introduction
8.2 Defining M&A
8.3 Distinction between mergers and acquisitions
8.4 Synergy
8.5 Varieties of mergers
8.6 Acquisitions
8.7 Doing the deal
8.8 Closing the deal
8.9 Break ups
8.10Advantages of break ups
8.11Disadvantages of break ups
8.12 The obstacles to making it work
8.13 Conclusion

MERGER AND ACQUISITIONS

8.1 Introduction

Mergers and acquisitions (M&A) and corporate restructuring are a big part of the corporate finance world. Every day, Wall Street investment bankers

arrange M&A transactions, which bring separate companies together to form larger ones. When they're not creating big companies from smaller ones, corporate finance deals do the reverse and break up companies through spinoffs, carve-outs or tracking stocks.

8.2 Defining M&A

The Main Idea

One plus one makes three: this equation is the special alchemy of a merger or an acquisition. The key principle behind buying a company is to create shareholder value over and above that of the sum of the two companies.

Two companies together are more valuable than two separate companies - at least, that's the reasoning behind M&A. This rationale is particularly alluring to companies when times are tough. Strong companies will act to buy other companies to create a more competitive, cost efficient company. The companies will come together hoping to gain a greater market share or to achieve greater efficiency. Because of these potential benefits, target companies will often agree to be purchased when they know they cannot survive alone.

8.3 Distinction between Mergers and Acquisitions

Although they are often uttered in the same breath and used as though they were synonymous, the terms merger and acquisition mean slightly different things. When one company takes over another and clearly established itself as the new owner, the purchase is called an acquisition. From a legal point of view, the target company ceases to exist, the buyer "swallows" the business and the buyer's stock continues to be traded.

In the pure sense of the term, a merger happens when two firms, often of about the same size, agree to go forward as a single new company rather than remain separately owned and operated. This kind of action is more precisely referred to as a "merger of equals." Both companies' stocks are surrendered and new company stock is issued in its place. For example, both Daimler-Benz and Chrysler ceased to exist when the two firms merged, and a new company, DaimlerChrysler, was created.

In practice, however, actual mergers of equals don't happen very often. Usually, one company will buy another and, as part of the deal's terms, simply allow the acquired firm to proclaim that the action is a merger of equals, even if it's technically an acquisition. Being bought out often carries negative connotations, therefore, by describing the deal as a merger, deal makers and top managers try to make the takeover more palatable.

A purchase deal will also be called a merger when both CEOs agree that joining together is in the best interest of both of their companies.

But when the deal is unfriendly - that is, when the target company does not want to be purchased - it is always regarded as an acquisition.

Whether a purchase is considered a merger or an acquisition really depends on whether the purchase is friendly or hostile and how it is announced. In other words, the real difference lies in how the purchase is communicated to and received by the target company's board of directors, employees and shareholders.

8.4 Synergy

Synergy is the magic force that allows for enhanced cost efficiencies of the new business. Synergy takes the form of revenue enhancement and cost savings. By merging, the companies hope to benefit from the following:

- **Staff reductions -** As every employee knows, mergers tend to mean job losses. Consider all the money saved from reducing the number of staff members from accounting, marketing and other departments. Job cuts will also include the former CEO, who typically leaves with a compensation package.
- **Economies of scale -** Yes, size matters. Whether it's purchasing stationery or a new corporate IT system, a bigger company placing the orders can save more on costs. Mergers also translate into improved purchasing power to buy equipment or office supplies - when placing larger orders, companies have a greater ability to negotiate prices with their suppliers.
- **Acquiring new technology** - To stay competitive, companies need to stay on top of technological developments and their business applications. By buying

a smaller company with unique technologies, a large company can maintain or develop a competitive edge.

- **Improved market reach and industry visibility -** Companies buy companies to reach new markets and grow revenues and earnings. A merge may expand two companies' marketing and distribution, giving them new sales opportunities. A merger can also improve a company's standing in the investment community: bigger firms often have an easier time raising capital than smaller ones.

That said, achieving synergy is easier said than done - it is not automatically realized once two companies merge. Sure, there ought to be economies of scale when two businesses are combined, but sometimes a merger does just the opposite. In many cases, one and one add up to less than two.

Sadly, synergy opportunities may exist only in the minds of the corporate leaders and the deal makers. Where there is no value to be created, the CEO and investment bankers - who have much to gain from a successful M&A deal - will try to create an image of enhanced value. The market, however, eventually sees through this and penalizes the company by assigning it a discounted share price.

8.5 Varieties of Mergers

From the perspective of business structures, there is a whole host of different mergers. Here are a few types, distinguished by the relationship between the two companies that are merging:

- **Horizontal merger -** Two companies that are in direct competition and share the same product lines and markets.
- **Vertical merger -** A customer and company or a supplier and company. Think of a cone supplier merging with an ice cream maker.
- **Market-extension merger -** Two companies that sell the same products in different markets.
- **Product-extension merger -** Two companies selling different but related products in the same market.
- **Conglomeration -** Two companies that have no common business areas.

There are two types of mergers that are distinguished by how the merger is financed. Each has certain implications for the companies involved and for investors:

- ⇨ **Purchase Mergers -** As the name suggests, this kind of merger occurs when one company purchases another. The purchase is made with cash or through the issue of some kind of debt instrument; the sale is taxable.

Acquiring companies often prefer this type of merger because it can provide them with a tax benefit. Acquired assets can be written-up to the actual purchase price, and the difference between the book value and the purchase price of the assets can depreciate annually, reducing taxes payable by the acquiring company.

- ⇨ **Consolidation Mergers -** With this merger, a brand new company is formed and both companies are bought and combined under the new entity. The tax terms are the same as those of a purchase merger.

8.6 ACQUISITIONS

As you can see, an acquisition may be only slightly different from a merger. In fact, it may be different in name only. Like mergers, acquisitions are actions through which companies seek economies of scale, efficiencies and enhanced market visibility. Unlike all mergers, all acquisitions involve one firm purchasing another - there is no exchange of stock or consolidation as a new company.

Acquisitions are often congenial, and all parties feel satisfied with the deal. Other times, acquisitions are more hostile. In an acquisition, as in some of the merger deals we discuss above, a company can buy another company with cash, stock or a combination of the two. Another possibility, which is common in smaller deals, is for one company to acquire all the assets of another company. Company X buys all of Company Y's assets for cash, which means that Company Y will have only cash (and debt, if they had debt before). Of course, Company Y becomes merely a shell and will eventually liquidate or enter another area of business.

Another type of acquisition is a reverse merger, a deal that enables a private company to get publicly-listed in a relatively short time period. A reverse merger occurs when a private company that has strong prospects and is eager to raise financing buys a publicly-listed shell company, usually one with no business and limited assets.

The private company reverse merges into the public company, and together they become an entirely new public corporation with tradable shares.Regardless of their category or structure, all mergers and acquisitions have one common goal: they are all meant to create synergy that makes the value of the combined companies greater than the sum of the two parts. The success of a merger or acquisition depends on whether this synergy is achieved.

Valuation Matters

Investors in a company that is aiming to take over another one must determine whether the purchase will be beneficial to them. In order to do so, they must ask themselves how much the company being acquired is really worth.

Naturally, both sides of an M&A deal will have different ideas about the worth of a target company: its seller will tend to value the company at as high of a price as possible, while the buyer will try to get the lowest price that he can. There are, however, many legitimate ways to value companies. The most common method is to look at comparable companies in an industry, but deal makers employ a variety of other methods and tools when assessing a target company. Here are just a few of them:

1. Comparative Ratios - The following are two examples of the many comparative metrics on which acquiring companies may base their offers:

a.Price-Earnings Ratio (P/E Ratio) - With the use of this ratio, an acquiring company makes an offer that is a multiple of the earnings of the target company. Looking at the P/E for all the stocks within the same industry group will give the acquiring company good guidance for what the target's P/E multiple should be.

b.Enterprise-Value-to-Sales Ratio (EV/Sales) - With this ratio, the acquiring company makes an offer as a multiple of the revenues, again, while being aware of the price-to-sales ratio of other companies in the industry.

2. Replacement Cost - In a few cases, acquisitions are based on the cost of replacing the target company. For simplicity's sake, suppose the value of a company is simply the sum of all its equipment and staffing costs. The acquiring company can literally order the target to sell at that price, or it will create a competitor for the same cost. Naturally, it takes a long time to assemble good management, acquire property and get the right equipment. This method of establishing a price certainly wouldn't make much sense in a service industry where the key assets - people and ideas - are hard to value and develop.

3. Discounted Cash Flow (DCF) - A key valuation tool in M&A, discounted cash flow analysis determines a company's current value according to its estimated future cash flows. Forecasted free cash flows (operating profit + depreciation + amortization of goodwill – capital expenditures – cash taxes - change in working capital) are discounted to a present value using the company's weighted average costs of capital (WACC). Admittedly, DCF is tricky to get right, but few tools can rival this valuation method.

Synergy: The Premium for Potential Success.

For the most part, acquiring companies nearly always pay a substantial premium on the stock market value of the companies they buy. The justification for doing so nearly always boils down to the notion of synergy; a merger benefits shareholders when a company's post-merger share price increases by the value of potential synergy.

Let's face it; it would be highly unlikely for rational owners to sell if they would benefit more by not selling. That means buyers will need to pay a premium if they hope to acquire the company, regardless of what pre-merger valuation tells them. For sellers, that premium represents their company's future prospects. For buyers, the premium represents part of the post-merger synergy they expect can

be achieved. The following equation offers a good way to think about synergy and how to determine whether a deal makes sense. The equation solves for the minimum required synergy:

In other words, the success of a merger is measured by whether the value of the buyer is enhanced by the action. However, the practical constraints of mergers, which we discuss in part five, often prevent the expected benefits from being fully achieved. Alas, the synergy promised by deal makers might just fall short.

8.7 Doing the Deal

Start with an Offer

When the CEO and top managers of a company decide that they want to do a merger or acquisition, they start with a tender offer. The process typically begins with the acquiring company carefully and discreetly buying up shares in the target company, or building a position. Once the acquiring company starts to purchase shares in the open market, it is restricted to buying 5% of the total outstanding shares before it must file with the SEC. In the filing, the company must formally declare how many shares it owns and whether it intends to buy the company or keep the shares purely as an investment. Working with financial advisors and investment bankers, the acquiring company will arrive at an overall price that it's willing to pay for its target in cash, shares or both. The tender offer is then frequently advertised in the business press, stating the offer price and the deadline by which the shareholders in the target company must accept (or reject) it.

The Target's Response

Once the tender offer has been made, the target company can do one of several things:

- **Accept the Terms of the Offer -** If the target firm's top managers and shareholders are happy with the terms of the transaction, they will go ahead with the deal.

- **Attempt to Negotiate -** The tender offer price may not be high enough for the target company's shareholders to accept, or the specific terms of the deal may not be attractive. In a merger, there may be much at stake for the management of the target - their jobs, in particular.
  If they're not satisfied with the terms laid out in the tender offer, the target's management may try to work out more agreeable terms that let them keep their jobs or, even better, send them off with a nice, big compensation package. Not surprisingly, highly sought-after target companies that are the object of several bidders will have greater latitude for negotiation. Furthermore, managers have more negotiating power if they can show that they are crucial to the merger's future success.
- **Execute a Poison Pill or Some Other Hostile Takeover Defense –** A poison pill scheme can be triggered by a target company when a hostile suitor acquires a predetermined percentage of company stock. To execute its defense, the target company grants all shareholders - except the acquiring company - options to buy additional stock at a dramatic discount. This dilutes the acquiring company's share and intercepts its control of the company.
- **Find a White Knight -** As an alternative, the target company's management may seek out a friendlier potential acquiring company, or white knight. If a white knight is found, it will offer an equal or higher price for the shares than the hostile bidder.

8.8 Closing the Deal

Finally, once the target company agrees to the tender offer and regulatory requirements are met, the merger deal will be executed by means of some transaction. In a merger in which one company buys another, the acquiring company will pay for the target company's shares with cash, stock or both.

A cash-for-stock transaction is fairly straightforward: target company shareholders receive a cash payment for each share purchased. This transaction is treated as a taxable sale of the shares of the target company. If the transaction

is made with stock instead of cash, then it's not taxable. There is simply an exchange of share certificates. The desire to steer clear of the tax man explains why so many M&A deals are carried out as stock-for-stock transactions.

When a company is purchased with stock, new shares from the acquiring company's stock are issued directly to the target company's shareholders, or the new shares are sent to a broker who manages them for target company shareholders. The shareholders of the target company are only taxed when they sell their new shares.

When the deal is closed, investors usually receive a new stock in their portfolios -the acquiring company's expanded stock. Sometimes investors will get new stock identifying a new corporate entity that is created by the M&A deal.

8.9 Break Ups

As mergers capture the imagination of many investors and companies, the idea of getting smaller might seem counterintuitive. But corporate break-ups, or demergers, can be very attractive options for companies and their shareholders.

8.10 Advantages of Break ups

The rationale behind a spinoff, tracking stock or carve-out is that "the parts are greater than the whole." These corporate restructuring techniques, which involve the separation of a business unit or subsidiary from the parent, can help a company raise additional equity funds. A break-up can also boost a company's valuation by providing powerful incentives to the people who work in the separating unit, and help the parent's management to focus on core operations.

Most importantly, shareholders get better information about the business unit because it issues separate financial statements. This is particularly useful when a company's traditional line of business differs from the separated business unit. With separate financial disclosure, investors are better equipped to gauge the value of the parent corporation. The parent company might attract more investors and, ultimately, more capital.

Also, separating a subsidiary from its parent can reduce internal competition for corporate funds. For investors, that's great news: it curbs the kind of negative internal wrangling that can compromise the unity and productivity of a company. For employees of the new separate entity, there is a publicly traded stock to motivate and reward them. Stock options in the parent often provide little incentive to subsidiary managers, especially because their efforts are buried in the firm's overall performance.

8.11 Disadvantages of break ups

That said, de-merged firms are likely to be substantially smaller than their parents, possibly making it harder to tap credit markets and costlier finance that may be affordable only for larger companies. And the smaller size of the firm may mean it has less representation on major indexes, making it more difficult to attract interest from institutional investors. Meanwhile, there are the extra costs that the parts of the business face if separated. When a firm divides itself into smaller units, it may be losing the synergy that it had as a larger entity. For instance, the division of expenses such as marketing, administration and research and development (R&D) into different business units may cause redundant costs without increasing overall revenues.

Restructuring Methods: There are several restructuring methods: doing an outright sell-off, doing an equity carve-out, spinning off a unit to existing shareholders or issuing tracking stock. Each has advantages and disadvantages for companies and investors. All of these deals are quite complex.

Sell-Offs: A sell-off, also known as a divestiture, is the outright sale of a company subsidiary. Normally, sell-offs are done because the subsidiary doesn't fit into the parent company's core strategy. The market may be undervaluing the combined businesses due to a lack of synergy between the parent and subsidiary. As a result, management and the board decide that the subsidiary is better off under different ownership.

Besides getting rid of an unwanted subsidiary, sell-offs also raise cash, which can be used to pay off debt. In the late 1980s and early 1990s, corporate raiders would use debt to finance acquisitions. Then, after making a purchase they would sell-off its subsidiaries to raise cash to service the debt. The raiders' method certainly makes sense if the sum of the parts is greater than the whole. When it isn't, deals are unsuccessful.

Equity Carve-Outs: More and more companies are using equity carve-outs to boost shareholder value. A parent firm makes a subsidiary public through an initial public offering (IPO) of shares, amounting to a partial sell-off. A new publicly-listed company is created, but the parent keeps a controlling stake in the newly traded subsidiary. A carve-out is a strategic avenue a parent firm may take when one of its subsidiaries is growing faster and carrying higher valuations than other businesses owned by the parent. A carve-out generates cash because shares in the subsidiary are sold to the public, but the issue also unlocks the value of the subsidiary unit and enhances the parent's shareholder value. The new legal entity of a carve-out has a separate board, but in most carve-outs, the parent retains some control. In these cases, some portion of the parent firm's board of directors may be shared. Since the parent has a controlling stake, meaning both firms have common shareholders, the connection between the two will likely be strong.

That said, sometimes companies carve-out a subsidiary not because it's doing well, but because it is a burden. Such an intention won't lead to a successful result, especially if a carved-out subsidiary is too loaded with debt, or had trouble even when it was a part of the parent and is lacking an established track record for growing revenues and profits.

Carve-outs can also create unexpected friction between the parent and subsidiary. Problems can arise as managers of the carved-out company must be accountable to their public shareholders as well as the owners of the parent company. This can create divided loyalties.

Spinoffs

A spinoff occurs when a subsidiary becomes an independent entity. The parent firm distributes shares of the subsidiary to its shareholders through a stock dividend. Since this transaction is a dividend distribution, no cash is generated. Thus, spinoffs are unlikely to be used when a firm needs to finance growth or deals. Like the carve-out, the subsidiary becomes a separate legal entity with a distinct management and board.

Like carve-outs, spinoffs are usually about separating a healthy operation. In most cases, spinoffs unlock hidden shareholder value. For the parent company, it sharpens management focus. For the spinoff company, management doesn't have to compete for the parent's attention and capital. Once they are set free, managers can explore new opportunities.

Investors, however, should beware of throw-away subsidiaries the parent created to separate legal liability or to off-load debt. Once spinoff shares are issued to parent company shareholders, some shareholders may be tempted to quickly dump these shares on the market, depressing the share valuation.

Tracking Stock

A tracking stock is a special type of stock issued by a publicly held company to track the value of one segment of that company. The stock allows the different segments of the company to be valued differently by investors. Let's say a slow-growth company trading at a low price-earnings ratio (P/E ratio) happens to have a fast growing business unit. The company might issue a tracking stock so the market can value the new business separately from the old one and at a significantly higher P/E rating. Why would a firm issue a tracking stock rather than spinning-off or carving-out its fast growth business for shareholders? The company retains control over the subsidiary; the two businesses can continue to enjoy synergies and share marketing, administrative support functions, a headquarters and so on.

Finally, and most importantly, if the tracking stock climbs in value, the parent company can use the tracking stock it owns to make acquisitions. Still,

shareholders need to remember that tracking stocks are class B, meaning they don't grant shareholders the same voting rights as those of the main stock.

Each share of tracking stock may have only a half or a quarter of a vote. In rare cases, holders of tracking stock have no vote at all.

Why They Can Fail

It's no secret that plenty of mergers don't work. Those who advocate mergers will argue that the merger will cut costs or boost revenues by more than enough to justify the price premium. It can sound so simple: just combine computer systems, merge a few departments, use sheer size to force down the price of supplies and the merged giant should be more profitable than its parts. In theory, 1+1 = 3 sounds great, but in practice, things can go awry.

Historical trends show that roughly two thirds of big mergers will disappoint on their own terms, which means they will lose value on the stock market. The motivations that drive mergers can be flawed and efficiencies from economies of scale may prove elusive. In many cases, the problems associated with trying to make merged companies work are all too concrete.

Flawed Intentions

For starters, a booming stock market encourages mergers, which can spell trouble. Deals done with highly rated stock as currency are easy and cheap, but the strategic thinking behind them may be easy and cheap too. Also, mergers are often attempt to imitate: somebody else has done a big merger, which prompts other top executives to follow suit.

A merger may often have more to do with glory-seeking than business strategy. The executive ego, which is boosted by buying the competition, is a major force in M&A, especially when combined with the influences from the bankers, lawyers and other assorted advisers who can earn big fees from clients engaged in mergers.

Most CEOs get to where they are because they want to be the biggest and the best, and many top executives get a big bonus for merger deals, no matter what happens to the share price later.

On the other side of the coin, mergers can be driven by generalized fear. Globalization, the arrival of new technological developments or a fast-changing economic landscape that makes the outlook uncertain are all factors that can create a strong incentive for defensive mergers. Sometimes the management team feels they have no choice and must acquire a rival before being acquired. The idea is that only big players will survive a more competitive world.

8.12 The Obstacles to making it Work

Coping with a merger can make top managers spread their time too thinly and neglect their core business, spelling doom. Too often, potential difficulties seem trivial to managers caught up in the thrill of the big deal. The chances for success are further hampered if the corporate cultures of the companies are very different. When a company is acquired, the decision is typically based on product or market synergies, but cultural differences are often ignored. It's a mistake to assume that personnel issues are easily overcome. For example, employees at a target company might be accustomed to easy access to top management, flexible work schedules or even a relaxed dress code. These aspects of a working environment may not seem significant, but if new management removes them, the result can be resentment and shrinking productivity.

More insight into the failure of mergers is found in the highly acclaimed study from McKinsey, a global consultancy. The study concludes that companies often focus too intently on cutting costs following mergers, while revenues, and ultimately, profits, suffer. Merging companies can focus on integration and cost cutting so much that they neglect day-to-day business, thereby prompting nervous customers to flee. This loss of revenue momentum is one reason so many mergers fail to create value for shareholders.

But remember, not all mergers fail. Size and global reach can be advantageous, and strong managers can often squeeze greater efficiency out of badly run rivals. Nevertheless, the promises made by deal makers demand the careful scrutiny of investors. The success of mergers depends on how realistic the

deal makers are and how well they can integrate two companies while maintaining day-to-day operations.

8.13 Conclusion

One size doesn't fit all. Many companies find that the best way to get ahead is to expand ownership boundaries through mergers and acquisitions. For others, separating the public ownership of a subsidiary or business segment offers more advantages. At least in theory, mergers create synergies and economies of scale, expanding operations and cutting costs. Investors can take comfort in the idea that a merger will deliver enhanced market power. By contrast, de-merged companies often enjoy improved operating performance thanks to redesigned management incentives. Additional capital can fund growth organically or through acquisition. Meanwhile, investors benefit from the improved information flow from de-merged companies.

M&A comes in all shapes and sizes, and investors need to consider the complex issues involved in M&A. The most beneficial form of equity structure involves a complete analysis of the costs and benefits associated with the deals.

Question

1. What do you mean by merger? Explain the variety of mergers.
2. What is synergy? What are the benefits getting from the company?
3. Distinguish merger and acquisition.
4. What is acquisition? Who are the target responses in acquisition?
5. What is closing the deal?
6. What are the restructuring of merger and acquisition?

CHAPTER– 9

9.1 Introduction

9.2 Investment objective

9.3 Strategy

9.4 Portfolio management service fee

9.5 Performance fee

9.6 Introduction of credit syndication

9.7 Meaning and definition of credit rating

9.8 Importance of credit rating

9.9 Importance of credit rating

9.10 Indications of the assigned ratings

9.11 Factors affecting assigned ratings

9.12 Nature of credit rating

9.13 Instruments for rating

9.14 Rating other than debt instruments

9.15 Functions of credit rating agency

9.16 Advantages of credit rating

9.17 Disadvantages of credit rating

9.18 Mutual fund

9.19 Business valuation

9.20 Elements of business valuation

9.21 Conclusion

PORTFOLIO MANAGEMENT SERVICES

9.1Introduction

SEBI registered Portfolio Manager (Reg. No.INP000003203) offers discretionary portfolio management services. Geojit has a team of experts who carefully take investment decisions based on the clients' objectives. The Portfolio Management team has a successful track record of more than 10 years in the capital market. The team has access to Geojit' strong Equity Research, and fundamental & technical analysis.

9.2 INVESTMENT OBJECTIVE

To generate medium to long-term capital growth (3-4 years) by identifying undervalued stocks and those with growth opportunities from a select list of well researched stocks.

9.3 STRATEGY

To suite your investment strategy, we offer two unique types of portfolio under our Portfolio Management Services.

- **Advantage Portfolio:** It is positioned to invest predominantly in equities of Mid and Small cap companies. The fund will normally invest in stocks of Mid and Small cap companies that have a sound track record, quality management, earnings and growth potentials and strong fundamentals.
- **Freedom Portfolio:** It invests across a wide gamut of fundamentally strong business in the large cap, Mid cap and Small cap stocks. It identifies undervalued stocks with high growth potential and available at reasonable valuations.

MINIMUM INVESTMENT

Rs. 25 lakhs for resident Indians and NRIs.

RISK FACTORS

As the stocks are normally held for medium to long term, the net asset value will be affected by market volatility.

9.4 PORTFOLIO MANAGEMENT SERVICE FEE

Option 1: 3% p.a. (charged @0.75% at the end of every quarter on the average of beginning and ending (NAV)

Option 2: 1% p.a. (charged @0.25% at the end of every quarter on the average of beginning and ending (NAV) and performance fee.

9.5 PERFORMANCE FEE

20% on gain in NAV over and above 12% p.a. based on the high watermark concept charged at the end of the year or on withdrawal.

CREDIT SYNDICATION

9.6 INTRODUCTION

Credit syndication services are services rendered by the merchant bankers in the form of organizing and procuring the financial facilities form financial institutions, banks, or other lending agencies. Financing arranged on behalf of the

client for meeting both fixed capital as well as working capital requirements is known as loan syndication service'

9.7 CREDIT SYNDICATION SERVICES

Merchant bankers provide various services towards syndication of loans. The services may be either loan sought for long term fixed capital or of working capital funds.

Objectives arranging medium and long term funds for long term fixed capital and working capital fund needs.

The scope of syndicated loan services as provided by merchant bankers includes identifying the sources of finance, approaching these sources, applying for the credit, and sanction and disbursal of loans to the clients. While carrying out the activities connected with credit syndication, the merchant banker ensure due compliance with the formalities of the financial institution, banks and regulatory authority. They are:

1. **General Information:** The purpose of furnishing general information is to enable the financing company to obtain a general idea about the applicant company and its proposed project.
2. **Promoter Information:** Information about promoters is furnished by the merchant banker with the objective of helping the lending agency to gain an understanding of the promoter, his activities economic background, credibility and integrity.
3. **Company Information:** The merchant banker has to furnish the following information as regard the company for loan syndication arrangements to be made:

- Brief history of the concern
- Schemes already executed in the case of existing company
- Expansion/diversification plans in the case of an existing company
- Nature, size and status of the project to assess the funds requirement in the case of a new company

• Changes in names, business, management, etc. and mergers, reorganizations, etc. that have taken place in the past.

4. Project profile Information: Full information relating to the project for which financial assistance is sought is furnished by the merchant banker. The type of information may pertain to plant capacity, nature of production process to be employed, and nature of technical arrangements available for the project.

5. Project cost Information: Details of the estimated cost of the project should be provided to the lending institution. This includes information as regards rupee cost/rupee equivalent of foreign exchange cost/total cost for land or site development/buildings/plant and machinery, imported/indigenous, technical know-how, etc. to be furnished. Besides, details of expenses likely to be incurred on foreign technicians/training of Indian technicians abroad, miscellaneous fixed assets, preliminary pre-operative expenses, provision for contingencies, margin money for working capital etc. should be stated in the loan application.

Project financing Information: Details regarding the mode of financing used for the project should be stated. This includes information on the extent of debt and equity capital funding source. Besides, details of rupee loans, foreign currency loans, debentures, internal cash accruals, and promoter‘s contribution. The security offered for the loan/bank guarantee, etc. should also be specified. Data should also be provided on the extent of loan arrangements already applied for and the limit of financial arrangements thereto.

7. Project marketing Information: As part of the credit syndication exercise, it is incumbent on the part of the merchant banker to furnish adequate information about the marketing arrangements made for the products of the borrowing unit.

8. Cash flow information : The merchant banker has to furnish details as to profitability and expected stream of cash flows and cost of the proposed project for this purpose, it is essential that working results of operations, cash

flow statements and projected balance sheet are given in prescribed form along with the basis of the calculations.

9. Other Information: The merchant banker has to indicate as to how the purpose of the economic and national importance of the proposed project will be realized. Besides, following are the other details to be furnished by the merchant banker to the lending agency.

1. CIF/FOB international price of inputs to be imported/exported.
2. Economic benefits in general and the region in particular available to the nation from the project.
3. Economic benefits in general and the region in particular available to the nation from the project.
4. Expected contribution to the growth, if any of ancillary industries in the region.
5. Government consent by way issue of letter of intent, industrial license, foreign exchange permission, approval of technical financial collaboration etc.

a. Making Application

The merchant banker files the duly filled-in application in a manner as desired by the term-lending institution. While presenting the application, it is incumbent on the part of the merchant banker to ensure that all the required formalities have been complied with. For instance, it is important that necessary sanction is obtained from the Government for the proposed project.

Loans are syndicated by development financial institutions though the lead institution especially in the case of consortium financing or joint consortium approach to lending is followed. The lead institution adopts single window scheme while appraising, sanctioning and disbursing loans. A part of credit syndication services, the merchant banker arranges for appraisal of the project by sufficiently interacting with the officials of the development financial institutions. The merchant banker holds formal discussions with the appraisal team of financial institutions. He helps the promoters/chief executive of the company by

providing information to the appraisal team. He takes part in the site inspection with the appraisal team and provides information to them about the technical aspect of the project implementation. He also assists the appraisal team on matters connected with the choice of technique to be adopted for appraisal of the project.

Merchant banker provides advice in the preparation of project/feasibility report and the market survey report, and the financial projections relating to the project.

1. **Technical Appraisal:** Technical appraisal involves the assessment of technical and engineering soundness of the project. While carrying out the technical appraisal of a project, aspects such as competence of the experts preparing design of facilities and specifications; purchase arrangements of equipment's; supervision of construction and installation; ability of consultants and their costs for services, are looked into. Attention is also paid to the aspects concerning the scale of operation, cost of production and prospective demand. Similarly, attention is paid to understand the appropriateness of the methods and processes to be used for the project. Consideration is also given to the level of availability of latest technology, degree of obsolescence in technological process, etc.

2. **Ecological Appraisal:** Regarding the ecological aspects of the project, the merchant banker ensures that the borrowing company has taken all possible steps for preventing air, water and soil pollution arising out of the industrial project proposed to be undertaken.

A certificate from the State Pollution Control Board has to be produced to the effect that the company has installed equipment adequate and appropriate to the requirement of meeting the environment protection. Ecological appraisal is mandatory with respect to highly polluting industries such as zinc, lead, copper, aluminum, steel, paper, pesticides/insecticides, refineries, fertilizers, paints, dyes, leathering tanning, rayon, sodium/potassium cyanide, basic drugs, foundry, batteries, acids/alkalis, plastics, rubber, cement, asbestos, fermentation, electro placing,etc.

3. Financial Appraisal: Financial appraisal involves analyzing the financial viability of the project under consideration. Analysis of the need for fixed capital and working capital is also carried out. Consideration is also given to the cost of the project as relating to acquisition of capital assets, interest cost on loans obtained for promotional, organizational, training and other purposes.

4. Promoters contribution: Promoter's contribution for establishment and running of a project is vital. The important sources of promoters_ contribution in the case of newly established companies include own equity, managed equity from special funds such as Risk Capital/venture Capital Funds or Seed Capital from IDBI through SFCs, etc. and foreign equity, deposits contributed by promoters, etc. In the case of existing companies the sources of promoter contribution include internal accruals, right issues, divestment of shares, additional equity, unsecured loans, etc. The extent of promoter's contribution and debt-equity norms must be scrutinized by the merchant banker.

5. Economic Appraisals: The project involves making an analysis of the expected contribution of the project to the particular sector, besides its contribution to the development of the national economy. Particular attention is paid to the project's usefulness in terms of best possible utilization of scarce resources. It is essential to consider the priority nature of the project. Accordingly, a project will be considered desirable if it has a tremendous impact on the balance of payment and the capacity to generate exchange surplus through new exports, import substitution and resultant savings in foreign exchange.

6. Commercial Appraisal: It involves the determination of commercial viability of the project in terms of arrangements for buying, transporting and marketing the product.

7. Managerial Appraisals: It is concerned with the evaluation of effectiveness and efficiency of the managerial personnel who are vested with the responsibility of organizing the available resources of the project. The merchant banker checks the managerial competency both at construction and operation stages to ensure the success of the project.

8. Arrangement of Loan Sanction –It is the function of a merchant banker to obtain the letter of intent/sanction from the lending institution/bank. The lending agency informs the merchant banker about the sanction of loan by the sanctioning authority. The sanction letter invariably contains terms and conditions pertaining to the sanction of loan. Some these terms include amount of loan, rate of interest applicable, commitment charge levied by the lender in order to motivate the borrowing unit to make efficient use of the loan, security for the loan, conversion option in the case of default and rehabilitation assistance, repayment terms of loan, and other terms and conditions.

Compliance for Loan Disbursement: It is essential duty of the merchant banker to ensure compliance of terms and conditions to have the loan facility disbursed by the bank or the financial institution. Compliance is required in respect of the following. 9.3 Compliance with the provisions of Memorandum and the Articles 9.4 Compliance with the provisions of Acts 9.5 Compliance with the provisions of loan agreement.

9. Compliance with memorandum and the articles The merchant banker ensures due compliance with the provisions of Memorandum and Articles of Association of the borrowing unit. This is to check the extent of powers commanded by the Board of Directors of the company to make borrowings from the lending agency. The borrowing powers of the Board are enshrined in the memorandum by means of its ‘objects c agency to ensure that the acts of directors are not ultra-vires so as to safeguard its interest.

b. Statutory Compliance

In addition, compliance is also called for with regard to the provisions constrained in various enactments concerning the management and regulation of joint stock companies in India. Some of these enactments include Companies Act, 1956, Industries (Development and Regulation) Act, 1951, Foreign Exchange Regulation Act, 1973, Securities Contracts (Regulation) Act, 1956. The Foreign Trade (Development and Regulation) Act, 1992, Income-Tax Act, 1961.

(i) The companies Act, 1956 contains specific provisions that stipulate the powers of borrowings vested with the Board of Directors of the company. For instance, section 292 and 293 of the Act outline the exercise of powers to borrow from banks and financial institutions. Similarly, sections 17 and 31 of the said Act give an account of restrictive covenants pertaining to powers of directors to borrow to be contained in the Memorandum of Association and Articles of Association of a company. The provisions mainly outline the procedures such as passing of resolutions etc. to be followed for raising loans from term lending agencies.

(ii) Compliance is also required under the provisions of the Industries (Development and Regulation) Act, 1951. The Act contains provisions of control and regulation for the setting up of new industries and also expansion of existing industries. The provisions mainly relate to registration and revocation of registration of industrial undertaking, licensing of new industrial undertakings, license and revocation of license for producing or manufacturing new articles, licensing industrial undertakings in special cases, etc. Besides, provisions also outline the powers of the Central Government to specify the requirements which shall be complied with by small scale industrial undertakings, power of the Central Government to exempt any industrial undertaking in special cases, etc.

Compliance is called for as regards provisions contained in the Foreign Exchange Management Act (FEMA). The provisions are applicable in the case of non-resident Indians being associated in any manner with the organization or management or operations of the client company or where foreign capital in any manner with the organization or management or operations of the client company or where foreign capital in any manner (i.e. By way of foreign

(iv) Provisions of the Securities Contracts (Regulation) Act, 1956 (SCRA) are also required to be complied with by the borrowing unit before seeking financial assistance from the term lending agency. Compliance is related to stipulations of enlistment of securities of the company in recognized stock exchanges (although listing is not mandatory under the said Act). Under Section

21 of the Act, Central Government is empowered to compel any public limited company to enlist its securities with a recognized stock exchange.

(v) Compliance with the provisions of the FIDRA (Foreign Trade Development and Regulation Act), 1992 are required compliance by the borrowing unit. This becomes necessary where the client company envisages procuring raw material, machinery, plant and equipments from overseas through imports under the import license granted by the Central Government under Import and Export (Control) Act, 1947.

(vi) An important enactment in India that requires closer compliance by the borrowing units is the Income-Tax Act, 1961. The Act contains provisions that require furnishing of a tax clearance certificate from assessing officer under section 230A of Income Tax Act before creation of security by way of English mortgage in favor of lenders.

c. Documentation and Creation of Security

An important function of a merchant banker is to create an adequate documentation of security by working closely with the ‘lead financial i loan. The type of documents to be prepared and executed by the merchant banker will be as per the requirements of the lead financial institution. Depending on the loan type, the merchant banker executes bridge loan document or interim loan document. The merchant banker provides the following details with regard to the security for the loan:

1. First mortgage and charge of all immovable properties both present and future of the borrower company in the form as may be indicated by lenders which are equitable mortgage by deposit of title deeds.

2. First charge by way of hypothecation:

(i) All movables such as stocks of raw material, semi-finished and finished goods, consumable stores and such offer movables as may be agreed to by the lead institution for securing the borrowings for working capital requirements in the ordinary course of the business, and

(ii) On specific items of machinery as permitted by the lender purchased and/or to be purchased by the client company under the deferred payment facilities granted the client company.

3. Security for bridge loan

4. Security for interim loan

5. Substantive security: Where the loan amount is being secured in terms of the loan agreement by first charge on the company's immovable and movable assets, present and future.

6. Personal guarantee: Where the loan amount is being secured in terms of the loan agreement by first charge on the company's immovable and movable assets, present and future

7. Personal guarantee: Where the borrowing is being secured by irrevocable and unconditional personal guarantee from its promoters/directors in favor of the lending institutions.

d. Pre –Disbursement Compliance

This function is aimed at merchant bankers assisting the borrowing unit in the withdrawal of the loan amount from the financial institution. This done with additional compliance of formalities of provision of information and documentation. Some of the pre-disbursement conditions that require compliance by the merchant banker are documentation. Some of the pre-disbursement conditions that require compliance by the merchant banker are as follows:

1. Completion of creation of security as stipulated in loan agreement
2. Completion of borrowing arrangements with other institutions and banks for raising funds as per the financing plan
3. Non-existence of event of default in payment of principal sum of the loan interest, arrears of interest, and in performance of other terms and conditions of the loan
4. Compliance of special conditions of sanction of loan
5. Review of progress as satisfactory

6. Subscription of share capital by promoters as stipulated in the loan agreement and as stipulated in proposal of financing the project cost.

CREDIT RATING

9.8 Meaning and Definition

Credit rating is the opinion of the rating agency on the relative ability and willingness of tile issuer of a debt instrument to meet the debt service obligations as and when they arise. Rating is usually expressed in alphabetical or alphanumeric symbols. Symbols are simple and easily understood tool which help the investor to differentiate between debt instruments on the basis of their underlying credit quality. Rating companies also publish explanations for their symbols used as well as the rationale for the ratings assigned by them, to facilitate deeper understanding.

In other words, the rating is an opinion on the future ability and legal obligation of the issuer to make timely payments of principal and interest on a specific fixed income security. Therating measures the probability that the issuer will default on the security over its life, which depending on the instrument may be a matter of days to thirty years or more.

In fact, the credit rating is a symbolic indicator of the current opinion of the relative capability of the issuer to service its debt obligation in a timely fashion, with specific reference to the instrument being rated.

It can also be defined as an expression, through use of symbols, of the opinion about credit quality of the issuer of security/instrument.

9.9 Importance of Credit Rating

Credit ratings establish a link between risk and return. They thus provide a yardstick against which to measure the risk inherent in any instrument. An investor uses the ratings toassess the risk level and compares the offered rate of return with his expected rate of return (for the particular level of risk) to optimize his risk-return trade-off.

The risk perception of a common investor, in the absence of a credit rating system, largely depends on his familiarity with the names of the promoters or the

collaborators. It is not feasible for the corporate issuer of a debt instrument to offer every prospective investor the opportunity to undertake a detailed risk evaluation. It is very uncommon for different classes of
investors to arrive at some uniform conclusion as to the relative quality of the instrument. Moreover they do not possess the requisite skills of credit evaluation.

Thus, the need for credit rating in today's world cannot be over emphasized. It is of great assistance to the investors in making investment decisions. It also helps the issuers of the debtinstruments to price their issues correctly and to reach out to new investors. Regulators like Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI) use credit rating to determine eligibility criteria for some instruments. For example, the RBI has stipulated a minimum credit rating by an approved agency for issue of commercial paper. In general,credit rating is expected to improve quality consciousness in the market and establish over a period of time, a more meaningful relationship between the quality of debt and the yield from it.
Credit Rating is also a valuable input in establishing business relationships of various types. However, credit rating by a rating agency is not a recommendation to purchase or sale of asecurity.

Investors usually follow security ratings while making investments. Ratings are considered to be an objective evaluation of the probability that a borrower will default on a given security issue, by the investors.

Whenever a security issuer makes late payment, a default occurs. In case of bonds, non-payment of either principal or interest or both may cause liquidation of a company. In most of the cases, holders of bonds issued by a bankrupt company receive only a portion of the amount invested by them.

Thus, credit rating is a professional opinion given after studying all available information at a particular point of time. Such opinions may prove wrong in the context of subsequent events. Further, there is no private contract between an investor and a rating agency and the investor is free to accept or reject the opinion of the agency. Thus, a rating agency cannot be held responsible for

any losses suffered by the investor taking investment decision on the basis of its rating. Thus, credit rating is an investor service and a rating agency is expected to maintain the highest possible level of analytical competence and integrity. In the long run, the credibility of rating agency has to be built, brick by brick, on the quality of its services provided, continuous research undertaken and consistent efforts made. The increasing levels of default resulting from easy availability of finance, has led to the growing importance of the credit rating. The other factors are:

i. The growth of information technology.

ii. Globalisation of financial markets.

iii. Increasing role of capital and money markets.

iv. Lack of government safety measures.

v. The trend towards privatisation.

vi. Securitisation of debt.

9.10 Indications of the Assigned Ratings

Rating symbols assigned to a security issue is an indicator of the following:

i. the nature and terms of the particular security being issued;

ii. the ability and the willingness of the issuer of a security to make payments in time;

iii. the probability that the issuer will make a default in payments; and

iv. the degree of protection available to the investors if the security issuer company is liquidated, re-organized or declared bankrupt.

9.11 Factors Affecting Assigned Ratings

The following factors generally influence the ratings to be assigned by a credit rating agency:

1. The security issuer’s ability to service its debt. In order, they calculate the past and likely future cash flows and compare with fixed interest obligations of the issuer.

2. The volume and composition of outstanding debt.

3. The stability of the future cash flows and earning capacity of company.

4. The interest coverage ratio i.e. how many number of times the issuer is able to meet its fixed interest obligations.
5. Ratio of current assets to current liabilities (i.e. current ratio (CR)) is calculated to assess the liquidity position of the issuing firm.
6. The value of assets pledged as collateral security and the security's priority of claim against the issuing firm's assets.
7. Market position of the company products is judged by the demand for the products, competitor's market share, distribution channels etc.
8. Operational efficiency is judged by capacity utilization, prospects of expansion, modernization and diversification, availability of raw material etc.
9. Track record of promoters, directors and expertise of staff also affect the rating of a company.

9.12 Nature of Credit Rating

1. Rating is based on information: Any rating based entirely on published information has serious limitations and the success of a rating agency will depend, to a great extent, on its ability to access privileged information. Cooperation from the issuers as well as their willingness to share even confidential information is important pre-requisites. The rating agency must keep information of confidential nature possessed during the rating process, a secret.
2. Many factors affect rating: Rating does not come out of a predetermined mathematical formula. Final rating is given taking into account the quality of management, corporate strategy, economic outlook and international environment. To ensure consistency and reliability a number of qualified professionals are involved in the rating process. The Rating Committee, which assigns the final rating, consists of specialized financial and credit analysts. Rating agencies alsoensure that the rating process is free from any possible clash of interest.
3. Rating by more than one agency: In the well-developed capital markets, debt issues are, more often than not, rated by more than one agency. And it is only natural that ratings given by two or more agencies differ from each other e.g., a

debt issue, may be rated ‘AA+’ by one agency and ‘AA’ or ‘AA-’ by another. It will indeed be unusual if one agency assigns a rating of AA while another gives a ‘BBB’.

4. Monitoring the already rated issues: A rating is an opinion given on the basis of information available at particular point of time. Many factors may affect the debt servicing capabilities of the issuer. It is, therefore, essential that rating agencies monitor all outstanding debt issues
rated by them as part of their investor service. The rating agencies should put issues under close credit watch and upgrade or downgrade the ratings as per the circumstances after intensive interaction with the issuers.

5. Publication of ratings: In India, ratings are undertaken only at the request of the issuers and only those ratings which are accepted by the issuers are published. Thus, once a rating is accepted it is published and subsequent changes emerging out of the monitoring by the agency will be published even if such changes are not found acceptable by the issuers.

6. Right of appeal against assigned rating: Where an issuer is not satisfied with the rating assigned, he may request for a review, furnishing additional information, if any, considered relevant. The rating agency will undertake a review and thereafter give its final decision.

Unless the rating agency had over looked critical information at the first stage chances of the rating being changed on appeal are rare.

7. Rating of rating agencies: Informed public opinion will be the touchstone on which the rating companies have to be assessed and the success of a rating agency is measured by the quality of the services offered, consistency and integrity.

8. Rating is for instrument and not for the issuer company: The important thing to note is that rating is done always for a particular issue and not for a company or the Issuer. It is quite possible that two instruments issued by the same company carry different ratings, particularly if maturities are substantially different or one of the instruments is backed by additional credit reinforcements like guarantees.

In many cases, short-term obligations, like commercial paper (CP) carry the highest rating even as the risk profile changes for longer maturities.

9. Rating not applicable to equity shares: By definition, credit rating is an opinion on the issuer's capacity to service debt. In the case of equity there is no pre-determined servicing obligation, as equity is in the nature of venture capital. So, credit rating does not apply to equity shares.

10. Credit vs. financial analysis: Credit rating is much broader concept than financial analysis. One important factor which needs consideration is that the rating is normally done at the request of and with the active co-operation of the issuer. The rating agency has access to unpublished information and the discussions with the senior management of issuers give meaningful insights into corporate plans and strategies. Necessary adjustments are made to the published accounts for the purpose of analysis. Rating is carried out by specialised professionals who are highly qualified and experienced. The final rating is assigned keeping in view the number of factors.

11. Time taken in rating process: The rating process is a fairly detailed exercise.

It involves, among other things analysis of published financial information, visits to the issuer's officesand works, 'intensive discussion with the senior executives of issuers, discussions with auditors, bankers, creditors etc. It also involves an in-depth study of the industry itself and a degree of environment scanning. All this takes time; a rating agency may take 6 to 8 weeks or more to arrive at a decision. For rating short-term instruments like commercial paper (CP), the time taken may vary from 3 to 4 weeks, as the focus will be more on short-term liquidity rather than

on long-term fundamentals. Rating agencies do not compromise on the quality of their analysis or work under pressure from issuers for quick results. Issuers are always advised to. Approach the rating agencies sufficiently in advance so that issue schedules can be adhered to.

9.13 Instruments for Rating

Rating may be carried out by the rating agencies in respect of the following:

i. Equity shares issued by a company.

ii. Preference shares issued by a company.

iii. Bonds/debentures issued by corporate, government etc.

iv. Commercial papers issued by manufacturing companies, finance companies, banks and financial institutions for raising sh0l1-term loans.

v. Fixed deposits raised for medium-term ranking as unsecured borrowings.

vi. Borrowers who have borrowed money.

vii. Individuals.

viii.Asset backed securities are assessed to determine the risk associated with them.

The objective is to determine quantum of cash flows emerging from the asset that wouldbe sufficient to meet committed payments.

9.14 Rating Other than Debt Instruments

Credit Rating has been extended to all those activities where uncertainty and risk is involved. Now-a-days credit rating is not just limited to debts instruments but also covers the following:

I. Country Rating

A country may be rated whenever a loan is to be extended or some major investment is to be made in it by international investors to determine the safety and security of their investments. A number of factors such as growth rate, industrial and agricultural production, government policies, inflation, fiscal deficit etc. are taken into consideration to arrive at such rating. Any upgrade movement in such—ratings has a positive impact on the stock markets. Morgan Stanlay, Moodys etc. give country ratings.

II. Rating of Real Estate Builders and Developers

CRISIL has started assigning rating to the builders and developers with the objective of helping and guiding prospective real estate buyers. CRISIL thoroughly scrutinises the sale deed papers, sanctioned plan, lawyers' report government clearance certificates before assigning rating to the builder or developer. Past experience of the builder, number of properties built by the builder, financial strength, time taken for completion are some of the factors taken into consideration by the CRISIL before giving a final rating to the real estate builder/ developer.

III. Chit Funds

Chit funds registered as a company are sometimes rated on their ability to make timely payment of prize money to subscribers. The rating helps the chit funds in better marketing of their fund and in widening of the subscribers base. This service is provided by CRISIL.

IV. Rating of States

States of India have also approached rating agencies for rating. Rating helps the State to attract investors both from India and abroad to make investments. Investors find safety of their funds while investing in a state with good rating.

Foreign companies also come forward and set up projects in such states with positive rating. Rating agencies take into account various economic parameters such as industrial and agricultural growth of the State, availability of raw material, labor etc. and political parties' agenda with respect to industry, labor etc., relationbetween Centre and State and freedom enjoyed by the states in taking decisions while assigning final rating to the states. States like Maharashtra, Madhya Pradesh, Tamil Nadu, AndhraPradesh and Kerala have already been rated by CRISIL.

V. Rating of Banks

CRISIL and ICRA both are engaged in rating of banks based on the following six parameters also called CAMELS.

C - C stands for capital adequacy of banks. A bank need to maintain at least 10% capital against risky assets of the bank.

A - A stands for asset quality. The loan is examined to determine non-performing assets. An asset/loan is considered non-performing asset where either interest or principal is unpaid for two quarters or more. Ratios like NPA to Net Advances, Adequacy of Provision & Debt Service Coverage Ratio are also calculated to know exact picture of quality of asset of a bank.

M - M stands for management evaluation. Here, the efficiency and effectiveness of management in framing plans and policies is examined. Ratios like RO!, Return on Capital Employed (ROC E), Return on Assets (ROA) are calculated to comment upon bank's efficiency to utilize the assets.

L - L indicates liquidity position. Liquid and current ratios are determined to find out banks ability to meet its short-term claims.

S - S stands for Systems and Control. Existing systems are studied in detail to determine their adequacy and efficacy.

Thus, the above six parameters are analysed in detail by the rating agency and then final rating is given to a particular bank.

Ratings vary from A to D. Where A denotes financial, managerial and operational soundness of a bank, and D denotes that bank is in financial crisis and lacks managerial expertise and is facing operational problems.

VI. Rating (Recommendation) for Equities

These days analysts specialised in equity ratings make a forecast of the stock prices of a company. They study thoroughly the trend of sales, operating profits and other variables and make a forecast of the earning capacity and profitability position of a company. They use financial statement analysis tools like ratio analysis, trend analysis, fund flow analysis and cash flow analysis to comment upon company's liquidity, solvency, profitability and overall efficiency position. Analysts suggests a target price of the stock giving signal to the investor to swing into action whenever the stock hits that particular price. The following are some of the recommendations made by the equity analysts for its investors:

i. Buy: It shows the stock is worth buying at its current price.

ii. Buy on Declines: This recommendation indicates stock is basically good but overpriced now. The investor should go for buying whenever the price declines.

iii. Long-term Buy: This recommendation suggests that a stock should be bought and held for a longer period at least a year in order to realise gains.

iv. Strong Buy: This buy recommendation strongly favors the purchase of a stock because analysts expect a steep rise in the prices of stock from its current price.

v. Out-performer: This recommendation shows that whatever may be the mood of the stock market the stock will perform better than the market.

vi. Overweight: This refers to that investor can increase the quantum or weight of that stock in his portfolio. This recommendation is applicable to those investors who keep number of stocks in their portfolio.

vii. Hold: This recommendation is a suggestion to the investor to exit because stock prices are not likely to be appreciated significantly from the current price level.

viii.Sell/Dispose/Sub-Standard/Under-weight: It indicates to the investor to sell/dispose off or decrease the weight of stock from its portfolio because stock is fundamentally overvalued at its current level and the investor' should exit from it immediately.

9.15 Functions of a Credit Rating Agency

A credit rating agency serves following functions:

1. Provides unbiased opinion: An independent credit rating agency is likely to provide an unbiased opinion as to relative capability of the company to service debt obligations because of the following reasons:

i. It has no vested interest in an issue unlike brokers, financial intermediaries.

ii. Its own reputation is at stake.

2. Provides quality and dependable information:. A credit rating agency is in a position to provide quality information on credit risk which is more authenticate and reliable because:

i. It has highly trained and professional staff who has better ability to assess risk.

ii. It has access to a lot of information which may not be publicly available.

3. Provides information at low cost: Most of the investors rely on the ratings assigned by the ratings agencies while taking investment decisions. These ratings are published in the form of reports and are available easily on the payment of negligible price. It is not possible for the investors to assess the creditworthiness of the companies on their own.

4. Provide easy to understand information: Rating agencies first of all gather information, and thenanalyze the same. At last these interpret and summarise complex information in a simple and readily understood formal manner. Thus in other words, information supplied by rating agencies can be easily understood by the investors. They need not go into details of the financial statements.

5. Provide basis for investment: An investment rated by a credit rating enjoys higher confidence from investors. Investors can make an estimate of the risk and return associated with a particular rated issue while investing money in them.

6. Healthy discipline on corporate borrowers: Higher credit rating to any credit investment enhances corporate image and builds up goodwill and hence it induces a healthy/ discipline on corporate.

7. Formation of public policy: Once the debt securities are rated professionally, it would be easier to formulate public policy guidelines as to the eligibility of securities to be included in different kinds of institutional port-folio.

9.16 Advantages of Credit Rating

Different benefits accrue from use of rated instruments to different class of investors or the company. These are explained as under:

A. Benefits to Investors

1. Safety of investments. Credit rating gives an idea in advance to the investors about the degree of financial strength of the issuer company. Based on rating he

decides about the investment. A highly rated issue gives an assurance to the investors of safety of Investments and minimizes his risk.

2. Recognition of risk and returns. Credit rating symbols indicate both the returns expected and the risk attached to a particular issue. It becomes easier for the investor to understand the worth of the issuer company just by looking at the symbol because the issue is backed by the financial strength of the company.

3. Freedom of investment decisions. Investors need not seek advise from the stock brokers, merchant bankers or the portfolio managers before making investments. Investors today are free and independent to take investment decisions themselves. They base their decisions on rating symbols attached to a particular security. Each rating symbol assigned to a particular investment suggests the creditworthiness of the investment and indicates the degree of risk involved in it.

4. Wider choice of investments. As it is mandatory to rate debt obligations for every issuer company, at any particular time, wide range of credit rated instruments are available for making investment. Depending upon his own ability to bear risk, the investor can make choice of the securities in which investment is to be made.

5. Dependable credibility of issuer. Absence of any link between the rater and rated firm ensures dependable credibility of issuer and attracts investors. As rating agency has no vested interest in issue to be rated, and has no business connections or links with the Board of Directors. In other words, it operates independent of the issuer company, the rating given by it is always accepted by the investors.

6. Easy understanding of investment proposals. Investors require no analytical knowledge on their part about the issuer company. Depending upon rating symbols assigned by the rating agencies they can proceed with decisions to make investment in any particular rated security of acompany.

7. Relief from botheration to know company. Credit agencies relieve investors from botheration of knowing the details of the company, its history, nature of

business, financial position, liquidity and profitability position, composition of management staff and Board of Directors etc. Creditrating by professional and specialised analysts reposes confidence in investors to rely upon the credit symbols for taking investment decisions.

8. Advantages of continuous monitoring. Credit rating agencies not only assign rating symbols but also continuously monitor them. The Rating agency downgrades or upgrades the rating symbols following the decline or improvement in the financial position respectively.

B. Benefits of Rating to the Company

A company who has got its credit instrument or security rated is benefited in the following ways.

1. Easy to raise resources. A company with highly rated instrument finds it easy to raise resources from the public. Even though investors in different sections of the society understand the degree of risk and uncertainty attached to a particular security but they still get attracted towards the highly rated instruments.

2. Reduced cost of borrowing. Investors always like to make investments in such instrument, which ensure safety and easy liquidity rather than high rate of return. A company can reduce the cost of borrowings by quoting lesser interest on those fixed deposits or debentures or bonds, which are highly rated.

3. Reduced cost of public issues. A company with highly rated instruments has to make least efforts in raising funds through public. It can reduce its expenditure on press and publicity. Rating facilitates best pricing and timing of issues.

4. Rating builds up image. Companies with highly rated instrument enjoy better goodwill and corporate image in the eyes of customers, shareholders, investors and creditors. Customers feel confident of the quality of goods manufactured, shareholders are sure of high returns, investors feel secured of their investments and creditors are assured of timely payments of interest and principal.

5. Rating facilitates growth. Rating motivates the promoters to undertake expansion of their operations or diversify their production activities thus leading to the growth of the company in future. Moreover highly rated companies find it

easy to raise funds from public through new issues or through credit from banks and FIs to finance their expansion activities.

6. Recognition to unknown companies. Credit rating provides recognition to relatively unknown companies going for public issues through wide investor base. While entering into market, investors rely more on the rating grades than on 'name recognition'.

C. Benefits to Intermediaries

Stock brokers have to make less efforts in persuading their clients to select an investment proposal of making investment in highly rated instruments. Thus rating enables brokers andother financial intermediaries to save time, energy costs and manpower in convincing their clients.

9.17 Disadvantages of Credit Rating

Credit rating suffers from the following limitations

1. Non-disclosure of significant information. Firm being rated may not provide significant or material information, which is likely to affect the investor's decision as to investment, to the investigation team of the credit rating company. Thus any decisions taken in the absence of suchsignificant information may put investors at a loss.

2. Static study. Rating is a static study of present and past historic data of the company at one particular point of time. Number of factors including economic, political, environment, and government policies have direct bearing on the working of a company. Any changes after theassignment of rating symbols may defeat the very purpose of risk indicativeness of rating.

3. Rating is no certificate of soundness. Rating grades by the rating agencies are only an opinion about the capability of the company to meets its interest obligations. Rating symbols do not pinpoint towards quality of products or management or staff etc. In other words rating does notgive a certificate of the complete soundness of the company. Users should form an independent view of the rating symbol.

4. Rating may be biased. Personal bias of the investigating team might affect the quality of the rating. The companies having lower grade rating do not advertise or use the rating while raising funds from the public. In such a case the investors cannot get the true information about the riskinvolved in the instrument.

5. Rating under unfavorable conditions. Rating grades are not always representative of the true image of a company. A company might be given low grade because it was passing through unfavorable conditions when rated. Thus, misleading conclusions may be drawn by the investorswhich hampers the company's interest.

6. Difference in rating grades. Same instrument may be rated differently by the two rating agencies because of the personal judgment of the investigating staff on qualitative aspects. This may further confuse the investors.

9.18 MUTUAL FUND

While equity mutual funds are considered safer than direct exposure to stocks, unique equity funds have innate risks. One, there is no comparable fund to get an idea about how the planned investment or strategy is likely to work.

INVESTING IN MUTUAL FUNDS: STRATEGIES

There are many books out in the market that focuses on investment strategies and investing in mutual funds. It could get quite confusing if you were to read so many of them. So here, we would like to outline just 5 broad ways of looking at investing in mutual funds.

1. Sit Tight, Hang On

After you have chosen the mutual fund and invested your money in it, simply sit tight on it. There are several good reasons for this:

i. Cost savings. Every time you decide to sell a mutual fund and replace it with another, you incur additional costs - initial entry load for the new fund, exit load from the old fund and so on. Add these costs together and you would be losing quite a bit.

ii. Hard to catch the right timing.If you're buying and selling, it must mean that you are trying to time your investments, hoping to catch the

momentum of each mutual fund. The truth is that it is very hard to catch market timing. Even if you can get 70% of your decisions right, the 30% of wrong decisions can cost you all your earnings or more. It has happened before.

iii. Earn potential returns. Don't decide to sell a fund only because it had gone up 20% within 6 months! You should sell a fund when its underlying valuation is high and buy a fund when its valuation is low. Even if a fund had gone up 20%, if its underlying valuation remains low, the fund is likely to go up in the coming future.

So, this is our first recommendation. Slow and steady wins the race. Let TIME be your ally. Sure, the temptation to sell a mutual fund after it has done 20% is great, but your best bet to a healthy financial future is to stay with the mutual fund. Over the long term, it may only give you an annualised return of only 15% a year (some years it will give negative returns), but if you compound 15% over those number of years, you will see how big your investments can become. (Use our Forward Compounder to find out).Create a SIP - read more about this in Best Strategy of All.

2. Actively Pursue Growth

This is our second recommended strategy. To do this well, you have to come back to Fundsupermart.com everyday! Read the latest breaking news we cover and check your portfolio's returns constantly.

The way to do this right is if you set very specific goals on each investment. Don't buy just because everyone is buying. Ask yourself what returns you can reasonably expect to see on the mutual fund within that kind of time frame. Sell only when those targets have been reached. Then, invest time in proper research and goal forming again, before you do your next purchase.

To capitalise on growth, you would be looking more at narrowly focused mutual funds, such as sector-focused mutual funds. Several mutual funds did more than 100% in 2006, largely because of the market boom. You might think that the

Indian stock market might not yield that kind of growth in 2010 or 2011. Where would such high growth come from? Infrastructure sector?Technology sector?Or Pharmaceutical sector? Do your research and invest accordingly.
For those of you who want excitement in your investments, this is the way to go. But remember that you should not bet your last rupee on short term gains. Mutual funds are medium to long term investment instruments. So even if you are a 'growth' investor, you still should let your investments sit for a year or so.

9.19 BUSINESS VALUATION

This is a process and a set of procedures used to estimate the economic value of an owner's interest in a business. Valuation is used by financial market participants to determine the price they are willing to pay or receive to consummate a sale of a business.
In addition to estimating the selling price of a business, the same valuation tools are often used by business appraisers to resolve disputes related to estate and gift taxation, divorce litigation, allocate business purchase price among business assets, establish a formula for estimating the value of partners' ownership interest for buy-sell agreements, and manyother business and legal purposes.

9.20 Elements of business valuation

1. Economic conditions

A business valuation report begins with a description of national, regional and local economic conditions existing as of the valuation date, as well as the conditions of the industry in which the subject business operates. A common source of economic information for the first section of the business valuation report is the Federal Reserve Board's Beige Book, published eight times a year by the Federal Reserve Bank. State governments and industry associations often publish useful statistics describing regional and industry conditions.

2. Financial Analysis

The financial statement analysis generally involves:

- common size analysis,

- ratio analysis (liquidity, turnover, profitability, etc.),
- trend analysis
- industry comparative analysis.

This permits the valuation analyst to compare the subject company to other businesses in the same or similar industry, and to discover trends affecting the company and/or the industry over time. By comparing a company's financial statements in different time periods, the valuation expert can view growth or decline in revenues or expenses, changes in capital structure, or other financial trends.

How the subject company compares to the industry will help with the risk assessment and ultimately help determine the discount rate and the selection of market multiples.

3. Normalization of financial statements

The most common normalization adjustments fall into the following four categories:

- **Comparability adjustments:** The valuator may adjust the subject company's financial statements to facilitate a comparison between the subject company and other businesses in the same industry or geographic location. These adjustments are intended to eliminate differences between the way that published industry data is presented and the way that the subject company's data is presented in its financial statements.
- **Non-operating adjustments :**It is reasonable to assume that if a business were sold in a hypothetical sales transaction (which is the underlying premise of the fair market value standard), the seller would retain any assets which were not related to the production of earnings or price those non-operating assets separately. For this reason, non-operating assets are usually eliminated from the balance sheet.
- **Non-recurring adjustments :**The subject company's financial statements may be affected by events that are not expected to recur, such as the purchase or sale of assets, a lawsuit, or an unusually large revenue or expense. These non-recurring items are adjusted so that the financial statements will better reflect the management's expectations of future performance.

- **Discretionary adjustments :**The owners of private companies may be paid at variance from the market level of compensation that similar executives in the industry might command. In order to determine fair market value, the owner's compensation, benefits, perquisites and distributions must be adjusted to industry standards. Similarly, the rent paid by the subject business for the use of property owned by the company's owners individually may be scrutinized.

9.21 Conclusion

Portfolio management is believed to be the leading strategy in the success of the modern companies. Adopting these strategies as discussed above enables the company to provide confidence to stakeholders (shareholders, customers, employees, and suppliers). . Additionally, embracing technology helps the company to lower down the cost of running the projects as well as improving reducing the payback period. In an effort to improve portfolio management, the company should embrace a culture of promoting the management of the portfolio by ensuring that the process is deeply rooted throughout the company. This involves workers across departments, they should be supportive in all aspect by way of communicating and investing their knowledge and skills in companies project undertakings. Most importantly, the management should set aside enough resources for the project management. Dedicating enough resources means getting effective solutions, additionally, the company must invest in training the professionals who participates directly in portfolio management to ensure the company is heading towards achieving its objectives. The management should be aware of the challenges that face the project management in order to avoid derailment of the projects development. Among them include, adopting poor tools and in-effective technology, in adequate knowledge and understanding.

Questions

1. What is a portfolio management service? Explain the types of portfolio management services.
2. What is credit syndication? What are the scopes of credit syndication services?
3. What is feasibility report? How it is relate to the project?
4. What is credit rating? Explain the importance of credit rating.
5. What is syndication of assigned rating? Explain the factors affecting credit rating?
6. Explain the nature of credit rating.
7. What are instrument using for credit rating?
8. State the rating other than debt instruments.
9. Explain the functions of credit rating agencies.
10. What are the advantages and disadvantages of credit rating?
11. What is mutual fund? Outline five broad ways of looking at investing in mutual fund.
12. What is business valuation? Explain the elements of business valuation.

UNIT – 4

CHAPTER - 10

10.1 Introduction
10.2 Definition
10.3 Origin
10.4 Regulation and development of mutual funds
10.5 Types of mutual fund
10.6 Classification of mutual fund
10.7 Importance / benefits of mutual funds
10.8 Mutual fund Vs Insurance
10.9 Mutual funds Industry in India
10.10 Major mutual fund companies in India
10.11 Constitution and management of mutual fund
10.12 Sponsor
10.13 Trustees
10.14 Contents of trust deed
10.15 Approval of the board for appointment of trustee
10.16 Functions of trustees
10.17 Rights and obligations of trustees
10.18 Asset management company
10.19 SEBI regulations
10.20 New SEBI guidelines for mutual funds
10.21 Conclusion

MUTUAL FUND

10.1 Introduction

A mutual fund is a pool of money from numerous investors who wish to save or make money just like you. Investing in a mutual fund can be a lot easier than buying and selling individual stocks and bonds on your own. Investors can sell their shares when they want.

10.2 Definition

According to Association of Mutual Funds in India (**AMFI**), "A Mutual fund is a trust that pools number of savings investors, who shares common financial goal'. From the aforesaid definition, we can understand the concept of Mutual fund and the key points as mentioned hereunder:-

- Mutual fund is a trust
- Mutual fund pools money from a group of investors called **Unit Holders**
- The investors share common financial goals
- Invest the money, collected from small investors into securities (shares, bonds etc.,). It is called as **diversified investment**.
- Mutual Fund use professional expertise (investment management skills) on investments made.
- Asset classes of investments match the stated investment objectives of the scheme
- Incomes and Gains from the investments are passed on to the unit holders based on the proportion of the number of units they own.

10.3 ORIGIN

Even though Historians are uncertain of the origin of investment funds, some say that the closed-end investment companies launched at Netherlands in the year 1822 by the King William-I is the first mutual funds, whereas some others say that Dutch merchant named Adriaan van Ketwich, whose investment trust was created in the year 1774 might have given the idea to the king. Ketwich probably theorized that diversification would increase the appeal for investments to smaller investors with the minimal capital. The name of Ketwich's fund, EendragtMaaktMagt, means "unity creates strength".

A further development of mutual funds was made in Switzerland in the year 1849, and subsequently it was followed in Scotland in the 1880s in the similar fashion. Consequent to the evolution of mutual fund rooted in Great Britain and France, the idea of pooling resources and spreading risk using closed-end investments, came to the United States in the year 1890s.

The first closed-end fund "Boston Personal Property Trust" was formed in U.S in the year 1893. The modern mutual fund evolution developed in the year 1970 in Philadelphia under the name Alexander Fund had special features of semi-annual issues and facility for investors to withdraw their investments on demand.

The Launching of the Modern Fund

In the year 1924, the modern mutual fund was created in pursuance of the formulation of the Massachusetts Investors' Trust in Boston. Generation of the mutual fund firm namely "MFS Investment Management" went public in the year 1928". The custodian of the Massachusetts Investors' Trust was State Street Investors. However, State Street Investors started generating their own fund at the helm in the year 1924 with Richard Paine, Richard Saltonstall and Paul Cabot. It is also pertinent to note that Saltonstall was also associated with Scudder, Stevens and Clark. In view of the said setup the first no-load fund was launched in the year 1928. Instantaneously, the first new launch of Wellington Mutual Fund emerged to include stocks and bonds, as opposed to direct merchant bank style of investments in business and trade.

10.4 REGULATION AND DEVELOPMENT OF MUTUAL FUNDS

19 open-ended mutual funds and nearly 700 closed-end funds existed before the stock market crash of 1929. Due to that crash, closed-end funds were wiped out. Small open-end funds managed to survive. To protect the investors, Government regulators created the **Securities and Exchange Commission** (SEC). It paved way to enact the **Securities Exchange Act of 1934**. As a result, mutual funds must register with the SEC and to reveal it in its prospectus.

The mutual fund industry grew-up gradually during 1950s with 100 top open-end funds. And in addition to that, 50 new funds emerged during the decade. Hundreds of new funds were launched during the decade of 1960s, which had aggressive growth till the bear market condition of 1969. The first index fund concept was established in the year 1971 by William Fouse and John McQuown of Wells Fargo Bank. The mutual fund industry further flourished due to the impact of Low-cost index fund and the rise of no-load fund.

The assets and household ownership of mutual funds experienced rapid growth simultaneously in United States also.

On account of increasing globalization of finance, expanding presence of large multinational financial groups and strong performance of equity and bond markets, the global growth of mutual funds boosted during 1990s.

10.5 TYPES OF MUTUAL FUND

There are various tools for investing money such as bank deposits, metals, real estates, and stock market instruments. The scale of risk and return is based on the type of investments. Investors should tradeoff between risk and return. If they invest in bank deposits, the risk is very lower and at the same time the return is also very lower than that of any other means of investment. The metals and real estate assets are not sold easily.

The expectation of investors is higher return with lower risk or Lower risk with optimum return within short period of time. It is possible only in stock market investments. But it is not possible to the common investor because he is not technically competent to understand the stock market operations. A common man can invest his money safely in stock market through the rescuer, Mutual funds.

Mutual funds are dynamic financial institutions which play a crucial role in an economy by mobilizing savings and investing them in the capital market. Savings pooled from small investors are invested through a fund manager to purchase a diversified portfolio of stocks or bonds. An investor can invest in mutual fund at lower cost with the advantage of diversification. Diversification

means “spreading out money across many different types of investments”. When one investment involves high risk, another might be lower. Diversification of investment holdings reduces the risk tremendously.

On the basis of their structure and objective, mutual funds can be classified into various types. Generally, there are two major types of Mutual Funds:-

- Open-end Mutual Funds
- Closed-end Mutual Funds

1. **Open End Mutual Funds**

An open-ended fund or scheme is one that is available for subscription and repurchase on a continuous basis. These schemes do not have a fixed maturity period. Investors can conveniently buy and sell units at **Net Asset Value** (NAV) related prices, which are notified a daily. The key feature of open-end schemes is their liquidity.

2. **Closed End Mutual Funds**

A close-ended fund or scheme has a stipulated maturity period say for e.g. 5-7 years. The fund is open for subscription only during a specified period at the time of launching of the scheme. Investors can invest in the scheme at the time of the initial public issue and thereafter they can buy or sell the units of the scheme through the stock exchanges, where the units are listed. In order to provide an exit route to the investors, some close-ended funds give an option of selling back the units to the mutual fund through periodic repurchase at NAV related prices. Stock Exchange Board of India (**SEBI**) Regulations stipulate that at least one of the two exit routes is provided to the investor i.e. either repurchase facility or through listing on stock exchanges. These mutual funds schemes disclose NAV generally on weekly basis. They are traded more like the general stocks.

The reasons to invest in this category are:

Prices are determined by market demands and thus, closed end funds trade at lower than the offer price more often.

The open end funds provide wide options for investors to choose from (a) stock funds and balanced funds which give full asset allocation benefit and (b) bond funds.

After the closure of the offer, buying and redemption of units by the investors directly from the Funds are not allowed. However, to protect the interests of the investors, SEBI provides investors with two avenues to liquidate their positions:

1. Closed-end Funds are listed on the stock exchanges where investors can buy/sell units from/to each other. The trading is generally done based on NAV at a discounted rate. The NAV of a closed-end fund is computed on a weekly basis (updated every Thursday).
2. Closed-end Funds may also offer "buy-back of units" to the unit holders. In this case, the corpus of the Fund and its outstanding units do get changed.

10.6 CLASSIFICATION OF MUTUAL FUND

A scheme can also be classified as growth scheme, income scheme, or balanced scheme considering its investment objective. Such schemes may be open-ended or close-ended schemes. Such schemes may be classified mainly as follows:

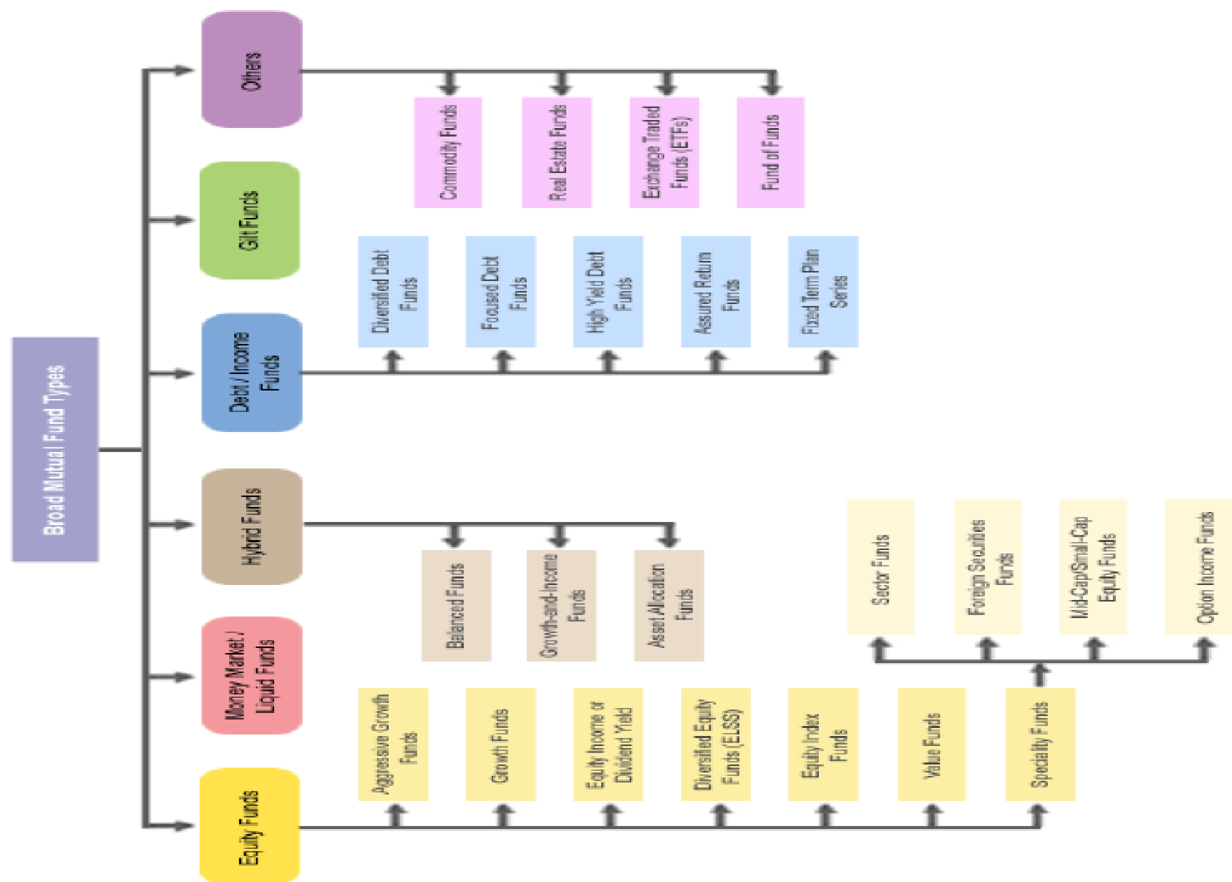
I. Equity Funds

Equity funds provide higher returns and at the same time it is more risky while compared to any other fund. For long term investment purpose, an investor is advised to invest in equity. There are different types of equity funds under different level of risk as follows:

a. Aggressive Growth Funds – The maximization of capital appreciation is the mantra for fund managers. So they invest in highly grown-up companies' equities and less in speculative investments. Investment in speculative nature of equities may lead to higher risk.

b. Growth Funds – Here, the objective is to achieve an increase in value of investment through capital appreciation and not in the regular income. Fund

manager selects the companies which are expected to earn above average in future for the investment of growth funds.



c. Equity Income or Dividend Yield Funds – These are for investors who are more concerned about regular returns from investments. Fund manager invests in those companies which declare high rate of dividends. Capital appreciation and risk level are less while compared to other equity funds.

d. Diversified Equity Funds – Fund manager invests this type of funds in the equities of all the companies and industries without any specified industry or sector. Due to this diversification of investment, the market risk is also diversified. Example **Equity Linked Savings Schemes** (ELSS). (ELSS investors can claim deduction from taxable income (up to Rs 1 lakh) at the time of filing the income tax return).

e. Equity Index Funds – It is based on the performance of a specific stock **market index. Equity index funds are two types namely broad indic**es (like

S&P CNX Nifty, Sensex) and narrow indices (like **BSEBANKEX or CNX Bank Index** etc). Investments in Narrow indices index funds are less diversifiable; therefore it is more risky than that of broad indices index funds.

f. Value Funds – Fund manager invests in shares of companies which have strong financial performance but whose price-earnings ratio is low. Price-earnings ratio is the relationship between the Market Price per share and Earnings per share. These companies' book value of the shares is higher than the market price. The market price of these shares may rise in future. With this assumption the fund manager invests huge fund for long term time horizon. The cyclical industries like cement, steel, sugar etc., are the examples of value stocks.

g. Specialty Funds - Specialty funds are concentrated on particular industry or companies. Concentration is based on certain criteria for investments and those criteria must match with their portfolio. It is much riskier than other funds. **i. Sector Funds:** The portfolio of sector funds comprises of only those companies that meet their criteria.

ii. Foreign Securities Funds: Fund manager invests in securities of one or more foreign companies. This fund gets the advantage of international diversification, but it has to face the foreign exchange rate risk and country risk.

iii. Mid-Cap or Small-Cap Funds: The Mutual Fund invests in securities of those companies whose market capitalization is lower. The market capitalization of Mid-Cap companies is between ` 500 crore and ` 2500. In case of Small-Cap companies' market capitalization is lower than ` 500 crore. The market capitalization is the market price of the share multiplied by the number of outstanding shares of the company. The volatility of this type of companies' securities is very high but the liquidity is very low. Due to this high volatility and low liquidity the risk of this kind of companies' securities will be very high.

iv. Option Income Funds: Option income funds are those funds invested in high yielding companies. The options are used for hedging activity i.e., to reduce the risk or volatility. The risk can be controlled by way of proper utilization of options. It generates stable income for investors.

II.Money Market / Liquid Funds

Money market instruments are short-term interest bearing debt securities i.e., Treasury bills issued by Governments, (30 days, 60 days, 90 days etc., but maturing within one year), certificate of deposits issued by banks, commercial papers issued by companies etc.,. These securities are having high liquidity and safety. The investments in these funds are called money market/liquid funds. The risk of these funds is due to interest rate fluctuation.

III.Hybrid Funds

Hybrid funds comprise the portfolio of equities, debts and money market securities. The debt and equity are equal in proportion for the investment.

The types of hybrid funds in India are as follows:

a. Balanced Funds

The equal proportion of debt, equity, preference and convertible securities is the portfolio of balanced funds. It gives regular income and moderates capital appreciation to investors. The risk of capital is at the minimum level. This fund is suitable for traditional investors of those who prefer long term investment.

b. Growth-and-Income Funds

The combination of the features of growth funds and income funds is referred as Growth-and Income Funds. The capital appreciation as well as declaration of high dividend companies' securities is comprised in the portfolio of this fund.

c. Asset Allocation Funds

There are two types of investment avenues namely financial assets (equity, debt, money market instruments) and non-financial assets (real estate, gold, commodities). The fund manager may adopt the strategy of variable asset allocation. It allows change over from one asset to another at any time depending upon the market trends.

IV. Debt / Income Funds

The investment of debt or income funds is purely only on the debt instruments issued by private companies, banks, financial institutions, governments and other entities. These funds are suitable to those investors who expect regular income and low risk. Debt instruments are graded by credit rating agencies. Grading indicates the risk of the debt securities. There are different types of debt funds based on investment objectives, which are as follows:-

a. Diversified Debt Funds

The portfolio of the fund comprises the debt securities of all companies belonging to all industries. The result of diversified investments in all sectors is risk reduction.

b. Focused Debt Funds

Debt funds that invest in debt securities issued by entities belonging to a particular sector or companies of the market are known as focused debt funds.

c. High Yield Debt funds

Generally, all debt funds have default risk. By and large, investors would like to invest in **"high investment grade**" securities which protect the risk of default. High yield debt funds invested in "below investment grade" securities provides high returns but the existence of default risk is higher due to more volatility.

d. Assured Return Funds

The investors of this fund will get assured returns with a low-risk investment opportunity. But there may be a shortfall in returns which is borne by Asset Management Company or sponsor. The security of investments depends upon the net worth of the guarantor, whose name is specified in the offer document. To safeguard the interest of investors, the sponsors must have adequate net worth to guarantee returns as per the norms of SEBI to offer assured return schemes. Unit trust of India had offered 'Monthly Income Plans' under the scheme of assured return schemes. But the UTI had failed to fulfill its promises due to heavy shortfall in returns.The UTI's payment obligations were taken over by the Government. Now-a-days no assured return schemes are offered in India.

e. Fixed Term Plan Series

The funds' attracts the short-term investors and invests in short term debt securities. It is a closed-end scheme that offers a series of plans and issues units to investors at regular intervals. But these plans are not listed on the stock exchanges.

V. Gilt Funds

The portfolio of Gilt fund' is only the government securities of medium and long term matured bonds. It provides much safety to the investors with no credit risk. But it is exposed to interest rate risk.

VI. Others

1.Commodity Funds

The focus of investment of this fund is on different commodities, such as metals (like gold, silver, copper etc.,), food grains, oils, etc., or options and futures, contracts of commodities, commodity producing companies etc. The concentration of investment may be made on a specialized commodity or on a diversified commodity fund. Specialized commodity fund bears more risk than that of diversified commodity fund.

2.Real Estate Funds

Real estate investment provides higher capital appreciation and generates regular and higher income to the investors. Real estate investment includes not only in direct investment in real estate but also investments in securities of housing finance companies or lending to real estate developers.

3.Exchange Traded Funds (ETF)

Exchange Traded Funds are traded on stock exchanges like a single stock at index linked prices and it follows stock market indices. Investors of this fund get benefits of both closed-end fund and open-end mutual fund. It is very popular in London and New York stock exchanges. In India, it is introduced recently. This fund is more diversified and flexible of holding like a single share.

4.Fund of Funds

It means funds of a mutual fund invested in units of mutual fund schemes offered by other Asset Management Companies. No investments are made on financial (shares, bonds) or physical assets of the Fund of Funds. The investors of this fund get benefit of diversifying into different mutual fund schemes with a small amount of investment. And also, it facilitates diversification of risks.

10.7 IMPORTANCE / BENEFITS OF MUTUAL FUNDS

1.Mobilizing Small Savings: Funds are mobilized by way of selling units. A unit is a proportional share of securities in the portfolio of a mutual fund. Small fund investors get benefits of portfolio investment with the small amount of their savings.

2.Investment Avenue : Mobilized funds are invested in various types of investment avenues. Investment avenues are Shares and Bonds of various Companies and Industries, Gold, Deposits, Govt. bonds, Money Market Instruments etc., Investors can get opportunity on the portfolio of assets proportionately. Individual investors may not invest in all these investment avenues.

3.Professional Management: 'Mutual Funds' utilizes professional experts and the experts manage the investment portfolios efficiently and profitably. Investors are free from taking risk of buying and selling shares.

4.Diversified Investment: Small investors can enjoy the benefit of portfolio investment through mutual funds. Mutual funds have the advantage of diversified investment in various industry segments.

5.Liquidity: Mutual fund investors can buy and sell their units in the secondary market in case of close - ended mutual funds. In case of open-ended mutual funds, the investors can withdraw holdings any time at the Net Asset Value.

6.Less Risk : Mutual fund investment involves very less risk. Because, the fund is managed with the professional expertise, portfolio investment, diversification and the economies of scale in transaction cost.

7.Legal Protection : Securities Exchange Board of India (SEBI) is the regulatory body of securities market in India; it provides the regulations and guidelines for Mutual funds

8.Tax Benefits : Under the provisions of Income Tax Act, the investors of mutual fund can get tax shelter on the their investment in Mutual fund.

9.Minimum Transaction Costs: The transaction cost of buying and selling of mutual fund units is very less. This facilitates the investors to switch over from one scheme to another and they get benefit of flexible investment opportunities.

10.Economic Development : Mobilization of savings leads to investment. Mutual fund money is utilized for the investment in various industrial sectors. Industrial sector development leads to enhance the countries' economy.

10.8 Mutual Fund vs Insurance

Mutual Fund	**Insurance**
Returns are higher	Lower returns, but risk too is low
Fund management is active	Ideal for long term investors
Lower distribution fees	Offer switching between asset classes without any load
Tax liabilities in some schemes	No Tax liability
Offers a range of products in debt and equity	Security is a big trigger for investing

10.9 Mutual Funds Industry in India

Mutual Fund in India was first started by **Unit Trust of India** (UTI) in the year 1964 in the form of investment trust. UTI initially started with open-ended mutual fund; the first unit scheme offered was the "US-64" and the face value of a single unit was ` 10, to attract the medium and low income group people. UTI enjoyed the monopoly of Mutual fund till 1987 and later the Government of India by amending the Banking Regulation Act, permitted commercial banks in the public sector to set up subsidiaries operating as trusts to perform the functions of mutual funds.

Before, the monopoly of the market had seen an ending phase; the Assets under Management (AUM) were ` 67 billion. The private sector entry to the fund family raised the AUM to ` 470 billion in March 1993 and at the end of April 2004; it reached the height of 1,540 billion.

Putting the AUM of the Indian Mutual Funds Industry into comparison, the total of it is less than the deposits of SBI alone and less than 11% of the total deposits held by the Indian banking industry. The main reason for its poor growth is that the mutual fund industry in India is new to the country. Hence, it is the prime responsibility of all mutual fund companies, to market correctly the product besides selling.

The growth of mutual fund industry in India is broadly put into four phases. The description of each phase is as under:

First Phase - 1964-87

In 1963, Unit Trust of India (UTI) was established by an Act of Parliament. It functioned under the Regulatory and administrative control of the Reserve Bank of India. In 1978, the Industrial Development Bank of India (IDBI) took over the regulatory and administrative control from RBI. The first scheme launched by UTI was Unit Scheme 1964. The detailed notes about UTI are given separately in this unit.

Second Phase - 1987-1993 (Entry of Public Sector Funds)

Entry of Non-UTI Mutual Funds

SBI Mutual Fund was the first public sector mutual funds followed by Canbank Mutual Fund (Dec 87), Punjab National Bank Mutual Fund (Aug 89), Indian Bank Mutual Fund (Nov 89), Bank of India (Jun 90), Bank of Baroda Mutual Fund (Oct 92), LIC (1989) and GIC (1990). The end of 1993 marked ` 47, 004 crores as assets under management.

Third Phase - 1993-2003 (Entry of Private Sector Funds)

During 1993, a new era started in the Indian mutual fund industry due to the entry of private sector funds. The Mutual Fund Regulations came into existence under which all mutual funds were to be registered and governed except UTI.

The erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private sector mutual fund registered in July 1993. In 1996, SEBI (Mutual Fund) Regulations were framed. During this phase, many foreign mutual funds were set up in India and the industry witnessed several mergers and acquisitions. As at the end of January 2003, there were 33 mutual funds with total assets of ` 1, 21,805 crores out of which the assets of UTI alone were ` 44,541 crores.

Fourth Phase - since February 2003

In February 2003, UTI was bifurcated into two separate entities. One is the Specified Undertaking of the Unit Trust of India with AUM (Asset Under Management) of ` 29,835 crores (as on January 2003). The Specified Undertaking of Unit Trust of India, functioning under an administrator and under the rules framed by Government of India does not come under the purview of the Mutual Fund Regulations. The second is the UTI Mutual Fund Ltd, sponsored by SBI, PNB, BOB and LIC. It was registered under SEBI Mutual Fund Regulations Act 1996.

10.10 Major Mutual Fund Companies in India

ABN AMRO Mutual Fund

ABN AMRO Mutual Fund was setup on April 15, 2004 with ABN AMRO Trustee (India) Pvt. Ltd. as the Trustee Company. The AMC, ABN AMRO Asset Management (India) Ltd. was incorporated on November 4, 2003. Deutsche Bank AG is the custodian of ABN AMRO Mutual Fund

Birla Sun Life Mutual Fund

Birla Sun Life Mutual Fund is the joint venture of Aditya Birla Group and Sun Life Financial. Sun Life Financial is a golbalorganisation evolved in 1871 and is being represented in Canada, the US, the Philippines, Japan, Indonesia and Bermuda apart from India. Birla Sun Life Mutual Fund follows a conservative long-term approach to investment. Recently it crossed AUM of ` 10,000 crores.

Bank of Baroda Mutual Fund (BOB Mutual Fund)

Bank of Baroda Mutual Fund or BOB Mutual Fund was setup on October 30, 1992 under the sponsorship of Bank of Baroda. BOB Asset Management Company Limited is the AMC of BOB Mutual Fund and was incorporated on November 5, 1992. Deutsche Bank AG is the custodian.

HDFC Mutual Fund

HDFC Mutual Fund was setup on June 30, 2000 with two sponsorersnemely Housing Development Finance Corporation Limited and Standard Life Investments Limited.

HSBC Mutual Fund

HSBC Mutual Fund was setup on May 27, 2002 with HSBC Securities and Capital Markets (India) Private Limited as the sponsor and Board of Trustees.

ING Vysya Mutual Fund

ING Vysya Mutual Fund was setup on February 11, 1999 with the same named Trustee Company. It is a joint venture of Vysya and ING. The AMC, ING Investment Management (India) Pvt. Ltd. was incorporated on April 6, 1998.

Prudential ICICI Mutual Fund

The mutual fund of ICICI is a joint venture with Prudential Plc. of America, one of the largest life insurance companies in the US of A. Prudential ICICI Mutual Fund was setup on 13th of October, 1993 with two sponsorers, Prudential Plc. and ICICI Ltd. The Trustee Com-pany formed is Prudential ICICI Trust Ltd. and the AMC is Prudential ICICI Asset Management Company Limited incorporated on 22nd of June, 1993.

Sahara Mutual Fund

Sahara Mutual Fund was set up on July 18, 1996 with Sahara India Financial Corporation Ltd. as the sponsor. Sahara Asset Management Company Private Limited incorporated on August 31, 1995 works as the AMC of Sahara Mutual Fund. The paid-up capital of the AMC stands at ` 25.8 crore.

State Bank of India Mutual Fund

State Bank of India Mutual Fund is the first Bank sponsored Mutual Fund to launch offshore fund, the India Magnum Fund with a corpus of ` 225 cr.

approximately. Today it is the largest Bank sponsored Mutual Fund in India. They have already launched 35 Schemes out of which 15 have already yielded handsome returns to investors. State Bank of India Mutual Fund has more than ` 5,500 Crores as AUM. Now it has an investor base of over 8 Lakhs spread over 18 schemes.

Tata Mutual Fund

Tata Mutual Fund (TMF) is a Trust under the Indian Trust Act, 1882. The sponsorers for Tata Mutual Fund are Tata Sons Ltd., and Tata Investment Corporation Ltd. The investment manager is Tata Asset Management Limited and its Tata Trustee Company Pvt. Limited. Tata Asset Management Limited's is one of the fastest in the country with more than ` 7,703 crores (as on April 30, 2005) of AUM.

Kotak Mahindra Mutual Fund

Kotak Mahindra Asset Management Company (KMAMC) is a subsidiary of KMBL. It is presently having more than 1,99,818 investors in its various schemes. KMAMC started its operations in December 1998. Kotak Mahindra Mutual Fund offers schemes catering to investors with varying risk - return profiles. It was the first company to launch dedicated gilt scheme investing only in government securities.

Unit Trust of India Mutual Fund

UTI Asset Management Company Private Limited, established in Jan 14, 2003, manages the UTI Mutual Fund with the support of UTI Trustee Company Privete Limited. UTI Asset Management Company presently manages a corpus of over ` 20000 Crore. The sponsorers of UTI Mutual Fund are Bank of Baroda (BOB), Punjab National Bank (PNB), State Bank of India (SBI), and Life Insurance Corporation of India (LIC). The schemes of UTI Mutual Fund are Liquid Funds, Income Funds, Asset Management Funds, Index Funds, Equity Funds and Balance Funds.

Reliance Mutual Fund

Reliance Mutual Fund (RMF) was established as trust under Indian Trusts Act, 1882. The sponsor of RMF is Reliance Capital Limited and Reliance Capital

Trustee Co. Limited is the Trustee. It was registered on June 30, 1995 as Reliance Capital Mutual Fund which was changed on March 11, 2004. Reliance Mutual Fund was formed for launching of various schemes under which units are issued to the Public with a view to contribute to the capital market and to provide investors the opportunities to make investments in diversified securities.

Standard Chartered Mutual Fund

Standard Chartered Mutual Fund was set up on March 13, 2000 sponsored by Standard Chartered Bank. The Trustee is Standard Chartered Trustee Company Pvt. Ltd. Standard Chartered Asset Management Company Pvt. Ltd. is the AMC which was incorporated with SEBI on December 20,1999.

Franklin Templeton India Mutual Fund

The group, Frnaklin Templeton Investments is a California (USA) based company with a global AUM of US$ 409.2 bn. (as of April 30, 2005). It is one of the largest financial services groups in the world. Investors can buy or sell the Mutual Fund through their financial advisor or through mail or through their website. They have Open end Diversified Equity schemes, Open end Sector Equity schemes, Open end Hybrid schemes, Open end Tax Saving schemes, Open end Income and Liquid schemes, Closed end Income schemes and Open end Fund of Funds schemes to offer.

Morgan Stanley Mutual Fund India

Morgan Stanley is a worldwide financial services company and its leading in the market in securities, investmenty management and credit services. Morgan Stanley Investment Management (MISM) was established in the year 1975. It provides customized asset management services and products to governments, corporations, pension funds and non-profit organisations. Its services are also extended to high net worth individuals and retail investors.

In India it is known as Morgan Stanley Investment Management Private Limited (MSIM India) and its AMC is Morgan Stanley Mutual Fund (MSMF). This is the first close end diversified equity scheme serving the needs of Indian retail investors focussing on a long-term capital appreciation.

Escorts Mutual Fund

Escorts Mutual Fund was setup on April 15, 1996 with Excorts Finance Limited as its sponsor. The Trustee Company is Escorts Investment Trust Limited. Its AMC was incorporated on December 1, 1995 with the name Escorts Asset Management Limited.

Alliance Capital Mutual Fund

Alliance Capital Mutual Fund was setup on December 30, 1994 with Alliance Capital Management Corp. of Delaware (USA) as sponsorer. The Trustee is ACAM Trust Company Pvt. Ltd. and AMC, the Alliance Capital Asset Management India (Pvt) Ltd. with the corporate office in Mumbai.

Benchmark Mutual Fund

Benchmark Mutual Fund was setup on June 12, 2001 with Niche Financial Services Pvt. Ltd. as the sponsorer and Benchmark Trustee Company Pvt. Ltd. as the Trustee Company. Incorporated on October 16, 2000 and headquartered in Mumbai, Benchmark Asset Management Company Pvt. Ltd. is the AMC.

Canbank Mutual Fund

Canbank Mutual Fund was setup on December 19, 1987 with Canara Bank acting as the sponsor. Canbank Investment Management Services Ltd. incorporated on March 2, 1993 is the AMC. The Corporate Office of the AMC is in Mumbai.

Chola Mutual Fund

Chola Mutual Fund under the sponsorship of Cholamandalam Investment & Finance Company Ltd. was setup on January 3, 1997. Cholamandalam Trustee Co. Ltd. is the Trustee Company and AMC is Cholamandalam AMC Limited.

LIC Mutual Fund

Life Insurance Corporation of India set up LIC Mutual Fund on 19th June 1989. It contributed ` 2 Crores towards the corpus of the Fund. LIC Mutual Fund was constituted as a Trust in accordance with the provisions of the Indian Trust Act, 1882.. The Company started its business on 29th April 1994. The Trustees

of LIC Mutual Fund have appointed JeevanBimaSahayog Asset Management Company Ltd as the Investment Managers for LIC Mutual Fund.

GIC Mutual Fund

GIC Mutual Fund, sponsored by General Insurance Corporation of India (GIC), a Government of India undertaking and the four Public Sector General Insurance Companies, viz. National Insurance Co. Ltd (NIC), The New India Assurance Co. Ltd. (NIA), The Oriental Insurance Co. Ltd (OIC) and United India Insurance Co. Ltd. (UII) and is constituted as a Trust in accordance with the provisions of the Indian Trusts Act, 1882.

The mutual funds are listed as follows:

A. Bank Sponsored

1. Joint Ventures – Predominantly Indian

CanaraRobeco Asset Management Company Limited

SBI Funds Management Private Limited

2. Joint Ventures – Predominantly Foreign

Baroda Pioneer Asset Management Company Limited

3. Others

UTI Asset Management Company Ltd

B. Institutions

LIC Mutual Fund Asset Management Company Limited

C. Private Sector

1. Indian

Axis Asset Management Company Ltd.

Benchmark Asset Management Company Pvt. Ltd.

DBS Cholamandalam Asset Management Ltd.

Deutsche Asset Management (India) Pvt. Ltd.

Edelweiss Asset Management Limited

Escorts Asset Management Limited

IDFC Asset Management Company Private Limited

JM Financial Asset Management Private Limited

Kotak Mahindra Asset Management Company Limited (KMAMCL)

Quantum Asset Management Co. Private Ltd.

Reliance Capital Asset Management Ltd.

Religare Asset Management Company Ltd.

Sahara Asset Management Company Private Limited

Tata Asset Management Limited

Taurus Asset Management Company Limited

2. Foreign

AIG Global Asset Management Company (India) Pvt. Ltd.

FIL Fund Management Private Limited

Fortis Investment Management (India) Pvt. Ltd.

Franklin Templeton Asset Management (India) Private Limited

Goldman Sachs Asset Management (India) Private Limited

Mirae Asset Global Investments (India) Pvt. Ltd.

3. Joint Ventures – Predominantly Indian

Birla Sun Life Asset Management Company Limited

DSP Black Rock Investment Managers Private Limited

HDFC Asset Management Company Limited

ICICI Prudential Asset Mgmt. Company Limited

Religare AEGON Asset Management Company Pvt. Ltd.

Sundaram BNP Paribas Asset Management Company Limited

4. Joint Ventures – Predominantly Foreign

Bharti AXA Investment Managers Private Limited

HSBC Asset Management (India) Private Ltd.

ING Investment Management (India) Pvt. Ltd.

JPMorgan Asset Management India Pvt. Ltd.

Morgan Stanley Investment Management Pvt.Ltd.

Principal Pnb Asset Management Co. Pvt. Ltd.

Shinsei Asset Management (India) Pvt. Ltd.

10.11 CONSTITUTION AND MANAGEMENT OF MUTUAL FUND

A Mutual fund is formed as trust, which has sponsor, trustees, Asset Management Company (AMC) and custodian. Sponsor is like the promoters of a company. More than one sponsor establishes the trust. They take initiative for promoting the Mutual Fund. Trustee is the person/ firm/company/institutions who look after the assets of the mutual fund for the benefit of the unit holders. Normally, bankers, insurance companies are appointed as trustees, who supervise the assets of the mutual fund. Asset Liability Management Company (ALM) manages the 'funds' which is mobilized by mutual fund. ALM is expertise in the field of investment portfolio and approved by SEBI. They take care of Mutual funds' investments in various types of securities in a diversified manner. Custodian is the person/company who/which holds the securities of various schemes of the fund in his/its custody and who/which is registered with SEBI.

The trustees are vested with the general power of superintendence and direction over AMC. They monitor the performance and compliance of SEBI Regulations by the mutual fund. SEBI Regulations require that at least two thirds of the directors of trustee company or board of trustees must be independent i.e. they should not be associated with the sponsors. Also, 50% of the directors of AMC must be independent. The registration of mutual funds under SEBI is mandatory.

10.12 Sponsor

The sponsor is a body corporate which initiates the launching of a mutual fund. As per SEBI norms, it should have minimum 5 years of experience in the relevant field of financial services with good track record and its' contribution of capital must be 40% of the net worth of the Asset Management Company. It appoints trustees, an asset management company and custodians.

10.13 Trustees

Trustee is a manager of another's property. In mutual fund he holds the assets of mutual fund for the benefit of unit holders. The trust should be constituted under the provisions of Indian Trust Act.

10.14 Contents of Trust Deed

The trust deed shall contain such clauses as are mentioned in the third Schedule to the Indian trust Act and such other clauses which are necessary for safeguarding the interests of the unit holders.

No trust deed shall contain a clause which has the effect of- limiting or extinguishing the obligations and liabilities of the trust in relation to any mutual fund or the unit holders; or Indemnifying the trustees or the asset management company for loss or damage caused to the unit holders by their acts of negligence or acts of commissions or omissions.

10.15 Approval of the Board for Appointment of Trustee

. No trustee shall initially or any time thereafter be appointed without prior approval of the Board.

. The existing trustees of any mutual fund may form a trustee company to act as a trustee with the prior approval of the Board.

10.16 Functions of the Trustees

All assets of Mutual fund should be kept under the custody of trustee.

It should provide information about the schemes to SEBI and Unit Holders.

It can appoint an asset management company for floating of mutual fund schemes.

It has rights to dismiss the AMC appointed by it.

It has power to monitor and supervise the activities of AMC

10.17 Rights and Obligations of the Trustees

The trustees and the asset management company shall with the prior approval of the Board enter into an investment management agreement.

The trustees shall have a right to obtain from the asset management company such information as is considered necessary by the trustees.

The trustees shall ensure that an asset management company has been diligent in empanelling the brokers, in monitoring securities transactions with brokers and avoiding undue concentration of business with any broker.

The trustees shall ensure that the transactions entered into by the asset management company are in accordance with these regulations and the scheme.

The trustees shall be accountable for, and shall be the custodian of, the funds and property of the respective schemes and shall hold the same in trust for the benefit of the unit holders in accordance with these regulations and the provisions of trust deed.

The trustees shall take steps to ensure that the transactions of the mutual fund are in accordance with the provisions of the trust deed.

The trustees shall be responsible for the calculation of any income due to be paid to the mutual fund and also of any income received in the mutual fund for the holders of the units of any scheme in accordance with these regulations and the trust deed.

The trustees shall quarterly review all transactions carried out between the mutual funds, Asset Management Company and its associates.

The trustees shall periodically review all service contracts such as custody arrangements, transfer agency of the securities and satisfy it that such contracts are executed in the interest of the unit holders.

10.18 Asset Management Company (AMC)

Asset Management company acts as investment manager and manages the affairs of Mutual Fund. It is appointed by the sponsor or the trustees. It should have a sound track record with a net worth of at least ` 100 crores. All schemes of the fund are operated by AMC and it is responsible for it. It may also operate as an underwriter with the approval of SEBI.

10.19 SEBI Regulations

The following rules and regulations of Securities Exchange of Board of India (SEBI) are related to the establishment and issue of schemes of Mutual Fund.

- Mutual fund shall be established in the form of trusts under the Indian Trust Act and managed by separately formed Asset Management Company.

- In the Board of directors of AMC must be 50% members are independent without the influence of sponsoring organization and they should have at least 10 years' experience in the field of portfolio management.
- A minimum of ` 10 crores must have AMC as net worth
- An AMC can function for only one mutual fund and it is prohibited to work for another.
- AMCs are also allowed to do other fund based businesses such as providing investment management services to offshore funds, venture capital funds and insurance companies.
- Minimum issue of fund for closed-end scheme and open end scheme should be ` 20 crores and ` 50 crores respectively.
- The maximum period for subscription is 45 days in case of close-end schemes, but no such limitation in case of open – end scheme.
- The entire subscription has to be returned to the investors when the minimum amount or 60% of the target amount is not raised.
- There should be a separate and responsible fund manager for each scheme.
- To protect the small investors, SEBI restrict the portfolio investment of Mutual Fund in a single company by 10% of Net Assets Value of a scheme.
- The issue expenses are restricted to 6% of raising funds under each scheme.
- A minimum of 90% of the profits must distribute to the unit holders in any given year.
- Accounting and Auditing of Mutual funds are mandatory and furnish the audited Annual statements to SEBI.

SEBI has power to impose penalty on mutual funds for violation of SEBI guidelines.

10.20 New SEBI Guidelines for Mutual Funds

The Securities and Exchange Board of India (SEBI) has brought in sweeping changes for the mutual fund industry, the impact of which will be felt on the investor in more ways than one.

First, for New Fund Offers (NFOs)

They will only be open for 15 days. (ELSS funds though will continue to stay open for up to 90 days) It will save investors from a prolonged NFO period and being harangued by advisors and advertisements. The motivation behind the rule seems to be simple; investor can invest anytime, no need to wait for NFO period.

NFOs can only be invested at the Close of the NFO Period

Earlier, Mutual funds would keep an NFO open for 30 days, and the minute they received their first cheque, the money would be directly invested in the market; creating a skewed accounting for those that entered later since they get a fixed NFO price.

Dividends can now only be paid out of Actually Realized Gains

Impact: it will reduce both the quantum of dividends announced, and the measures used by MFs to gather investor money using dividend as an incentive to attract new investors.

Equity Mutual funds have been asked to play a more active role in corporate governance of the companies they invest in. This will help mutual funds become more active and not just that, they must reveal, in their annual reports from next year, what they did in each "vote".

SEBI has now made it mandatory for funds to disclose whether they voted for or against moves (suggested by companies in which they have invested) such as mergers, demergers, corporate governance issues, appointment and removal of directors. MFs have to disclose it on their website as well as annual reports.

Equity Funds were allowed to charge 1% more as management fees if the funds were "no-load"; but since SEBI has banned entry loads, this extra 1% has also been removed.

SEBI has also asked Mutual Funds to reveal all commission paid to its sponsor or associate companies, employees and their relatives.

Regarding the Fund-of-Fund (FOF) – The market regulator has stated that information documents that Asset Management Companies (AMCs) have been

entering into revenue sharing arrangements with offshore funds in respect of investments made on behalf of Fund of Fund schemes create conflict of interest. Henceforth, AMCs shall not enter into any revenue sharing arrangement with the underlying funds in any manner and shall not receive any revenue by whatever means/head from the underlying fund.

These guidelines set by the SEBI will lead to greater transparency for the common investor. SEBI formulates policies and regulates the mutual funds to protect the interest of the investors. With these guidelines falling in place, it would create better trust and transparency and investable environment that would attract investors with greater faith and confidence.

10.21 Conclusion

Mutual funds have become a major vehicle for mobilization of saving particularly from the small and household sectors for investment in the stock market. Mutual funds have responded to this challenge by diversifying through organic growth, innovative new products and building trust with the investors. With greater flexibility in operation, the mutual fund industry is expected to play its desired role to harness savings for economic development, inculcate equity culture, strengthening the capital market.

Questions

1. What is Mutual fund & explain the origin .
2. Explain the regulations and development of mutual fund.
3. What are the types of mutual fund?
4. Classify the mutual funds?
5. State the importance of mutual fund.
6. Distinguish Mutual fund Vs Insurance’
7. List out the Mutual fund industries in India
8. Discuss the major mutual fund companies in India.
9. What are the constitution and management of mutual fund?
10. What are the functions and obligation of trustee?
11. What is AMC?

12.How the SEBI directive for mutual fund ?

13.State SEBI guidelines for mutual fund ?

CHAPTER -11

11.1 Introduction
11.2 Establishment of UTI
11.3 Structure
11.4 Objectives
11.5 Functions
11.6 Recent development and Investment polices of UTI
11.7 Types of funds
11.8 Evaluation and Performance of Mutual Funds
11.9 Money market mutual funds
11.10 Types of money market mutual funds
11.11 RBI guidelines on MMMFS
11.12 Conclusion

Unit Trust of India

11.1 Introduction

Unit Trust of India is a financial organisation in INDIA, which was created by the UTI Act passed by the Parliament of India on 30 December 1963 under the direction of Col. AkashBehl. He had fought very hard and intensely to get this organisation come into reality.[1] For more than two decades it remained the sole vehicle for investment in the capital market by the Indian citizens. In mid- 1980s public sector banks were allowed to open mutual funds. The real vibrancy and competition in the MF industry came with the setting up of the Regulator SEBI and its laying down the MF Regulations in 1993.UTI maintained its pre-eminent place till 2001, when a massive decline in the market indices and negative investor sentiments after theKetan Parekh scam created doubts about the capacity of UTI to meet its obligations to the investors. This was further compounded by two factors; namely, its flagship and largest scheme US 64 was sold and re-purchased not at intrinsic NAV but at artificial price and its Assured Return Schemes had promised returns as high as 18% over a period going up to two decades

11.1 Establishment of UTI

The Unit Trust of India (UTI) was established by the government of India on 1st February, 1964 under the Unit Trust of India Act, 1963 (the bill was introduced by the then Finance Minister Sri.T.T.Krishnamachari).

11.3 Structure

The initial capital of UTI was ` 5 crores which was contributed by Reserve Bank of India (RBI), State Bank of India (SBI), Life Insurance Corporation of India (LIC), Scheduled banks and foreign banks. The management was entrusted to an independent Board of Trustees appointed by the Government.

11.4OBJECTIVES

The basic objective of the UTI is to offer both small and large investors the means of acquiring shares in the widening prosperity resulting from the steady, industrial growth of the country.

There are two primary objectives of UTI,

- To promote and pool the small savings from the lower and middle income people who cannot have direct access to the stock exchange, and
- To give them an opportunity to share the benefits and fruits of prosperity resulting from rapid industrialization in India.

11.5 Functions

The main functions of UTI are as follows:

- To encourage savings of lower and middle-class people.
- To sell units to investors in different parts of the country.
- To convert the small savings into industrial finance.
- To give them an opportunity to share the benefits of industrialization in the country.
- To provide liquidity to units.

11.6 Recent Developments and Investment Policies of UTI

UTI Mutual Fund is managed by UTI Asset Management Company Private Limited (Estb: on Jan 14, 2003) appointed by the UTI Trustee Company Private Limited for managing the schemes of UTI Mutual Fund and the schemes transferred / migrated from UTI Mutual Fund. UTI Mutual Fund has come into existence with effect from 1st February 2003. UTI Asset Management Company presently manages a corpus fund of over ` 34,500 Crores.

UTI Mutual Fund has a track record of managing a variety of schemes catering to the needs of every class of citizenry. It has a nationwide network consisting 70 UTI Financial Centers (UFCs) and UTI International offices in London, Dubai and Bahrain.

11.7 Types of Funds

UTI funds are classified based on the following two aspects:-

I. Maturity period

II. Investment objective

I. Based on Maturity

a. Open-Ended Fund/Scheme

An open-ended fund or scheme is one that is available for subscription and repurchase on a continuous basis. These schemes do not have a fixed maturity period. Investors can conveniently buy and sell units at Net Asset Value (NAV) related prices, which are declared on a daily basis. The key feature of open-ended schemes is its liquidity.

b. Close-Ended Fund/Scheme

A close-ended fund or scheme has a stipulated maturity period, say for example 5-7 years. The fund is open for subscription only during a specified period at the time of launching of the scheme. Investors can invest in the scheme at the time of the initial public issue and thereafter they can buy or sell the units of the scheme through the stock exchanges where the units are listed. In order to provide an exit route to the investors, some close-ended funds give an option of selling back the units to the mutual fund through periodic repurchase at NAV related prices. SEBI Regulations stipulate that at least one of the two exit routes is provided to the investor i.e. either repurchase facility or through listing on stock exchanges. These mutual funds schemes disclose NAV generally on weekly basis.

II. Investment Objective

a. Liquid Funds Category

UTI - Money Market Fund - It is an open-ended pure debt liquid plan, seeking to provide highest possible current income, by investing in a diversified portfolio of short-term money market securities.

UTI - Floating Rate Fund - It is to generate regular income through investment in a portfolio comprising substantially of floating rate debt / money market instruments and fixed rate debt / money market instruments.

UTI - Liquid Fund Cash Plan - The scheme seeks to generate steady & reasonable income with low risk & high level of liquidity from a portfolio of money market securities & high quality debt.

b. Income Funds Category

UTI - G-Sec Fund - Investment Plan - It is an open-end Gilt-Fund with the objective to invest only in Central Government securities including call money, treasury bills and repos of varying maturities with a view to generate credit risk free return.

UTI - G-Sec Fund - Short Term Plan - It is an open-end Gilt-Fund with the objective to invest only in Central Government securities including call money, treasury bills and repos of varying maturities with a view to generate credit risk free return.

- ➢ UTI - GILT Advantage Fund -LTP - It is to generate credit risk-free return through investments in sovereign securities issued by the Central and / or a State Government LTP.
- ➢ UTI - Variable Investment Scheme - It is an open ended debt oriented fund with 100% investment in Debt/G-sec. Investment can be made in the name of the children upto the age of 15 years.
- ➢ UTI - Bond Advantage Fund - LTP - It aims to generate attractive returns consistent with capital preservation and liquidity.
- ➢ UTI - Monthly Income Scheme – It is an open-ended debt oriented fund investing a minimum of 90% in Debt and G-Sec and a maximum of 10% in equity instruments. The fund aims to distribute income periodically and it is best suited to the investors.
- ➢ UTI - Liquid Fund - Short Term Plan - The scheme seeks to generate steady & reasonable income with low risk & high level of liquidity from a portfolio of money market securities & high quality debt.
- ➢ UTI - MIS - Advantage Plan – It is to generate regular income through investments in fixed income securities and capital appreciation / dividend income through investment of a portion of net assets of the scheme in

equity and equity related instruments so as to endeavor to make periodic income distribution to Unit holders.

➢ UTI - Bond Fund – It is an open-end 100% pure debt fund, which invests in rated corporate debt papers and government securities with relatively low risk and easy liquidity.

➢ UTI - Capital Protection Oriented Scheme - The scheme will invest in a portfolio predominantly of fixed income securities that are maturing in line with duration of the respective plans. Each Plan will have a separate portfolio. The debt component of the portfolio structure shall have the highest investment grade rating. The equity components of the scheme will mainly focus on those companies / stocks that have potential to appreciate in the medium to long run.

c. Asset Allocation Funds Category

UTI - Variable Investment Scheme - The UTI Variable Investment Scheme is an open-ended scheme with dynamic allocation between equity and debt classes.

d. Index Funds Category

UTI - Master Index Fund - UTI MIF is an open-ended passive fund with the primary investment objective to invest in securities of companies comprising the BSE sensex in the same weightage as these companies have in BSE sensex.

UTI - Nifty Index Fund - UTI NIF is an open-ended passive fund with the objective to invest in securities of companies comprising of the S&P CNX Nifty in the same weightage as they have in S&P CNX Nifty.

UTI - Gold Exchange Traded Fund – Its objective is to endeavor to provide returns that, before expenses, closely track the performance and yield of Gold.

e. Equity Funds Category

UTI - Equity Tax Saving Plan - It is an open-ended equity fund investing a minimum of 80% in equity and equity related instruments. It aims at enabling members to avail tax rebate under Section 88 of the IT Act and provide them with the benefits of growth.

UTI - Master share unit Scheme – It is an open-end equity fund aiming to provide benefit of capital appreciation and income distribution through investment in equity.

UTI – Master gain Unit Scheme - Master Gain is open-ended equity scheme with an objective of investing at least 80% of its funds in equity and equity related instrument with medium to high risk profile and up to 20% in debt and money market instruments with low to medium risk profile.

UTI - Opportunities Fund - This scheme seeks to generate capital appreciation and/or income distribution by investing the funds of the scheme in equity shares and equity-related instruments.

UTI - Software Fund – It is an open-ended fund which invests exclusively in the equities of the Software Sector companies. One of the growth sectors funds aiming to invest in equity shares of companies belonging to information technology sector to provide returns to investors through capital growth as well as through regular income distribution.

UTI - Banking Sector Fund - It is an open-ended equity fund with the objective to provide capital appreciation through investments in the stocks of the companies/institutions engaged in the banking and financial services activities.

UTI - Master Value Fund - It is an open-ended equity fund investing in stocks which are currently under valued to their future earning potential and carry medium risk profile to provide 'Capital Appreciation'.

UTI - MNC Fund – It is an open-ended equity fund with the objective to invest predominantly in the equity shares of multinational companies in diverse sectors such as FMCG, Pharmaceutical, Engineering etc.

UTI - Mid Cap Fund – It is an open-ended equity fund with the objective to provide 'Capital appreciation' by investing primarily in mid cap stocks.

UTI - Infrastructure Fund – It is an open-ended equity fund with the objective to provide Capital appreciation through investing in the stocks of the companies engaged in the sectors like Metals, Building materials, oil and gas, power,

chemicals, engineering etc. The fund will invest in the stocks of the companies which form part of Basic Industries.

UTI - Leadership Equity Fund - This scheme seeks to generate capital appreciation and/or income distribution by investing the funds of the scheme in stocks that are "Leaders" in their respective industries/sectors/sub-sector.

UTI - Contra Fund - The fund aims to provide long-term capital gain/dividend distribution through investments in listed equities and equity-related instruments. The Fund's investment policies are based on insights from behavioral finance.

UTI - Wealth Builder Fund - The objective of the scheme is to achieve long term capital appreciation by investing predominantly in a diversified portfolio of equity and equity related instruments.

UTI - Long-Term Advantage Fund - The investment objective of the scheme is to provide medium to long term capital appreciation along with income tax benefit.

UTI - India Lifestyle Fund – Its aim is to provide long term capital gain and/or income distribution from a diversified portfolio of equity and equity related instruments of companies that are expected to benefit from changing Indian demographics, Indian lifestyles and rising consumption pattern.

f. Balanced Funds Category

I. UTI - Balanced Fund – It is an open-ended balance fund investing between 40% to 60% in equality related securities and the balance in debt (fixed income securities) with a view to generate regular income together with capital appreciation.

II. UTI - US 2002 – It is an Open-ended balance fund scheme aims at providing income distribution/ cumulation of income and capital appreciation over a long term from a prudent portfolio mix of equity and fixed income securities.

III. UTI - Mahila Unit Scheme – It is an open-ended scheme is designed with a minimum 70% investment in Debt/G-Securities and a maximum 30% investment in equity. The fund is designed to provide an enabler to adult female persons in pooling their own savings and/ or gifts into an investment vehicle so as to get

periodic cash flow near to the time of any chosen festival/ occasion or to allow income/ gains redeployed in the scheme and repurchase units partially or fully as and when desired.

IV. UTI – Children's Career Plan (Balanced) - It is an open-ended debt oriented fund with investment in Debt/G-Securities of minimum 60% and a maximum of 40% in Equity. Investment can be made in the name of the children up to the age of 15 years so as to provide them, after they attain the age of 18 years, to receive scholarship to meet the cost of higher education and/or to help them in setting up a profession, practice or business or enabling them to set up a home or finance the cost of other social obligation.

V. UTI - CRTS - This is an open-end income oriented scheme. The scheme aims at catering to the investment needs of charitable, religious, educational trusts and similar institutions to provide them an investment vehicle to avail of tax exemption and also to have regular income.

VI. UTI - ULIP - This is an open-ended balanced fund with an objective of investing not more than 40% of the funds in equity and equity related instruments and balance in debt and money market instruments with low to medium risk profile.

Investment by an individual in the scheme is eligible for exemption under section 88 of the IT Act 1961. In addition the scheme also offers Life Insurance and Accident Insurance cover.

VII. UTI - Retirement Benefit Pension Fund **-** It is an open-ended balanced fund with a maximum equity allocation of 40% and the balance in debt. This ensures to provide pension to investors particularly self-employed persons after they attain age of 58 years, in the form of periodical cash flow up to the extent of repurchase value of their holding through systematic withdrawal plan.

11.8 EVALUATION AND PERFORMANCE OF MUTUAL FUNDS

1.Performance Measures of Mutual Funds

Mutual Fund industry today, with about 34 players and more than five hundred schemes, is one of the most preferred investment avenues in India.

However, with such a huge number of schemes to choose from, the retail investor faces problems in selecting funds. Factors such as investment strategy and management style are qualitative, but the ‘funds performance record’ is an important indicator too. Though past performance alone cannot be indicative of future performance, it is, frankly, the only quantitative way to judge how good a fund is at present.

Therefore, there is a need to correctly assess the past performance of different mutual funds. Worldwide, good mutual fund companies are known by their AMCs and this fame is directly linked to their superior stock selection skills. For mutual funds to grow, AMCs must be held accountable for their selection of stocks. In other words, there must be some performance indicator that will reveal the quality of stock selection of various AMCs.

Return alone should not be considered as the basis of measurement of the performance of a mutual fund scheme. It should also include the risk taken by the fund manager because different funds will have different levels of risk attached to them. Risk associated with a fund, in general, can be defined as variability or fluctuations in the returns generated by it.

The higher the fluctuations in the returns of a fund are during a given period, the higher is the risk associated with it.

These fluctuations in the returns generated by a fund are resultant of two guiding forces. The first one is general market fluctuations, which affect all the securities, present in the market, called market risk or systematic risk and second is fluctuations due to specific securities present in the portfolio of the fund, called unsystematic risk. The total risk of a given fund is the sum of these two and is measured in terms of standard deviation of returns of the fund. Systematic risk, on the other hand, is measured in terms of Beta, which represents fluctuations in the NAV of the fund as against market. The more responsive the NAV of a mutual fund is to the changes in the market; higher will be its beta. Beta is calculated by relating the returns on a mutual fund with the returns in the market. While

unsystematic risk can be diversified through investments in a number of instruments, systematic risk cannot be.

In order to determine the risk-adjusted returns of investment portfolios, several eminent authors have worked since 1960s to develop composite performance indices to evaluate a portfolio by comparing alternative portfolios within a particular risk class. The most important and widely used measures of performance are:

- The Treynor Measure
- The Sharpe Measure
- Jenson Model
- Fama Model

11.9 Money Market Mutual Funds

In April 1991, Money Market Mutual Funds (MMMFs) were introduced in India. They provide an additional short term investment avenue to investors and bring money market instruments within the reach of individuals.

A money market mutual fund is a fund that invests solely in money market instruments. Money market instruments are forms of debt that mature in less than one year and have high liquidity.

Treasury bills make up the bulk of the money market instruments. Securities in the money market are relatively risk-free and most secure mutual fund investments. Its aim is to preserve principal while yielding a modest return. It is similar to a high-yield bank account but is not entirely risk free. Investor should concentrate on the rate of interest.

11.10 Types of Money Market Mutual Funds

a) Institutional Money Market Mutual Funds

These funds are held by governments, institutional investors and businesses etc. Huge sum of money is parked in institutional money funds.

b) Retail Money Market Mutual Funds

Retail money market funds are used for parking money temporarily. The investment portfolio of money market funds comprises of treasury bills, short term debts, tax free bonds etc.

Special Features of Money Market Mutual Funds

Money market mutual funds are one of the safest instruments of investment for the retail low income investors. The assets in a money market fund are invested in safe and stable instruments of investment issued by governments, banks, 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 funds allow retail investors the opportunity of investing in money market instrument and benefit from the price advantage.

Money market mutual funds are usually rated by the rating agencies.

11.11 RBI Guidelines

RBI Guidelines on MMMFs

The setting up of MMMFs would require the prior authorization of the Reserve Bank. Furthermore, the MMMFs to be set up by banks, their subsidiaries and public financial institutions would be required to comply with the guidelines and directives that may be issued by the RBI from time to time. Although the guidelines were issued in 1992-93, yet no institutions has so far come forward to establish a MMMF. The major hurdle has been the stringent limits for investments prescribed by the RBI. Moreover, the relative quietness on the money market front led to the absence of the "necessity" factor to establish MMMFs.

In November 1995, the RBI permitted the private sector mutual funds to set up MMMFs, with a view to provide greater liquidity and depth to the money market. While allowing the private sector MFs, the RBI also relaxed some of the earlier guidelines. The important relaxations were

1. Ceiling for raising resources and minimum size of ` 500 million withdrawn.
2. Minimum limit 25% while investing in T-bills and the Government of India papers of residual maturity upto 1 year withdrawn

3. Maximum limit of 30% while investing in call/notice money withdrawn
4. Maximum limit of 15% while investing in CPs withdrawn
5. Maximum limit of 20% while investing in Commercial bills withdrawn
6. Dividend / income on subscriptions by individual NRI in MMMFs can be repatriated, but not principal
7. Private sector MMMF should need the RBI and SEBI approval

In April 1992, the Reserve Bank announced the guidelines for Money Market Mutual Funds. The Reserve Bank had made several modifications in the scheme to make it more flexible and attractive to banks and financial institutions. These guidelines were subsequently incorporated into the revised SEBI regulations. In October 1997, MMMFs were permitted to invest in rated corporate bonds and debentures with a residual maturity of up to one year, within the ceiling existing for Commercial Paper (CPs). The minimum lock-in period was also reduced gradually to 15 days, making the scheme more attractive to investors. MMMFs would come under the purview of SEBI regulations. Banks and Financial Institutions desirous of setting up MMMFs would however have to seek necessary clearance from RBI for undertaking this additional activity before approaching SEBI for registration.

Conclusion

Mutual funds have been made by investors so investors' interest must be safeguarded by implementing above suggestions. Mutual fund can be more purposeful for common investors if it makes qualitative improvement by setting standard of behaviour, professionalism and self regulation.

Questions

1. What is UTI? What are the objectives of UTI?
2. Explain the functions of UTI?
3. State the recent development and investment policies of UTI.
4. What are the types of UTI funds?
5. Evaluate the performance of mutual fund?
6. What is money market? And what are the types of it?

7. Explain the RBI guidelines of MMMFs.
8. What are the special feature of MMMFs?

CHAPTER – 12

12.1 Introduction

12.2 Origin

12.3 Venture capital and development capital

12.4 Types of venture capital financing

12.5 Expansion

12.6 Venture capital – investment process

12.7 Venture capital in India

12.8 Conclusion

VENTURE CAPITAL

12.1 Introduction

Venture Capital is a form of “risk capital” which is invested in a project or a business where there is a substantial element of risk relating to the future creation of profits and cash flows. Risk capital is invested as shares (equity) rather than as a loan and the investor requires a higher “rate of return” to compensate him for his risk.

12.2 Concept

Venture capital provides seed capital or funding for expansion of companies in the form of share capital, to help unquoted companies grow and succeed. If an entrepreneur is looking to start-up, expand, buy-into a business, buy-out a business in which he works, turnaround or revitalize a company etc., venture capital could help do this. Obtaining venture capital is substantially different from raising a debt or a loan from a lender. Lenders have a legal right to interest on a loan and repayment of the capital, irrespective of the success or failure of a business.

Venture capital is invested in exchange for an equity stake in the business. As a shareholder, the venture capitalists’ return is dependent on the growth and profitability of the business. This return is generally earned when the venture capitalist “exits” by selling its shareholding when the business is sold.

12.3 Origin

Venture capital funding is first originated in the UK in the late 18th century, when European entrepreneurs and merchant bankers were helping the growth of industry in USA, South Africa and India. This informal method of financing became an industry in the late 1970s and early 1980s when a number of venture capital firms were founded. There are now over 100 active venture capital firms in the UK, which provide several billion pounds each year to unquoted companies mostly located in the UK. The venture capital funds are active in UK in the form of

- Clearing bank captive funds,
- Funds sponsored by savings and investment institutions and merchant bankers

- Business expansion scheme funds
- Corporate, academic and other private sector funds
- Semi-State bodies (both Central and Local Government).

12.4 Venture Capital and Development Capital

Venture capital is advanced for ventures using a new technology or new innovation. The venture capital company remains interested in the overall management of the project due to the high risk involved in the venture. Funds are made available throughout the project, commencing from commercial production to the successful marketing of products, to ensure continuous revenue earnings, enhanced worth of the investments and finally making available a proper exit route for liquating the investments.

Development capital is generally granted in the form of loans for setting up industrial units, and also for expansion and modernization. The lender takes special care in ensuring the end use of the credit and requires prompt payment of interest and repayment of the loan amount.

12.5 Types of Venture Capital Financing

There are three main groups into which venture capital investment can be divided. They are early stage, expansion, and buyout. Each of these groups is further divided into subgroups, as illustrated in the chart on the next page:

1.Early Stage

Early stage investing is divided into three subgroups: seed financing, startup financing, and 1st stage financing.

2.Seed Financing

This type of financing will be very early in the life of the business, usually pre-revenue and sometimes even before the product or service is created. It will also make it easier for the entrepreneur to get loans after being financed this way.

The entrepreneur will use seed money for market research and early product or service development.

3.Startup Financing

Startup financing is used by businesses to finish the development of their products and services. In some cases, it will also be used for marketing the products and services. This helps the company launch their operations.

1st Stage Financing

This is the last subgroup of financing in the early stage category, and would be used to continue operations of the company at a higher scale. Products (or services) would start to be produced in a large scale, and the initial funding would have been used by this time.

12.6 Expansion

Expansion investing is also broken up into three subgroups: 2nd stage financing, bridge financing, and 3rd stage financing.

2nd Stage Financing

This stage of financing is used by a business for initial expansion plans whether that involves products or services. The company usually will not be profitable even after receiving this type of financing.

4.Bridge Financing

Bridge financing is used as a short term investment that will maintain liquidity, especially if an inflow of cash is going to be received. One example could be if the company plans to have an IPO, bridge financing can be used to sustain the company for a short period of time that is till it receives money from the allottees.

3rd Stage Financing

This type of financing is also called mezzanine financing, and is invested into a company that has achieved its breakeven point, and in some cases is achieving profitability. This type of financing will be used by a company for marketing, plant expansion, and new products or services.

5.Buyout

The buyout stage of investing can be broken down into two subgroups: acquisition financing and leveraged buyouts (LBO).

6.Acquisition Financing

This type of financing is used to acquire either part of a company or the entire company. The original business making the acquisition would have expanded to the point where this strategy is feasible.

7.Leveraged Buyout (LBO)

This type of financing is otherwise known as a management buyout. The management group of the company will acquire an equity stake in a company and potentially buyout certain assets of the company. The company acquisition will be primarily financed through debt. Management teams or companies themselves use this strategy when they do not want to commit capital to the deal.

8.Capital Firms - Fund Sources

There are several sources for raising funds by Venture capital firms. To obtain their funds, venture capital firms have to reveal a good track record and the prospect of producing returns greater than can be achieved through fixed interest or quoted equity investments.

Most UK venture capital firms raise their funds for investment from external sources, mainly institutional investors, such as pension funds and insurance companies.

Venture capital firms' investment preferences may be affected by the source of their funds. Many funds raised from external sources are structured as Limited Partnerships and usually have a fixed life of 10 years. Within this period the funds invest the money committed to them and by the end of the 10th year they will have to return the investors' original money, plus any additional returns made. This generally requires the investments to be sold, or to be in the form of quoted shares, before the end of the fund.

12.7 Venture Capital - Investment Process

The investment process, from reviewing the business plan to actually investing in a proposition, can take a venture capitalist any period from one month

to one year but typically it takes between 3 and 6 months. There are always exceptions to the rule and deals can be done in extremely short time frames. Much depends on the quality of information provided and made available.

The key stage of the investment process is the initial evaluation of a business plan. Most approaches to venture capitalists are rejected at this stage. In considering the business plan, the venture capitalist will consider several principal aspects such as:

Is the product or service commercially viable?

Does the company have potential for sustained growth?

Does the management have the ability to exploit this potential and control the company

through the growth phases?

Does the possible reward justify the risk?

Does the potential financial return on the investment meet their investment criteria?

In structuring its investment, the venture capitalist may use one or more of the following types of share capital:

1.Ordinary Shares

These are equity shares that are entitled to all income and capital after the rights of all other classes of capital and creditors have been satisfied. Ordinary shares holders have voting rights. In a venture capital deal these are the shares typically held by the management and family shareholders rather than the venture capital firm.

2.Preferred Ordinary Shares

These are equity shares with special rights. For example, they may be entitled to a fixed dividend or share of the profits. Preferred ordinary shares holders have voting rights.

3.Preference Shares

These are non-equity shares. They rank ahead of all classes of ordinary shares for both income and capital. Their income rights are defined and they are usually

entitled to a fixed dividend. The shares may be redeemable on fixed dates or they may be irredeemable. Sometimes they may be redeemable at a fixed premium (eg. at 120% of cost). They may be convertible into a class of ordinary shares.

4.Loan Capital

Venture capital loans typically are entitled to interest and are usually, though not necessarily, repayable. Loans may be secured on the company's assets or may be unsecured. A secured loan will rank ahead of unsecured loans and certain other creditors of the company. A loan may be convertible into equity shares. Alternatively, it may have a warrant attached which gives the loan holder the option to subscribe for new equity shares on terms fixed in the warrant. They typically carry a higher rate of interest than bank term loans and rank behind the bank for payment of interest and repayment of capital.

Venture capital investments are often accompanied by additional financing at the point of investment. This is nearly always the case where the business in which the investment is being made is relatively mature or well-established. In this case, it is appropriate for a business to have a financing structure that includes both equity and debt.

Other forms of finance provided in addition to venture capitalist equity include:

Clearing banks – They principally provide overdrafts and short to medium-term loans at fixed or, more usually, variable rates of interest.

Merchant banks – They organize the provision of medium to longer-term loans, usually for larger amounts than clearing banks. Later they can play an important role in the process of "going public" by advising on the terms and price of public issues and by arranging underwriting when necessary.

Finance houses - They provide various forms of installment credit, ranging from hire purchase to leasing; often asset based and usually for a fixed term and at fixed interest rates.

Factoring companies - They provide finance by buying trade debts at a discount, either on a recourse basis (you retain the credit risk on the debts) or on a non-recourse basis (the factoring company takes over the credit risk).

Government and European Commission sources - They provide financial aid to UK companies, ranging from project grants (related to jobs created and safeguarded) to enterprise loans in selective areas.

Mezzanine firms – They provide loan finance that is halfway between equity and secured debt. These facilities require either a second charge on the company's assets or are unsecured. Because the risk is consequently higher than senior debt, the interest charged by the mezzanine debt provider will be higher than that by the principal lenders and sometimes a modest equity "up-side" will be required through options or warrants. It is generally most appropriate for larger transactions.

12.8 Venture Capital in India

Venture capital was originated in India very late. Bhatt Committee (Committee on Development of Small and Medium Entrepreneurs) in the year 1972 recommended the creation of venture capital. The committee urged the need for providing such capital to help new entrepreneurs and technologists in setting up industries.

Brief description of some of the venture capital funds of India is as follows:

Risk capital foundation: The Industrial Finance Corporation of India (IFCI) launched the first venture capital fund in the year 1975. The fund, 'Risk Capital Foundation' (RCF) aimed at supplementing promoters' equity with a view to encourage technologies and professionals to promote new industries.

Seed capital scheme: This venture capital fund was launched by IDBI in 1976, with the same objective in mind.

Venture capital schemes: Venture capital funding obtained official sponsorship with the announcement by the Central Government of the "Technology Policy Statement" in 1983. It prescribed guidelines for achieving technological self

reliance through commercialization and exploitation of technologies. The ICICI, an all-India financial institution in the private sector set up a Venture Capital Scheme in 1986, to encourage new technocrats in the private sector to enter new fields of high technology with inherent high risk. The scheme aimed at allocating funds for providing assistance in the form of venture capital to economic activities having risk, but also high profit potential.

PACT: The ICICI undertook the administration of Program for Application of Commercial Technology (PACT) aided by USAID with an initial grant of US$ 10 million. The program aims at financing specific needs of the corporate sector industrial units along the lines of venture capital funding.

Government fund: IDBI, as nodal agency, administers the venture capital fund created on April1, 1986, by the Central Government. The government started imposing a Research and Development (R & D) under the R & D Cess Act, 1986, levy on all payments made for the purchase of technology from abroad, including royalty payments, lump sum payments for foreign collaboration and payment for designs and drawings.

➢**TDICI:** In 1988, an ICICI sponsored company, viz, Technology Development and Information Company of India Ltd. (TDICI) was founded, and venture capital operations of ICICI were taken over by it with effect from July 1, 1988.

➢**RCTFC:** The Risk Capital Foundation (RCF) sponsored by IFCI was converted into Risk Capital and Technology Finance Corporation Ltd. (RCTFC) in the year 1988. It took over the activities of RCF in addition to the management of other financing technology development schemes and venture capital fund.

➢**VECAUS:** VECAUS–I, the UTI sponsored “Venture Capital Unit Scheme” was launched in the year 1989. Technology Development and Information Company of India Ltd. (TDICI) was appointed as its manager. In the year 1990, the corporation was also entrusted with the responsibility of managing another UTI sponsored venture fund named “VECAUS-II”. In 1991, UTI launched VECAUS –III and RCTC was appointed as fund manager.

Other funds: The liberalized guidelines introduced by the government, in 1988 gave rise to the setting up of a number of venture capital funds, especially in the private sector.

12.9 Conclusion

In the US and UK, the venture capitalists are playing a strategic role in the promotion and development of industries in partnership with the entrepreneurs. It's phenomenal contribution to the harnessing of technical innovation to successful commercial exploitation is there as standing testimony. In the radically changing economic environment, now further accelerated by the high technology explosion both the entrepreneurs and the venture capitalists are equally important to the well-being of any country. Venture capital promotes entrepreneurship, accelerates the process of industrialization, promotes new products and services and generates employment opportunities and brings a new boost to the economy.

Questions

1. What is venture capital? Explain the concept of venture capital.
2. What are the types of venture capital financing?
3. What is investment process of venture capital
4. Explain the Venture capital funds in India?

UNIT – V

CHAPTER – 13

13.1 Introduction
13.2 Definition
13.3 Types of Insurance
13.4 Types of Insurance Companies
13.5 Types of Insurance policies
13.6 Types of Ordinary life insurance
13.7 Insurance industry in India
13.8 Reforms in Indian insurance sector
13.9 Conclusion

INSURANCE

13.1 Introduction

Insurance is a contract whereby the insurer undertakes to compensate the insured for any loss suffered by the later in consideration of premium paid for certain period. There are different insurance companies such as LIC, GIC, United India, New India assurance etc., offering wide range of insurance options. They provide comprehensive coverage with affordable premium. An insured can choose the policy according to his needs and ability to pay periodical premium to cover the risk of insurance for the stipulated period. The periodical insurance

premiums are calculated according to the total insurance amount specified or estimated value of the property/things insured.

Thus, Insurance provides financial protection against a loss arising out of happening of an uncertain event. Hence, insurance is used as an effective tool for risk management.

13.2 Definition

Insurance is a contract between two parties, whereby one party agrees to undertake the risk of another, in exchange for consideration known as premium and promises to pay a fixed sum of money to the other party on happening of an uncertain event (death) or after the expiry of a certain period/maturity period in case of life insurance or to indemnify the loss to the other party on happening of an uncertain event in case of general insurance.

The party bearing the risk is known as the 'insurer' or 'assurer' and the party whose risk is covered is known as the 'insured' or 'assured'.

13.3 Types of Insurance

Various types of insurances are as mentioned hereunder:

1. Life insurance: Descendant's family receives insured amount in the case of death of the insured. In other case the insured himself gets the insured amount
2. Automobile/Motor insurance: Usually automobile insurances cover damages to the automobile and legal financial expenditure of the automobile driver/cleaner.
3. Workmen Compensation Insurance: It covers the employee for the loss of life or total/partial permanent disablement (loss of limb) or for occupational disease arising out of his employment during and in the course of his employment.
4. Health insurance: Health insurance covers the expenditure associated with treatment and medical expenditure including medicine.

5. Credit insurance: Borrowers often fail to repay the debts, loans and mortgages, due to certain unavoidable circumstances. Credit insurance can be of great help to the lenders during such crisis.
    a. Property insurance: Property protection insurance provides protection from risks associated to theft, fire, floods etc. This type of insurance can be further classified into specialized forms as follows: - Fire insurance
    b. Earthquake insurance
    c. Flood insurance
    d. Home insurance
    e. Boiler insurance

At present insurance market is much vibrant than before and this has an impact on the rates of insurance premium.

13.4 Types of Insurance Companies

Insurance companies can be categorized into two main divisions which are classified as follows:

1.General Insurance Companies: They provide all types of insurance apart from life insurance i.e., fire insurance, marine insurance, vehicle insurance etc.,

2.Life Insurance Companies: The companies, dealing with life insurance, pension products and annuities are life insurance companies.

13.5 Types of Insurance Policies

Insurance provides compensation to a person for an anticipated loss to his life, business or an asset. Insurance is broadly classified into two parts covering different types of risks:

I. Life Insurance (Long-term)

II. General Insurance (Non-life Insurance)

I. Life Insurance

"A contract in which the insurer undertakes to a pay a certain sum of money to the insured, either on the expiry of a specified period, or on the death of the insured, in consideration of payment of 'premium' for a certain period of time, is known as 'life insurance".

It is otherwise called as 'Life Assurance'. Generally, the tenure of Life insurance policy is long-term in nature; it may either be for a certain period or whole life period of the insured. Insurance against risk to one's life is covered under ordinary life assurance. Ordinary life assurance can be further classified into several types:

13.6 Types of Ordinary Life Assurance

1. Whole Life Assurance

In whole life assurance, insurance company collects premium from the insured for whole life or till the time of his retirement and pays claim to the family of the insured only after his death.

2. Endowment Assurance

In case of endowment assurance, the term of policy is defined for a specified period say about 15, 20, 25 or 30 years. The insurance company pays the claim to the family of the assured in the event of his death, within the policy's period or in an event of the assured surviving the policy's period. In the event of the insured surviving beyond the coverage/specified period, the maturity value/sum assured along with bonus will be paid to the insured himself.

3. Assurances for Children

Child's Deferred Assurance:Under this policy, the insurance company pays the claim to the insured on the maturity date of the policy, which is calculated to coincide either with the date of child's eighteenth or twenty first birthday or attaining majority. The policy holder may either claim the payment on the date of maturity period or continue the insurance coverage. If the parent dies before the option date, the policy remains continued until the option date without paying premium for the remaining period. Suppose, the child dies before the option date, the parent gets back the premium plus bonus.

School fee policy: School fee policy can be availed by affecting an endowment policy on the life of the parent with the sum assured, payable in installments over the schooling period of their children.

4. Term Assurance

Term assurance is life insurance which provides coverage at a fixed rate of payments for a limited period of time in respect of the term offered by the assured. In case, the insured dies during the term, the death benefit will be paid to the beneficiary. If the insured survives after that period expires, either he has to pay additional premium for obtaining further coverage or he has to forgo coverage. It is the least expensive way to purchase a substantial death benefit on a coverage amount over a specific period of time.

5. Annuities

Annuity is a contract under which the insurer (insurance company) promises to pay the insured a series of payments until the insured's death.

The insured make the premium payment in the mode of either lump sum or installments to the insurer. Generally, life annuity is chosen by a person having surplus wealth and wants to use this money after his retirement. The annuities can be further classified into two types, which are as follows: -

a. **Immediate Annuity:**It means that the insured pays a lump sum amount (purchase price) to the insurer and in turn the insurer promises to pay him a specified sum on a monthly/quarterly/half-yearly/yearly basis.
b. **Deferred Annuity:** A deferred annuity can be purchased either by way of installments or by paying a single premium. The insured receives the annuity after the deferment period.

6) Money Back Policy

A money back policy is issued for a particular period, and the sum assured is paid through periodical payments to the insured, spread over this time period. In case of death of the insured within the term of the policy, full sum assured along with bonus accruing on it, is payable by the insurance company to the

nominee of the deceased. Generally, Money back policy is preferred by the person, who requires periodical receipts.

II. General Insurance

General insurance is also known as non-life insurance. It is normally meant for a short-term period of twelve months or less. In recent years, insurance companies are entering the long-term insurance agreements also and the period would not exceed five years. General insurance can be classified into the following categories:

Fire Insurance

Fire insurance provides protection against damage to property caused by accidents due to fire, lightening or explosion. Fire insurance also includes damage caused due to other perils like storm, tempest or flood, burst of pipes, earthquake, riot, civil commotion, malicious damage, explosion, impact (e.g. - aircraft).

Marine Insurance

Hull, cargo and freight are the three basic risk covering area for Marine insurance. Those risks areas are exposed to are collectively known as "Perils of the Sea". These perils include theft, fire, collision etc.

Marine Cargo: Marine cargo policy provides protection to the goods loaded in a ship against all perils between the departure and arrival to warehouse. Therefore, marine cargo covers carriage of goods by sea as well as transportation of goods by land.

Marine Hull: Marine hull policy provides protection against damage to ship caused due to the perils of the sea. In the event of any loss sustained due to collisions at sea, Marine hull policy covers only 3/4th liability of the hull owner (ship-owner) and the remaining 1/4th of the liability is looked after by associations formed by ship owners for the purpose.

Miscellaneous

Miscellaneous insurance covers all types of general insurance, except the fire and marine insurances. Some of the examples of general insurance are motor

insurance, theft insurance, health insurance, personal accident insurance, money insurance, engineering insurance etc.

13.7 INSURANCE INDUSTRY IN INDIA

India has a deep-rooted history in the field of Insurance. In fact, the principles of insurance finds place, even in Manu (Manusmrithi), Yagnavalkya (Dharmasastra) and Kautilya (Arthasastra). Those writings talk in terms of pooling of resources that could be re-distributed in times of calamities such as fire, floods, epidemics and famine. This was probably a pioneer to modern day insurance. Ancient Indian history has preserved the earliest traces of insurance in the form of marine trade loans and carriers' contracts.

In 1818, the Oriental Life Insurance Company was established in Kolkata. It failed in the year 1834 due to the business of the Madras Equitable life insurance which was started in Madras from the year 1829.

The Triton Insurance Company Ltd was formed in 1850 and it was the first general insurance sector in India. The British Insurance Act was enacted in 1870. The Bombay Mutual (1871), Oriental (1874) and Empire of India (1897) insurance companies were started. In 1907, Indian Mercantile Insurance Limited was started, which was the first company to handle all forms of Indian insurance.

A new era began in the Indian insurance sector, by passing of the Life Insurance Act, 1912. The Indian Insurance Companies Act was passed in 1928. This Act empowered the Government of India to gather necessary information about the life insurance and non-life insurance organizations operating in the Indian financial markets. This Act was amended in 1938 with comprehensive provisions for effective control over the activities of insurers to protecting the interest of public. The Principal Agencies system was abolished in the Amendment Act of 1950. On 19th January, 1956 an ordinance was passed for nationalizing the Life Insurance Sector and the Life Insurance Corporation came into existence.

In 1972, with the passing of the General Insurance Business (Nationalization) Act, general insurance business was nationalized with effect

from 1st January, 1973. 107 insurers were amalgamated and grouped into four companies, namely National Insurance Company Ltd., the New India Assurance Company Ltd., the Oriental Insurance Company Ltd and the United India Insurance Company Ltd. The General Insurance Corporation of India was incorporated as a company in 1971 and it commenced business on January 1st 1973.

13.8 REFORMS IN INDIAN INSURANCE SECTOR

In 1993, the Government set up a committee under the chairmanship of RN Malhotra, former Governor of RBI, to propose recommendations for reforms in the insurance sector. The objective was to complement the reforms initiated in the financial sector.

Following the recommendations of the Malhotra Committee Report, in the year 1999, the Insurance Regulatory and Development Authority (IRDA) was constituted as an autonomous body to regulate and develop the insurance industry. The IRDA was incorporated as a statutory body in April, 2000. The key objectives of the IRDA include promotion of competition so as to enhance customer satisfaction through increased consumer choice and lower premium, ensuring the financial security of the insurance market, to safeguard the interests of insurance policy holders and to initiate different policy measures to help sustain growth in the Indian insurance sector.

IRDA has notified 27 Regulations on various issues such as Registration of Insurers, Regulation on insurance agents, Solvency Margin, Re-insurance, Obligation of Insurers to Rural and Social sector, Investment and Accounting Procedure, Protection of policy holders’ interest etc. IRDA brought out guidelines on Initial Public Offers (IPOs).

At present, the number of Insurance companies operating in India is 24 General insurance companies and 23 Life insurance companies. The growth rate of insurance sector is enormously increasing day-by-day. The contribution of

Insurance services sector in the country's GDP is 7%. Insurance sector is strengthening the risk taking ability of the country and promoting for economic development by providing long- term funds for infrastructure development.

13.9 Conclusion

Thus, Insurance protects the interest and secure fair treatment to policyholders. Insurance promotes, monitors and enforce high standards of integrity, financial soundness, and provides speedy settlement of genuine claims and prevent insurance frauds and other malpractices and put in place effective grievance redressal machinery. Insurance builds a reliable management information system to enforce high standards of financial soundness amongst market players.

Questions

1. Define Insurance.
2. What are the types of insurance
3. State the types of insurance companies
4. List out the types of insurance policies
5. Explain the insurance industries in India
6. State the reforms in Indian Insurance sector.

CHAPTER -14

14.1 Introduction

14.2 Credit card origin

14.3 The shape of Credit cards

14.4 Major India Credit card types

14.5 Features of credit cards

14.6 Debit card Vs Credit card

14.7 Travelers' cheque Vs Credit card

14.8 PROS and CONS of using credit cards

14.9 Conclusion

OTHER FINANCIAL SERVICES

14.1 Introduction

Financial services are the economic services provided by the finance industry, which encompasses a broad range of businesses that manage money, including creditunions, banks, creditcard companies, insurancecompanies, acco untancy companies, consumer-finance companies, stock brokerages, investment funds and some government-sponsored enterprises.

14.2 CREDIT CARDS

Credit Cards Origin

Credit is a method of selling goods or services without the buyer having cash in hand. The concept of the credit card is “buy now, pay later” and it is a way of offering credit to a consumer. Credit card carries an identifying number that speeds shopping transactions.

According to Encyclopedia Britannica, “the use of credit cards originated in the United States during the 1920s, when individual firms, such as oil companies and hotel chains, began issuing them to customers.” In olden days, Credit cards were issued by merchants to their customers on credit sales. These cards were accepted only by the issuer himself not by any other person and the seller would not accept the others’ card.

Around 1938, companies started to accept each other’s cards. Today, credit cards allow making purchases with countless third parties.

14.3 The Shape of Credit Cards

Long ago, credit cards were made from metal coins, metal plates, celluloid, metal, fiber, and paper. Now-a-days, credit cards are mostly made of plastic.

First Bank Credit Card

The Flatbush National Bank of Brooklyn, New York was the first bank started issuing credit cards in 1946. The card was invented by John Biggins in the program namely “Charge-It” conducted between bank customers and local merchants. Merchants deposited sales slips into the bank and the bank billed the customer who used the card.

Diners Club Credit Card

In 1950, the Diners Club issued their credit card in the United States. Diners’ Club founder Frank McNamara invented the Diners Club credit card and introduced to his customers intended to pay restaurant bills. The card holder of diners club could eat without money at any restaurant which would collect money from Diners’ Club. Diners’ Club would settle the restaurants’ bill first and later they collect the bill amount along with some charges from the customer (card holder). So, the Diners Club card was called as charge card. In 1958, the first

credit card was issued by American Express. Later bank of America also issued America bank credit card which is popularly known as Visa card.

The Popularity of Credit Cards

During 1960s, more companies offered credit cards, advertising them as a time-saving device rather than a form of credit. American Express and Master Card became popular overnight.

Standard Credit Cards

Standard credit cards are otherwise called as "plain-vanilla" credit cards which offer no additions or rewards.

This is a common kind of credit cards which allows the card holder to have a revolving balance up to a certain credit limit. Card holders can use the card according to his needs and they have to settle their account before the due date. If he fails to pay before the due date interest is charged on outstanding balances at the end of each month.

Premium Credit Cards

Many incentives and benefits are offered by premium credit cards e.g. Gold and Platinum cards which offer cash back, reward points, travel upgrades, and other rewards to cardholders. The card holder of premium cards are charged higher fees and the card is issued to the person who has prescribed higher income and credit score requirements.

Charge Cards

Charge card is a type of credit card that requires the cardholders to pay their balance in full at the end of each billing cycle instead of making payments on the balance over several months. Charge cards do not have spending limit and finance (interest rate) charge. Late payments are subject to a fee, charge restrictions, or card cancellation depending on the card agreement.

Limited Purpose Cards

Limited purpose credit cards can only be used at specific locations. Limited purpose cards are used like credit cards with a minimum payment and finance

charge. Store credit cards and gas credit cards, petro card are examples of limited purpose credit cards.

Secured Credit Cards

Instead of assessing credit worthiness, some money is to be deposited to get a secured credit card. The credit limit on a secured credit card is limited up to the amount deposited. The credit limit may be extended in some cases. Cardholder must make monthly payments on their secured credit card balance.

Prepaid Cards

Prepaid cards are similar to debit cards. The cardholder can use the card after payment of some money in advance.

The spending limit is limited up to the amount paid in advance by the cardholder. If the cardholder wants more credit limit, he has to load more money into the card. Prepaid cards do not have finance charges or minimum payments since the balance is withdrawn from the deposit.

Business Credit Cards

A card which is designed specifically for business use is called as business credit card. It is an easy method for business people to maintain business and personal cash transactions separately. There are 12 major types of credit cards provided by banks and financial institutions in India. These cards provide a wide variety of financial benefits to holders.

14.4 Major India Credit Card Types

Following are various types of credit cards available in India:

Premium Credit Cards

Cash Back Credit Cards

Gold Credit Cards

Airline Credit Cards

Silver Credit Cards

Business Credit Cards

Balance Transfer Credit Cards

Co-branded Credit Cards

Low Interest Credit Cards

Lifetime Free Credit Cards

Rewards

There are some additional credit cards that are available in India as well. Rewards credit cards available in India can be subdivided into six categories – Points, Hotels and Travels, Retail, Auto and Fuel.

Premium Credit Cards

There are 33 various premium credit cards available in India:

ABN AMRO Make My Trip Go Credit Card

ABN AMRO Platinum Credit Card

ABN AMRO Titanium One Credit Card

American Express Kingfisher First Credit Card

American Express Platinum Credit Card

Axis Bank Visa Platinum Credit Card

Bajaj Allianz Super Value Titanium Credit Card

Citibank Platinum Credit Card

Deutsche Bank Landmark Platinum Credit Card

Deutsche Bank Miles & More Platinum Credit Card

Deutsche Bank Miles & More Signature Credit Card

Deutsche Bank Platinum Credit Card

HDFC Bank Platinum Plus Credit Card

HDFC Bank Platinum Plus Credit Card

HDFC Bank Titanium Credit Card

HDFC Bank Visa Signature Credit Card

HSBC Platinum Credit Card

ICICI Bank Ascent American Express Credit Card

ICICI Bank Platinum Credit Card

ICICI Bank Platinum Identity Credit Card

ICICI Bank Platinum Premiere Credit Card

ICICI Bank Thomas Cook Titanium Credit Card

ICICI Bank Titanium Credit Card

ICICI Signature Credit Card

Jet Airways Citibank Platinum Credit Card

Kotak Mahindra League Platinum Credit Card

Kotak Mahindra Royal Signature Credit Card

SBI (State Bank of India) Platinum Credit Card

Standard Chartered Emirates Platinum Credit Card

Standard Chartered Emirates Titanium Credit Card

Standard Chartered Platinum Credit Card

Standard Chartered Super Value Titanium Credit Card

Yare Barclaycard Platinum Credit Card

14.5 FEATURES OF CREDIT CARD

Interest Rate

Interest rate is the prime feature of any credit card. Interest rate is directly influencing the payment for borrowing money on the credit card. In general, the interest rate is expressed as the annual percentage rate (APR).

Grace Period

The card issuers may provide a grace period to pay off the balance. The grace period is the amount of time given to the cardholder for the payment of his credit card balance in full to avoid interest charges. Credit card grace periods range is subject to the conditions of the card issuers.

Fees

Annual fee is normally charged by the card issuer. Over-limit fee is charged on the amount exceeding the credit limit of the card holder. Cash advance fee is charged when the card holder makes a cash advance on his credit card. Balance transfer fees are added when a cardholder transfers a balance to his credit card.

Credit Limits

Credit limit is the maximum spending amount of the cardholder by using his card. The cardholder may exceed his credit limit if he has opted 'over-the-

limit' option. He is charged with the fee for over-the-limit when a transaction goes over the credit limit.

14.6 Debit Cards Vs Credit Cards

Debit card	Credit card
The spending power depends on the drawing capacity which in the case of Debit Card is your own assets with the bank.	It allows a borrowing power on the bank, for which you have to pay some charge or fees.
Debit card is as good as money in the accounts with the bank	Credit card has the additional advantage of your overdrawing if necessary, payments are made by the bank to the extent of the purchases and if they exceed the limit, Interest has to be paid to the excess amount spend.
There is no risk of overspending, and it does not involve interest payment	Borrowing is possible and interest to be paid on the overdrawn amount.

14.7 Travelers' Cheques VS Credit Cards

Travelers' Cheque	Credit Cards	
What is it?	A Travelers Cheque is bearer cheque in	A Credit card enables one to make an immediate

	foreign currency for a predetermined value.	"cashless purchase" and pay later.
Issued by?	Authorized dealers in foreign currency	Banks
Eligibility	In order to procure travelers cheque we have to furnish your passport and a confirmed ticket	In order to procure a credit card, we are assessed by the bank in terms of the income and credit worthiness.
Revolving Credit Facility	A Travelers cheque when procured, involves an upfront payment or an immediate debit the bank account.	Credit cards allow carrying forward the outstanding due on a month to month basis while paying only the minimum balance. This is called revolving credit facility. Banks charge interest on the outstanding for the period of time it is due.
Pre-determined spending limit	The travelers cheque is already drawn for particular amount, it cannot be exceeded	Credit cards have a predetermined spending limit based on the bank's assessment of the credit worthiness. We can spend within this limit and carry forward the outstanding if we cannot pay it at the month end.

14.8 PROS AND CONS OF USING CREDIT CARD

PROS

1.Instant Cash

Credit card holders can get cash instantly whenever and wherever they need.

2.Convenience

Credit cards are convenient and time saving for cardholders from searching for an ATM or keeping cash on-hand.

3.Purchase Power and Ease of Purchase

The purchasing power of the credit card holder can increase due to allowing credit purchase by using credit cards. It makes easier to buy things. There is no need to carry bulk amount of cash with the card holder for purchase of goods. It is very useful and easy for e-ticket booking (Train, Air, bus, hotels, Theater, pilgrim dharsan etc.).

4.Protection of Purchases

The credit card statement can be a voucher for the purchase when the original receipt is lost. Some credit card company may offer insurance coverage on large purchases.

5.Create a Good Credit Worthiness

The credit worthiness of the cardholders is proved through making prompt payment. The creation of good credit worthiness is useful to the cardholder in certain circumstances like applying for loans, jobs etc.

6.Emergencies

Credit card helps to make some emergency payment for certain dues like motor vehicle installment due, rent, Hospital bill etc., and also it will be very helpful in emergency situations like car breaking down, flood, fire etc.

7.Credit Card Benefits

Credit cards offer some additional benefits like discounts from particular stores or companies, bonus such as free airline miles or travel discounts, and special insurances (like travel or life insurance.).

CONS

1.High Interest Rates

Charging high cost of loan is the biggest drawback of credit cards. The interest rate for purchase, balance transfer, cash advance etc. is very high. These interest rates make the actual cost of any purchase higher because of the higher interest rate component. Getting money is easier by using credit card with high rate of interest.

2.Lavish Spending

Normally, the human tendency is to spend lavishly when they have more liquid cash. Credit cardholders are easily influenced to spend more money through some offers like lucrative discounts, cash back etc. which drive cardholders to increase their debt.

3.Heavy Penalty

Issuers of credit cards are charging heavy penalty for late payments made by the card holders. The issuer can take very serious action against the cardholders for default in repayment of debt with penalty.

14.9 Conclusion

Credit cards are a new innovation in financial services introduced by the financial institutions in extending easy availability of money. Credit cards have been transforming the Indian economy in a big way. Credit card is fast catching the imagination of the people, in particular, the younger generation in a great manner. Credit cards are more convenient to people who can avail of varied services without paying in money at the cash counter.

Questions

1. State the origin of credit cards and its types.
2. What are the major Indian credit card types?

3. What are the features of credit cards?
4. Distinguish debit card and credit card?
5. Differentiate Travelers cheque and credit cards?
6. State the pros and cons of credit cards.

CHAPTER - 15

15.1 Meaning

15.2 Origin

15.3 Rating indications

15.4 Factors influencing assigned ratings

15.5 Benefits of credit rating

15.6 Limitations of credit rating

15.7 The regulatory framework for credit rating agencies

15.8 SEBI code of conduct

15.9 Regulating authority

15.10 Regulatory prescription of use of ratings for investment purposes

15.11 CRAs registered with SEBI

15.12 The objectives of ICRA Limited

15.13 Credit rating process

15.14 Rating methodology

15.15 CRISIL long term debt instruments symbols and definitions

15.16 CRISIL short term debt instrument symbols

15.17 ICRAs medium term rating scale

15.18 Conclusion

CREDIT RATING

15.1 Meaning

Credit rating is an opinion of rating agency about a debt instrument. The opinion is expressed through symbols which indicate the degree of risk associated with repayment of principal and payment of interest on debt instrument. Credit rating agency gets fee for their services from corporate entities which approach for rating of their instruments. Credit rating is not mandatory to all corporate sectors except for certain instruments. The financial position of the corporations is reviewed frequently and the ratings are revised by the credit rating agency.

15.2 Origin

In 1841, the first mercantile credit agency was set up in New York to rate the ability of merchants to pay their financial obligations. Later on, it was taken over by Robert Dun. This agency published its first rating guide in 1859. The second agency was established by John Bradstreet in 1849 which was later merged with first agency to form Dun & Bradstreet in 1933. It became the owner of Moody's Investor's Service in 1962. Since 1970's, a number of credit rating agencies have been set up all over the world including countries like Malaysia, Thailand, Korea, Australia, Pakistan, Philippines etc. In India, CRISIL (Credit Rating and Information Services of India Ltd.) was setup in 1987 as the first rating agency.

15.3 Rating Indications

Rating symbols assigned to a security issue is an indicator of the following:

- the nature and terms of the particular security being issued;
- the ability and the creditworthiness of the issuer of a security to make payments in time;
- the probability that the issuer will make a default in payments.

15.4 Factors influencing Assigned Ratings

The ratings are assigned by the credit rating agency based on the following factors:

- ✓ The issuer's ability to meet the obligations of debt.
- ✓ The volume and composition of outstanding debt.
- ✓ The earning capacity of the company and its stability of 'future cash flows'.
- ✓ The interest coverage ratio i.e. it is the relationship between fixed interest and profit of the company (EBIT) whose ability to meet its fixed interest obligations.
- ✓ Current Ratio which is calculated to assess the liquidity position of the issuing firm.
- ✓ The value of assets pledged as collateral security
- ✓ Market demand for the products, competitors' market share, and distribution channels etc.
- ✓ Operational efficiency is judged by capacity utilization, prospects of expansion, modernisation and diversification, availability of raw material etc.
- ✓ Track record of promoters, directors and expertise of staff.

15.5 Benefits of Credit Rating

The beneficiaries of Credit rating are investors, companies and intermediaries benefited in the following ways:-

1.Benefits to Investors

i.Safety : Investors get an idea about the degree of financial strength of the issuer company through credit rating.

ii.Risk and Returns : Credit rating indicates the degree of risk and possibility of returns on debt instruments. The indication (symbol) helps the investor to take decision for making investment on such instruments.

iii.Investment Decisions : Credit rating symbol expresses the creditworthiness of the instruments as a layman can easily understand about the risk & return status of such instruments. Hence, he can take his own decision instead of seeking any advice from the stock brokers.

iv.Investment Choice : Commonly, there are two different types of investors i.e., risk taker and risk averter. The level of risk taking is different for different

investors. Hence, the investor can choose the securities for his investment based on his risk bearing capacity.

v.Easy Perception : All debt instruments are rated mandatorily. No analytical knowledge is required to make investment on debt instruments. Therefore, investors can make investment easily and quickly.

vi.No Need of Issuing Company Details : Credit rating agencies conduct detailed investigation about the issuing companies' details like nature of business, financial position, liquidity and profitability position before evaluating the instruments issued by them. Therefore, investors need not bother about the company.

vii.Monitoring System : The constant monitory system is followed by credit rating agencies after grading the instruments.

2.Benefits to the Company

i.Quick Mobility of Fund : Highly rated instruments indicate the ability of the yield of the instruments. Normally, investors are interested to invest in this kind of instruments. Hence, the issuing company can mobilize fund quickly through the issue of such type of securities.

ii.Lower Cost of Debt : The highly rated instruments are quoted with lower rate of interest. So, the company can get cheaper source of debt fund.

iii. Reducing Issue Expenses : The rating itself is an advertisement for highly rated instruments. Hence, the issuing company has no need to spend for publicity of such instruments. Therefore, the issuing cost can be reduced to the issuing company.

iv. Increasing Goodwill : The goodwill of the company would increase when their instruments get high rate. The high rated instruments build good image of the company in the eyes of stakeholders.

v. Motivation for Growth : The promoters of the company with highly rated instruments are motivated to expand their operations and move towards the growth path of the company.

vi. Recognition : Credit rating is a way for getting opportunity to recognize the new companies or unknown companies.

3.Benefits to Intermediaries

The less effort is sufficient to approach the investors for the selection of instruments by the intermediaries in case of highly rated instruments.

15.6 LIMITATIONS OF CREDIT RATING

Credit rating suffers from the following limitations:

1.Hidden Information : Investors can get loss when the company does not disclose the important information to the investigation team of credit rating agency.

2.Non-Consideration of External Factors : The external factors like economic, political, environment and government policies which may affect the creditworthiness of the firm are not considered while evaluating the instruments. Generally, the rating is based on historic data which may mislead the investors.

3.No Guarantee : Rating is simply an opinion about the capability of the company but it is not a certificate or guarantee of the credit rating agency.

4. Biased : The quality of the rating may be affected due to the personal bias of the investigating team.

5. Difference in Rating Grades : Investors get confused due to different rating scale for the same instrument given by different rating agencies.

15.7 THE REGULATORY FRAMEWORK FOR CREDIT RATING AGENCIES

SEBI Regulations

The Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 empower SEBI to regulate CRAs operating in India. In fact, SEBI was one of the first few regulators, globally, to put in place an effective and comprehensive regulation for CRAs.

SEBI regulation for CRAs has been designed to ensure the following:

- ✓ Credible players enter this business (through stringent entry norms and eligibility criteria)

- ✓ CRAs operate in a manner that enables them to issue objective and fair opinions (through well-defined general obligations for CRAs)
- ✓ There is widespread investor access to ratings (through a clearly articulated rating dissemination process).
- ✓ The applicant should be registered as a company under the Companies Act, 1956 and possess a minimum network of ` 5 crore.

The following are some of the General Obligations specified in the CRA regulations. CRAs are amongst the very few market intermediaries for which such detailed operating guidelines have been prescribed under the regulations.

- Code of Conduct stipulated by SEBI
- Agreement with the client
- Monitoring of ratings
- Procedure for review of rating
- Internal procedures to be framed by the CRA
- Disclosure of Rating Definitions and Rationale by the CRA
- Submission of information to the Board
- Compliance with circulars etc., issued by the Board
- Appointment of Compliance Officer
- Maintenance of Books of Accounts records, etc.
- Confidentiality
- Rating process

These regulations cover issues with respect to confidentiality of information and disclosure with respect to the rationale of the rating being assigned. Several other provisions exist, like the regulator‘s right to inspect a CRA. An important feature of the regulation is that CRAs are prohibited from rating their promoters and associates.

15.8 SEBI Code of Conduct

SEBI's code of conduct for CRAs addresses some of the basic issues relating to conflicts of interest. The Code of Conduct is designed to ensure transparent and independent functioning of CRAs. Some of the salient provisions of the Code of Conduct are:

- ✓ A CRA shall make all efforts to protect the interests of investors.
- ✓ A CRA shall at all times exercise due diligence, ensure proper care and exercise independent professional judgment in order to achieve and maintain objectivity and independence in the rating process.
- ✓ A CRA shall have in place a rating process that reflects consistent and international rating standards.
- ✓ A CRA shall keep track of all important changes relating to the client companies and shall develop efficient and responsive systems to yield timely and accurate ratings.
- ✓ A CRA shall disclose its rating methodology to clients, users and the public.

15.9 Regulating Authority

In India, the regulating authority of Credit Rating Agencies and financial instruments are SEBI, RBI and IRDA. The list of various financial instruments, and the relevant regulators, are given below:

Products / Instruments requiring mandatory rating before issuance

Sl. No	Instrument	Regulator
1	Public / Rights/ Listed issue of bonds	SEBI
2	IPO Grading	SEBI
3	Capital protection oriented funds	SEBI
4	Collective Investment Schemes of plantation companies	SEBI
5	Commercial Paper	RBI
6	Bank loans	RBI (Basel II capital computation for banks)
7	Security Receipts	RBI (For NAV declaration)

8	Securitised instruments (Pass Through Certificates)	RBI ((Basel II capital computation for banks)
9	Fixed Deposits by NBFCs & HFCs	RBI
10	LPG/SKO Rating	Ministry of Petroleum and Natural Gas
11	Maritime Grading	Directorate General of Shipping (for some courses)

15.10 Regulatory prescription of use of ratings for investment purposes

S. No	Product	Regulator
1	Banks‘ investments in unrated non-SLR portfolio	RBI
2	Investments by Insurance companies	IRDA
3	Provident Fund investments	Government of India

15.11CRAs registered with SEBI

Name of the CRAs Year of commencement of Operations CRISIL 1988 ICRA 1991 CARE 1993 Fitch India 1996 Brickworks 2008

A. Credit Rating Information Services of India (CRISIL Ltd.)

CRISIL is the first rating agency in India. It was set-up in 1987 jointly by the erstwhile ICICI Ltd. and UTI. The other shareholders are Asian Development Bank (ADB), LIC, State Bank of India, HDFC etc. The head office of the company is located at Mumbai and it has established offices outside India also. The CRISIL Ltd. is the world's fourth largest rating agency. 'CRISIL' has rated over 4700 debt instruments issued by 2200 companies.

The activities of CRISIL Ltd. are as under

- ✓ To provide credit rating service in respect of Ratings of corporate debt issuances, Ratings of banks, non-banking finance companies, Ratings of borrowing programmes of governments and government bodies, Ratings of structured finance instruments and Ratings of micro-finance institutions
- ✓ To provide analytical tools for management of risk such as market risk, credit and operational risk and valuation services
- ✓ To undertake research on economy, industry and company performance and publish such reports
- ✓ To provide corporate as well as market advisory services to corporate and non-corporate clients.

B. Investment Information and Credit Rating Agency of India Ltd. (ICRA)

ICRA was established in the year 1991 by the collaboration of financial institutions, investment companies, and banks. The company has formed the ICRA group together with its subsidiaries. The company offers products like short-term debt schemes, Issue-specific long-term rating and offers fund based as well as non-fund based facilities to its clients.

15.12 The objectives of the ICRA Ltd. are as follows:

- To rate rupee denominated debt instruments issued inter alia, by manufacturing companies, commercial banks, non-banking finance companies, financial institutions, public sector undertakings and local bodies, etc.
- To take-up assignments for credit assessment of companies/ undertakings intending to use the same for obtaining specific line of assistance from commercial banks, financial institutions, non-bank financial services companies.
- It provides services of general assessment. At the request of banks or any other potential users, it prepares, as per their requirements, general assessment reports. It does not assign any specific symbols in respect of such general assessments. It provides a report on various aspects of the functioning of companies such as operations, quality of management etc.

- To undertake research based study reports to address the unique needs and requirements of an individual client. The assignments include due diligence studies, equity assessment/valuation, industry analysis, and market study etc.
- To offer advisory services to banks, finance companies, manufacturing companies, government, regulatory authorities and local bodies in the following areas of strategic consulting, risk management and inputs for policy formulation

C. Credit Analysis and Research Limited (CARE)

CARE was incorporated in 1993. It was promoted by Industrial Development Bank of India (IDBI), Canara Bank, Unit Trust of India (UTI) and other financial and lending institutions. CARE has completed over 7,564 rating assignments since its inception in 1993.

The functions of CAREL are as under

- To undertake credit rating of all types of debt instruments, both short term and long term.
- To make available information on any company, industry or sector required by a business enterprise.
- To undertake equity research study of listed or to be listed companies on the major stock exchanges

D. FITCH Ratings

Fitch Ratings is a global rating agency committed to provide the world's credit markets with independent and prospective credit opinions, research, and data. The headquarters of Fitch Ratings is in New York and London and it is a part of the Fitch Group.

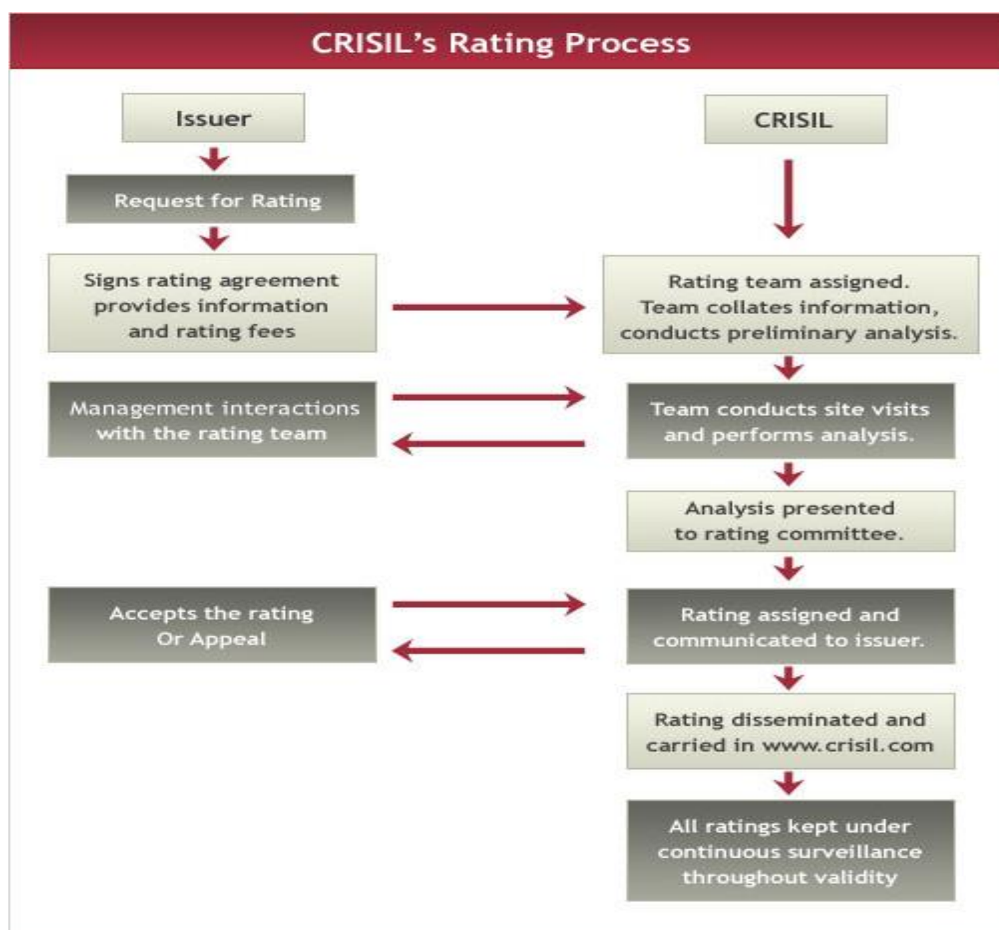
E. BRICKWORK Ratings

Brickwork Ratings is a private credit rating agency. It was registered under SEBI in the year 2008. It was founded by bankers, credit rating professionals, former regulators as well as professors, was committed to promoting Financial Literacy.

15.13 CREDIT RATING PROCESS

The rating process is designed to ensure that all ratings are based on the highest standards of independence and analytical rigour. From the initial meeting with the management to the assignment of the rating, the rating process normally takes three to four weeks. However, the rating agency has sometimes arrived at rating decisions in shorter time frames, to meet urgent requirements. The process of rating starts with a rating request from the issuer, and the signing of a rating agreement. Credit rating agency employs a multi-layered, decision-making process in assigning a rating.

The following picture depicts the CRISIL's Credit rating process:



The process/ procedure followed by all the major credit rating agencies in the country are almost similar and usually comprises of the following steps.

1) Receipt of the Request

The issuing company approaches the credit rating agency to rate their instruments which are issued to the public. It is the starting point in the process of rating. The rating agency and Issuer Company enter into an agreement. The general terms and conditions of the agreement are as follows:

- ➢ To Keep confidential information about the issuing company
- ➢ Acceptance of the rating is in the hands of issuing company
- ➢Providing all information is essential on the part of issuing company

2) Assignment to Analytical Team

Credit rating agency entrusts the job to its expertise team for investigating the issuing company after entering into the agreement with them. Normally, the team consists of two members and it may vary depending upon jobs.

3) Obtaining Information

The issuing company must provide all the requisite information to the analytical team. The analytical team analyses the information relating to its financial statements, cash flow projections and other relevant information.

4) Team Visits and Interacts with Management

The analytical team must visit the issuing company for better understanding of the client's operations and interact with the company's executives.

5) Presentation of Findings

The analytical team presents the report on the issuing company to the internal committee of the credit rating agency.

6) Rating Committee Meeting

The rating committee conducts meeting with the analytical team to discuss about the assessment of all factors concerned to the issuer. After a deep discussion, the rating committee evaluates the issuing company and rates their instruments. The decision of the rating committee is final. The issuing company cannot be involved directly in the process of rating.

7) Communication of Decision

The issuing company gets the information from CRA about the rating grade assigned by them. The supported documents or explanations would be furnished to the issuing company. The issuing company may accept or reject the ratings. The rejected ratings are not disclosed by the Credit rating agency.

8) Broadcasting to the Public

The credit rating agency can broadcast the rating information through printed reports to the public after the acceptance of the issuer.

9) Continuous Surveillance

The Credit Rating Agency is continuously monitoring the issuing company till the validity period of the ratings.

15.14 Rating Methodology

The rating methodology is a detailed analysis of all the factors affecting the creditworthiness of an issuer company. The important factors are business, financial and industry characteristics, operational efficiency, management quality, competitive position of the issue, commitment to new projects etc.

The credit rating agency analyses the following factors for evaluating the instruments such as:

I. Business Risk Analysis

II. Financial Analysis

III. Management Risk Analysis

IV. Project Risk Analysis

V. External support

These are explained as under:

I. BUSINESS RISK ANALYSIS

Business risk analysis involves the analysis of the industry risk, market position and operating efficiency of the company which has various factors that depicts in the following chart:

Business Risk Analysis		
Industry Risk	Market Position	Operating Efficiency
➢ Macro Economic Factor ➢ Industry Structure ➢ Industry Demand Supply Scenario ➢ Industry Growth Prospectus ➢ Industry Profitability ➢ Market Size ➢ Extent of Competition ➢ Extent of Cyclicality ➢ Regulatory Environment	➢ Key Competitive Advantages ➢ Market Share Movements ➢ SWOT Analysis ➢ Brand Strength ➢ Product Profile ➢ Trend Analysis ➢ Pricing Power ➢ Distribution Network	➢ Cost Structure ➢ Technological Factors ➢ Access to Resource ➢ Labour Relations ➢ Capacity Utilisation ➢ Integration (forward & Backward) ➢ Flexible Production Capacities ➢ R & D Capabilities

B. MARKET POSITION

The credit rating agency determines the market position of the issuing company with reference to the following parameters:

i. Revenue Generation Addressed a. Market Size and Segments

b. Market Share and Trends

c. Entry Barriers and Capacity

d. Product Range and Customer Diversity

ii. Competitive Advantages a. Brands, Product Quality

b. Strength of Distribution network and geographical Reach

c. Long Term contracts for Product off take / marketing arrangement

d. Ability to pass on Input Cost Increase

C. OPERATING EFFICIENCY

Operating Efficiency can be measured by using the following aspects:

i. Cost Structure a. Technology used

b. Capacity Utilization

c. Regular up keep / modernization of facilities

ii. Input Structure a. Access to resource, cost of key inputs

b. Level of Integration

c. Assured, Quality supply of Critical Utilises

d. Labour Relations – Union

II. FINANCIAL ANALYSIS

Financial risk analysis aims at determining the financial strength of the issuer company. The credit rating agency can use some accounting tools & techniques to analyze the financial risk which are depicted in the following picture.

Financial Risk Analysis			
Accounting Quality	**Financial Position**	**Cash Flow Adequacy**	**Financial Flexibility**
➢ Accounting Polices ➢ Reporting Disclosures ➢ Analytical adjustments	➢ Capital Structure ➢ Profitability Analysis ➢ Debt Protection Ratios ➢ Off-Balance Sheet Obligations	➢ Sources of uses of Funds ➢ Cash accruals in relation to debt repayments	➢ Bank Limits ➢ Cash and marketable securities ➢ Access to Capital markets

	➢ Sensitivity Analysis ➢ Liquidity Short Term Factors ➢ Working Capital Management	➢ Capital Expenditure Plans, funding profile	➢ Relationship with bankers ➢ Contingency Plans ➢ Ability to Defer Capital Expenditure

B. Past and Future Financial Record

Past performance

Capital Structure (Debt – Equity)

Debt Protection measure (Interest Coverage & Cash DSCR) & Liquidity

Profitability Trends in Operating / Net Margins (indicating asset side Performance) – provide a tool to measure cash generation.

Trends in Company's Funding mix Philosophy – Phasing of Capex Programmes.

Future Performance Based on Industry Trends, Company's own operations and future plans.

C. Cash Flow Adequacy and Financial Flexibility

Assess the adequacy and stability of cash Flow in relation to debt, working capital needs and capital expenditure requirement.

Comparison of sources and uses of funds

Ability to raise alternative financing eg. Equity, Quasi Equity, Loans from Promoters

Financial support from group / promoters and its past track record

Availability of un encumbered liquid assets

III. Management Risk Analysis

Rating of a debt instrument requires evaluation of the management strengths and weaknesses because company's performance is highly influenced by the management goals, plans, strategies etc., which can be analyzed through the following aspects:

Management Risk Analysis			
Integrity	**Risk Appetite**	**Competence**	**Governance Practices**
➢ Adherence to Laws & Regulations ➢ Track Record of debt repayments ➢ Intra-group transactions ➢ Reputation in financial markets	➢ Financial Policy ➢ Growth Plans funding profile ➢ Unrelated diversification ➢ Attitude to Business risk ➢ Risk Management practices	➢ Track Record ➢ Consistency of performance ➢ Success of past strategies ➢ Succession plans ➢ Quality of Senior Management ➢ Experience in managing downturns ➢ Ability to attract/retain talent	➢ Equitable treatment of Shareholders ➢ Transparency & Disclosure ➢ Value creation to stakeholder ➢ Board Composition

IV. Project Risk Analysis

The instrument issuing company's project should be evaluated to measure the risk of the project. It is very important for rating debt instrument. The following factors are considered to evaluate the project by the credit rating agency.

Project Size

Implementation risk

Funding Risk

Technology Risk

Track Record in timely implementation

Cost Overruns, contingency

V. External Factors

The credit rating agency has to analys the external factors and its supports also. They are as follows:

External Factors		
Government Support	**Group Support**	**Parent Support**
➢ Policy Role ➢ Strategic importance to the Government ➢ Critically of sector to economy ➢ Implication of default / moral obligations ➢ Political implications of default ➢ Domino effect ➢ Public perception of sovereign backing	➢ Economic rationale ➢ Relevance of the entity to the group ➢ Percentage ownership by the group/promoters ➢ Economic incentive to the group ➢ Moral Obligations ➢ Extent of management control ➢ Shared name / common logo for the group of companies ➢ Commonality of resources	➢ Economic Rationale ➢ Strategic importance of the parent ➢ Extent of parent holding ➢ Economic incentive to parent ➢ Moral Obligations ➢ Strategic importance of the parent ➢ Shared Name ➢ Domiciliary Status

➢ Stated posture of the government	➢ Management's Stated Posture	➢ Management's stated posture

4. Bank loans
5. Fixed deposits and bank certificate of deposits
6. Mutual fund debt schemes
7. Initial Public Offers (IPOs)

CRISIL has revised the symbols and definitions of its long-term and short-term credit ratings on debt instruments, structured finance instruments, and debt mutual fund schemes.

This is in compliance with a June 15, 2011, Securities and Exchange Board of India (SEBI) circular, "Standardisation of Rating Symbols and Definitions," which mandates the use of common rating symbols and rating definitions by all credit rating agencies (CRAs). As per the circular, all CRAs are required to revise their rating symbols and definitions as recommended by SEBI. Accordingly, CRISIL has effected changes in rating symbols and definitions with effect from July 11, 2011. The rating symbols and definitions of the following class of instruments have been revised:

Long-term debt instruments;
Short-term debt instruments;
Long-term structured finance instruments;
Short-term structured finance instruments;
Long-term mutual fund schemes; and
Short-term mutual fund schemes.

15.15 CRISIL Long Term Debt Instruments Symbols and Definitions (Period >= 365 Days)

Long Term Rating Symbols	Rating Definitions under Basel II	Risk Weight age under Basel II
CRISIL AAA	Highest Safety	20 %
CRISIL AA	High Safety	30%
CRISIL A	Adequate Safety	50 %
CRISIL BBB	Moderate Safety	100%
CRISIL BB	Moderate Risk	150%
CRISIL B	High Risk	150%
CRISIL C	Very High Risk	150%
CRISIL D	Default	

Long-Term Debt Instruments	
Revised Rating symbol	Revised rating definition as stipulated by SEBI in its Circular No. CIR/MIRSD/4/2011 dated June 15, 2011
CRISIL AAA (Highest Safety)	Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such instruments carry lowest credit risk.
CRISIL AA (High Safety)	Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations. Such instruments carry very low credit risk.

CRISIL A (Adequate Safety)	Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk.
CRISIL BBB (Moderate Safety)	Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.
CRISIL BB (Moderate Risk)	Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.
CRISIL B (High Risk)	Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.
CRISIL C Very High Risk	Instruments with this rating are considered to have very high risk of default regarding timely servicing of financial obligations.
CRISIL D (Default)	Instruments with this rating are in default or are expected to be in default soon.

15.16 CRISIL Short Term Debt instruments Symbols (Period < 365 Days)

Rating Short Term Rating Symbol	Rating Definitions under Basel II

CRISIL A1	Very Strong Degree of Safety
CRISIL A2	Strong degree of safety
CRISIL A3	Moderate Degree of Safety
CRISIL A4	Minimum Degree of safety
CRISIL D	Default

Long-Term Debt Mutual Fund Schemes

Revised Rating symbol	Revised rating definition as stipulated by SEBI in its Circular No. CIR/MIRSD/4/2011 dated June 15, 2011
CRISIL AAAmfs	Schemes with this rating are considered to have the highest degree of safety regarding timely receipt of payments from the investments that they have made.
CRISIL AAmfs	Schemes with this rating are considered to have the high degree of safety regarding timely receipt of payments from the investments that they have made.
CRISIL Amfs	Schemes with this rating are considered to have the adequate degree of safety regarding timely receipt of payments from the investments that they have made.
CRISIL BBBmfs	Schemes with this rating are considered to have the moderate degree of safety regarding timely receipt of payments from the investments that they have made.
CRISIL BBmfs	Schemes with this rating are considered to have moderate risk of default regarding timely receipt of payments from the investments that they have made.
CRISIL Bmfs	Schemes with this rating are considered to have high risk of default regarding timely receipt of payments from the investments that they have made.
CRISIL Cmfs	Schemes with this rating are considered to have very high risk of default regarding timely receipt of payments from the investments that they have made.

Short-Term Debt Mutual Fund Schemes	
Revised Rating symbol	Revised rating definition as stipulated by SEBI in its Circular No. CIR/MIRSD/4/2011 dated June 15, 2011
CRISIL A1mfs	Schemes with this rating are considered to have very strong degree of safety regarding timely receipt of payments from the investments that they have made.
CRISIL A2mfs	Schemes with this rating are considered to have strong degree of safety regarding timely receipt of payments from the investments that they have made.
CRISIL A3mfs	Schemes with this rating are considered to have moderate degree of safety regarding timely receipt of payments from the investments that they have made.
CRISIL A4mfs	Schemes with this rating are considered to have minimal degree of safety regarding timely receipt of payments from the investments that they have made.

15.17 ICRA's Medium-Term Rating Scale (only for Public Deposits)

ICRA's Medium-Term Rating Scale

Symbols	Indicator	Profile
MAAA	Highest Safety	The rated deposits programme carries the lowest credit risk
MAA	High Safety	The rated deposits programme carries low credit risk
MA	Adequate Safety	The rated deposits programme carries average credit risk.
MB	Inadequate Safety	The rated deposits programme carries high credit risk

MC	Risk Prone	The rated deposits programme carries very high credit risk.
MD	Default	The rated instrument has very low prospects of recovery.
Symbols	Indicator	Profile
A3	Adequate Safety	Instruments rated in this category carry higher credit risk than instruments rated A2 and A1.
A4	Risk Prone	Instruments rated in this category carry high credit risk.
A5	Default	Instruments rated in this category have very low prospect of recovery.

While ratings act as a guide to the average investor, it also enhances the credibility of the rated organizations.

Presently, credit rating is mandatory in India for debt instruments with conversion/redemption exceeding 18 months for fixed deposit programmes of all non- banking finance companies. It is optional for PSU bonds and privately placed non-convertible debentures.

Are the Indian rating agencies able to meet evaluation standards and eliminate influence of vested interests? For this, it is imperative that they are independent. In the Indian case, the existing three rating agencies, viz CRISIL, ICRA, and CARE are promoted by financial institutions. They may well serve as in-house rating agents to assess credit risk of their customers. But what would be the yardsticks and whether they would remain impartial when their promoters themselves would be the clients? We may think of other independent rating agencies in the field but there is every likelihood that industrial groups may start their own rating agencies, on the patterns of their own financial agencies. In such an eventuality, there is every danger of such agencies becoming an in-house sort of entity thereby compromising on objectivity in rating standards.

Multiple agencies may increase competition in rating but ir may also land up in indifferent rating standards and there is also the risk of succumbing to

pressures for attracting business. There have been criticisms of Indian credit rating agencies. First, that they assign ratings which are not comparable against international standards, Secondly the rating symbols they assign are internally inconsistent, and thirdly agencies are not kept at arm's length from their sponsors.

15.18 Conclusion

The primary benefit of credit rating has been to enable the investor to identify the risks associated with various debt obligations. The other benefits include decreasing the potential conflict between the underwriters and the investors, providing greater liquidity in secondary markets, encouraging increased disclosure on the part of the companies, better accounting standards and improved financial information for the promotion of individual and institutional investor protection.

With the eruption of new financial instruments and the realization on the part of the investor of the invaluable service that credit rating agencies provide, credit rating is bound to find its niche in the investment decision making process and act as a positive step in the direction of increasing investor protection. Thus credit rating has firmly docked itself on the shores of the Indian capital market. The Credit rating agencies have ample opportunities to play a unique role in strengthening the capital market and building investor's confidence in the Indian Financial System.

Question

1. What is credit rating? Explain its indication?
2. What are the factors influencing assigned ratings?
3. What are the benefits of credit ratings?
4. Explain the regulatory framework for credit rating agencies.
5. State the regulation authority of credit rating agencies and financial instruments?
6. What is CRISIL?
7. Explain credit rating process.
8. State the rating methodology of credit rating.

9. Explain the credit rating symbols.

CHAPTER– 16

16.1Introduction

16.2Definiton

16.3 Is Retirement Plan Essential?

16.4 Types of Retirement Plans

16.5 PROS of defined benefit plan

16.6 CONS of defined benefit plan

16.7 Defined Contribution Pension Plan

16.8Advantages of Defined Contribution Pension Plans

16.9Disadvantages of Defined Contribution Pension Plans

16.10 NEW PENSION SYSTEM (NPS) FOR NON-GOVERNMENT EMPLOYEES

16.11 List of Pension Fund Managers (PFMs)

16.12 Features and Options of the Scheme

16.13 Conclusion

PENSION PLAN

16.1 Introduction

Retired persons require reasonable money continuously to lead a comfortable life till their death. A Retirement Plan provides financial assurance

for the payment of certain sum of money periodically to the retired persons. In India, the government servants are receiving pension after retirement. There is no such pension to the private employees. Instead, there are various retirement plans available to private employees. Hence, the private employees can take private Retirement Plans to secure their future in terms of finance. The trend of opting for Retirement Plans is becoming increasingly popular in India.

16.2 Definition

According to the Supreme Court of India (1982), “Pension is a term applied to periodic money payments to a person, who retires at a certain age, considered age of disability; payments usually continue for the rest of the natural life of the recipient.”

16.3 Is Retirement Plan Essential?

There are several reasons for the popularity of Retirement Plans in India, these are as follows:-

Socio - Cultural Change

The trend of joint family system is slowly deteriorating and the nuclear family system is being followed especially in urban areas in India due to various reasons like employment, income, independency and reluctance etc. Due to socio-cultural changes, the retired persons are increasingly under pressure to arrange their own income after retirement. Now-a-days, the retired/old age persons also like to be more financially independent.

Increase in Cost of Living

At present, the cost of living is very high due to various economic reasons like inflation, food scarcity, population etc. The medical service is very expensive and causes heavy financial burden to the old age persons as the coverage of medical insurance is limited besides, the process of medical insurance claim being cumbersome. Therefore, the old age persons are increasingly looking at creating a sufficient and reasonable post-retirement income for the bare survival after retirement.

Longer span of life

The life span of human being has increased due to advanced medical facilities. Hence, a strong financial support is required to the retired persons due to the longevity.

16.4 Types of Retirement Plans

There are various retirement plans and schemes in India, both in the private and public sectors such as:-

1.Life Annuity Plan : Life annuity plan guarantees a person a specific amount of income until he survives. After the person's death, the originally invested amount is refunded to his nominee or legal heirs, in the absence of any nominee.

2.Guaranteed Period Annuity : In this plan, the person is guaranteed a specific income for a minimum number of years.

If the person dies before that period, the nominees will continue to receive that income till the period is completed. If the person outlives that period, he or she can continue to receive the income till his death.

3. Annuity Certain : Under this retirement plan, a fixed amount of income is paid for a fixed number of years. The payments will stop at the end of the fixed period, even if the retiree lives beyond this fixed period.

4.Deferred Annuity : Under this plan, the person first saves from his income to create a corpus fund for a number of years. Thereafter, that fund is used for investing in a specific retirement plan that gives him an assured income till his life time.

5.Defined Benefit Pension Plan : Under this plan, the pension amount is known and assured, but it is not dependent on any external factor. The investor must contribute some amount periodically either by himself or through his employer or both. This amount is invested which earns some returns. But the investor can get assured sum irrespective of the kind of returns generated by the investment. Their pension amounts were linked to their grade and last drawn salary.

16.5 PROS OF DEFINED BENEFIT PLAN

➢ Investor can get peace of mind because they know they will get assured and defined pension amount.

- Investors need not worry about monitoring the investments periodically.

16.6 CONS OF DEFINED BENEFIT PENSION PLANS

- There is no disadvantage to the employees whereas this plan is disadvantageous to the employee because they have to ensure that the funds contributed for the pension are invested in such a way that they generate adequate returns to cover future pension of the employee.
- If the returns are not enough to pay the pension, the employer has to provide the deficiency either from other sources or contributions of serving employees. (e.g., Government)

16.7 Defined Contribution Pension Plan

The amount of contribution towards pension is fixed but the benefit amount is undetermined. This type of plan is called defined contribution pension scheme or plan. Here pension depends on the returns made on the investments. There are multiple options of investments such as equity (high risk and high returns), debt (low risk and moderate returns) or govt. securities (no risk and low returns). The Fund would grow into a large amount at the time of retirement through the investment (of both contribution and returns) over the years. Investors are permitted to withdraw only a part of pension fund as lump-sum. Remaining portion of fund would be invested in annuity and that would provide fixed amount every month.

16.8 Advantages of Defined Contribution Pension Plans

- ✓ The main advantage to the employees is that the pension fund investment is market-linked. They can make excellent returns on the investments through proper selection of portfolio of investments.
- ✓ The advantage for the employer is that it doesn't have to worry about the management of the pension funds and the returns generated by them.

16.9 Disadvantages of Defined Contribution Pension Plans

- ✓ The disadvantage to the employees is that there is a chance of getting lower amount of pension due to improper selection of investment.

✓ Continuous monitoring is a burden to the employees.

16.10 NEW PENSION SYSTEM (NPS) FOR NON-GOVERNMENT EMPLOYEES

The Structure of the scheme and entities involved are as follows:

a. The New Pension System is administered by the Pension Fund Regulatory Development Authority (PFRDA).

b. A Central Recordkeeping Agency (CRA) maintains all the records (like account balances) related to the NPS. National Security Depository Limited (NSDL) has been selected as the nationwide CRA for the New Pension System.

c. There are six Pension Fund Managers (PFMs). The PFM are responsible for investing funds and generating returns from them.

d. There are also entities called Points of Presence (PoPs). The PoPs are responsible for the sales and marketing of the NPS. (These are similar to the distributors of mutual funds).

16.11 List of Pension Fund Managers (PFMs)

1. ICICI Prudential Life Insurance Company Limited
2. IDFC Asset Management Asset Management Company Limited
3. Kotak Mahindra Asset Management Company Limited
4. Reliance Capital Asset Management Company Limited
5. SBI Pension Funds Limited
6. UTI Retirement Solutions Limited

16.12 Features and Options of the Scheme

I. Permanent Retirement Account Number (PRAN)

Each investor in the New Pension Scheme (NPS) would be allotted a Permanent Retirement Account Number (PRAN). This would be a unique identification number that would be used to identify an investor irrespective of his PFM.

II. Investment Options Available to an Investor

Investors would get multiple options for investing their funds in the NPS. These options span the entire risk spectrum from risky to risk-free. There are three investment options

1. **Growth option:**A growth option would be an equity based option, wherein the investments would be primarily done in equities. This option has the potential to give the highest returns but it carries a higher risk. The investment would be passive. There wouldn't be any active buying and selling of stocks based on the fund manager's analysis. Instead, funds would be invested only in the 50 stocks comprising the NSE's NIFTY stock index. This option is most suitable for young people who are just starting their careers. This would also be suitable for middle-aged people who do not have many dependents.

1. **Moderate option**: The funds would be invested in corporate debt and other fixed income instruments. This option has the potential to give moderate returns but it carries a moderate risk. This option is most suitable for risk-averse young people and for mid-career people. This would also be suitable for some of the more adventurous (risk taking) people nearing retirement.
2. **Cautious option:** The most cautious option would be government security based. Here, investors' money would be invested in government securities. These securities are risk free and hence this option would give risk free returns. The returns are expected to be the lowest among all three options. This option is most suitable for employees approaching their retirement and risk-averse mid-career employees.

Investors would get an option to allocate their funds between these three options in any proportion they prefer. Thus, they can create a balance between the risky and risk-free options based on their own risk profile. If they do not want to allocate their funds, there is an auto choice feature. Here, investments would be allocated among the three options depending on their age. Thus, when they are young, more investment would be made in the equity based fund, and when they are old, more and more funds would be invested in the low risk government securities based fund.

Switching Options: Investors could periodically reallocate their funds among the three options once in a year. Also, they could switch the fund managers (PFMs)

periodically. That is, they would be able to move the management of their funds from one PFM to another. This process is expected to be simple, as all the records are centrally kept by the CRA and the Permanent Retirement Account Number (PRAN) would be investors' identification number across all Pension Fund Managers (PFM).

Costs and Fees involved in the scheme.

The management fee for NPS is less than 0.01% per annum.

The annual record keeping fee for NPS would be just ` 280.

Transaction fee is 6 for each transaction.

Defined Contribution system: The periodical payment is fixed, but the pension amount is not fixed. It totally depends on the returns on investment. This scheme is a defined contribution scheme, without the benefit not being defined.

➢ **Maturity withdrawals:** Investor can get money only at the age of 60 years. Early withdrawals are not allowed except for marriage of sons/daughters and purchase of house. Investor can get only 60% of the corpus as lump sum and remaining 40% should be invested in an annuity (accumulated corpus), which is used to provide a fixed monthly amount.

➢ **Coexist with other schemes (EPF / EPS):** New Pension System (NPS) would not replace any existing scheme like the Employee Provident Fund scheme or the Employee Pension Scheme.

➢**Income tax exemption:**The amount of contribution to NPS is exempted from income tax under section 80C and also the interest or profit earned on the investment in NPS would not be taxed in the year in which it is earned; but, the amount would be taxed at the time of withdrawal.

16.13Conclusion

They say life begins at retirement. No deadlines, no routines, no pressures – just a long, long vacation. It's when you have all the time in the world to pursue

a new hobby, travel, or just laze around at your beach house. However, enjoying this post-retirement lifestyle would mean having sufficient funds in your bank account even after your regular income stops.

This is where our unique Life Insurance Retirement/Pension Plans can help you secure your retirement dreams by ensuring that you have enough funds when you finally decide to call it a day. So start planning for your retirement today by systematically investing in our Retirement Plans.

Questions

1. Define pension plan?
2. What are the types of retirement plan?
3. State the pros and cons of pension plan.
4. What are the contributions of pension plan? State the advantages and disadvantages the same?
5. What is new pension system for non – government employee?
6. List the pension fund managers? Explain the features and option of the scheme.