

Course title: International financial regulation

Lesson 10. The role of financial intermediaries

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Financial Intermediation:

A significant constituent of the organization of the financial system is an array of financial intermediaries which collect savings from others and issue in return claims against themselves and use the fund thus raised to purchase ownership or debt claim. The key intermediation businesses are:

1. Commercial Banking
2. Lease Financing
3. Hire Purchase
4. Venture Capital
5. Securitization

COMMERCIAL BANKING

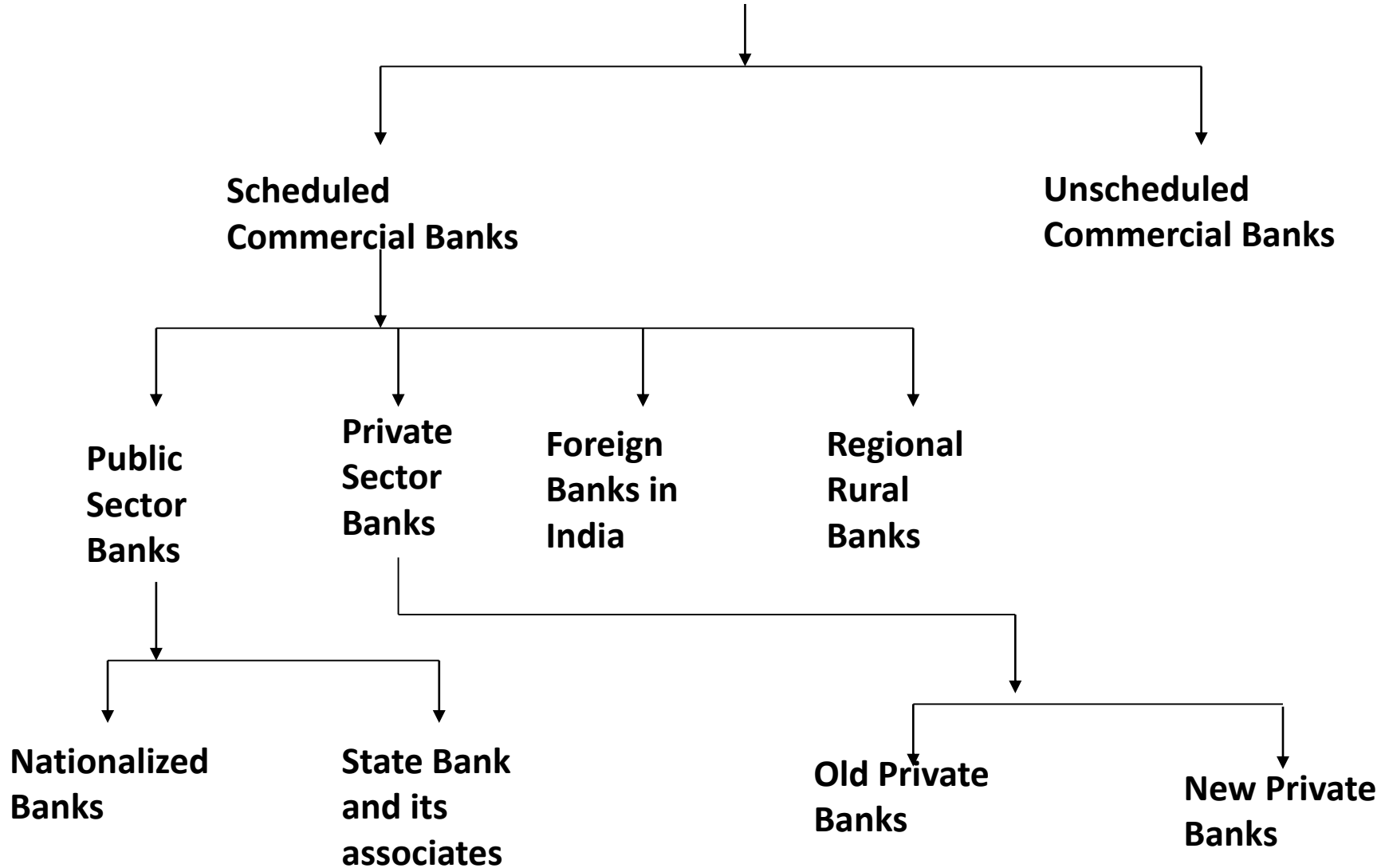
Commercial banks are the oldest, biggest and fastest growing financial intermediaries in India.

TYPES OF BANKS

- A. *Scheduled Banks*** : Scheduled Banks in India constitute those banks which have been included in the Second Schedule of Reserve Bank of India (RBI) Act, 1934. RBI in turn includes only those banks in this schedule which satisfy the criteria laid down vide Section 42 (6) (a) of the Act.
- B. *Non Scheduled Bank*** : “Non-scheduled bank in India” means a banking company as defined in clause (c) of Section 5 of the Banking Regulation Act, 1949 (10 of 1949), which is not a scheduled bank.”

CLASSIFICATION

Commercial Banks



ROLE OF COMMERCIAL BANKS

- The most common services offered by commercial banks in India are as follows :
- **i) Bank accounts** : It is the most common service of the banking sector. An individual can open a bank account which can be either savings, current or term deposits.
- **ii) Loans** : You can approach all banks for different kinds of loans. It can be a home loan, car loan, and personal loan, loan against shares and educational loans.

- **iii) Money Transfer** : Banks can transfer money from one corner of the globe to the other by issuing demand drafts, money orders or cheques.
- **iv) Credit and debit cards** : Most banks offer credit cards to their customers which can be used to purchase products and services, or borrow money.
- **v) Lockers** : Most banks have safe deposit lockers which can be used by the customers for storing valuables, like important documents or jewellery.

Banking Services for NRIs in India

- Almost all the Indian Banks provide services to the NRIs. There are different types of accounts for them. They are :
- Non-Resident (Ordinary) Account – NRO A/c
- Non-Resident (External) Rupee Account – NRE A/c
- Non-Resident (Foreign Currency) Account – FCNR A/c

MAJOR REFORM INITIATIVES

1. Interest rate deregulation. Interest rates on deposits and lending have been deregulated with banks enjoying greater freedom to determine their rates.
2. Adoption of prudential norms in terms of capital adequacy, asset classification, income recognition, provisioning, exposures limits, investment fluctuation reserve, etc.
3. Reduction in pre-emptions-lowering of reserve requirements (SLR and CRR), thus releasing more lendable resources which banks can deploy profitably.
4. Government equity in banks has been reduced and strong banks have been allowed to access the capital market for raising additional capital.
5. Banks now enjoy greater operational freedom in terms of opening and swapping of branches, and banks with a good track record of profitability have greater-flexibility.

6. New private sector banks have been set up and foreign banks permitted to expand their operations in India including through subsidiaries. Banks have also been allowed to set up Offshore Banking Units in Special Economic Zones.
7. New areas have been opened up for bank financing : insurance, credit cards, infrastructure financing, leasing, gold banking, besides of course investment banking asset management, factoring etc.
8. New instruments have been introduced for greater flexibility and better risk management : e.g. interest rate swaps, forward rate agreements, cross currency forward contracts, forward cover to hedge inflows under foreign direct investment, liquidity adjustment facility for meeting day-to-day liquidity mismatch.
9. Several new institutions have been set up including the National Securities Depositories Ltd., Central Depositories Services Ltd., Clearing Corporation of India Ltd., Credit Information Bureau India Ltd.

10. Universal Banking has been introduced. With banks permitted to diversify into long-term finance and DFIs into working capital, guidelines have been put in place for the evolution of universal banks in an orderly fashion.
11. Technology infrastructure for the payments and settlement system in the country has been strengthened with electronic funds transfer, Centralized Funds Management System, Structured Financial Messaging Solution, Negotiated Dealing System and move towards Real Time Gross Settlement.
12. Adoption of global standards. Prudential norms for capital adequacy, asset classification, income recognition and provisioning are now close to global standards. RBI has introduced Risk Based Supervision of banks (against the traditional transaction based approach). Best international practices in accounting systems, corporate governance, payment and settlement systems, etc. are being adopted.
13. RBI guidelines have been issued for putting in place risk management systems in banks. Risk Management Committees in banks address credit risk, market risk and operational risk. Banks have specialized committees to measure and monitor various risks and have been upgrading their risk management skills and systems.

ASSET LIABILITY MANAGEMENT IN BANKS (ALM)

The ALM process rests on three pillars :

- 1. ALM Information Systems :** The ALM Information System consists of the following
 - i. Management information systems
 - ii. Information availability, accuracy, adequacy and expediency
- 2. ALM organization :** It includes the following :
 - i. Structure and responsibilities
 - ii. Level of top management involvement
- 3. ALM process :** The ALM process consists of the following steps
 - i. Risk parameters
 - ii. Risk identification
 - iii. Risk measurement
 - iv. Risk management
 - v. Risk policies and tolerance levels.

RBI Guidelines

As per RBI guidelines, commercial banks are to distribute the outflows/inflows in different residual maturity period known as time buckets. The Assets and Liabilities were earlier divided into 8 maturity buckets (1-14 days; 15-28 days; 29-90 days; 91-180 days; 181-365 days, 1-3 years and 3-5 years and above 5 years), based on the remaining period to their maturity (also called residual maturity). All the liability figures are outflows while the asset figures are inflows. In September, 2007, having regard to the international practices, the level of sophistication of banks in India, the need for a sharper assessment of the efficacy of liquidity management and with a view to providing a stimulus for development of the term-money market, RBI revised these guidelines and it was provided that

a. The banks may adopt a more granular approach to measurement of liquidity risk by splitting the first time bucket (1-14 days at present) in the Statement of Structural Liquidity into three time buckets viz., next day, 2-7 days and 8-14 days. Thus, now we have 10 time buckets. After such an exercise, each bucket of assets is matched with the corresponding bucket of the liability. When in a particular maturity bucket, the amount of maturing liabilities or assets does not match, such position is called a mismatch position, which creates liquidity surplus or liquidity crunch position and depending upon the interest rate movement, such situation may turnout to be risky for the bank. Banks are required to monitor such mismatches and take appropriate steps so that bank is not exposed to risks due to the interest rate movements during that period.

b. The net cumulative negative mismatches during the Next day, 2-7 days, 8-14 days and 15-28 days buckets should not exceed 5%, 10%, 15% and 20% of the cumulative cash outflows in the respective time buckets in order to recognize the cumulative impact on liquidity.

LEASE FINANCING

Lease Financing

Conceptually, a lease is a contractual arrangement/transaction:

- In which the owner of an asset/ equipment (lessor) provides the asset for use to another/transfers the right to use the asset to the user (lessee) for an agreed period of time in return for periodic payment (rental)
- At the end of the lease period the asset reverts back to the owner. Leasing essentially involves the divorce of ownership from the economic use of an equipment/asset

Classification:

- (i) Finance and operating lease
- (ii) Direct lease and sale and lease back lease
- (iii) Single investor and leveraged lease and
- (iv) Domestic lease and international lease which can be further sub-classified as cross-border and import lease

Finance & Operating Lease:

the classification of lease into finance and operating is of fundamental importance. The distinction between the two types of leases is based on the extent to which the risks and rewards of ownership are transferred from the lessor to the lessee

- Risk means the possibility of loss arising out of under-utilization or technological obsolescence of the leased asset
- Reward refers to the incremental net cash flows generated by the usage of the equipment over its economic life and the realization of the anticipated residual value on the expiry of the economic life

If a lease transfers a substantial part of the risks and rewards, it is called finance lease; otherwise it is operating lease

Major Players:

The major players in leasing in India are:

- Independent leasing companies
- Other finance and investment companies
- Manufacturer-lessors
- Development finance institutions
- In-house lessors and banks

Product Profile:

As far as the product profile of leasing in India is concerned, by and large leases are of finance type and operating leases are not very popular:-

- The lease rentals are payable generally in equated monthly installments at the beginning of every month
- The rental structures are related to the requirements of the lessee and projected cash flow pattern. They are structured so as to recover the entire investment during the primary period
- Most of the transactions are direct lease; sale and lease back type are rare. Equipment leasing covers a wide range of assets and equipment but project leasing and cross-border leasing are not popular

Advantages:

The significance of lease financing is based on several advantages both to the lessors and the lessees such as:

- Flexibility
- User-orientation
- Tax-based benefits
- Convenience
- Expeditious disbursements of funds
- Hundred per cent financing and better utilization of own funds and so on.

However, the advantages of off-balance sheet financing in the sense that it does not affect the debt capacity of the firm is not real

Law/ Legislation:

- There is no law/legislation/act/direction which exclusively applies to equipment leasing. Such transactions are governed by the relevant provisions of number of acts/laws/directions and so on. Some of these are quite intricate involving fine points of law.
- Since the features of an equipment lease transaction closely resemble the features of bailment

The provision of Contract Act in general and those relating to contracts of bailment in particular apply to equipment lease transactions. The implied obligations of the bailor (lessor) and bailee (lessee) are defined by this enactment. However, one implied obligation of lessor, namely, fitness of the bailed goods is inapplicable. As in a typical equipment lease transaction, the lessor plays the role of a financier, the implied obligation of the lessor (bailor) relating to fitness of the goods/assets is expressly negative by the lease agreement.

- Some provisions of Motor Vehicle Act and Stamp Act also apply to equipment leasing

Regulatory Authority:

With a view to coordinate, regulate and control the functioning of all the NBFCs, RBI has issued directions under the RBI Act. These also apply to leasing companies

Documentation:

- The lease documentation process is fairly simple. It starts with the submission of a proposal by the lessee. On approval, the lessor issues a letter of offer detailing the terms and conditions of the lease. The letter of offer is accepted by the lessee by passing a Board resolution. This is followed by the lessor and lessee entering into a formal lease agreement.

- The lease agreements provide for a number of obligations on the part of the lessee which do not form part of his implied obligations under the Contract Act. While the exact contents of the lease contract differ from case to case, a typical lease contract provides:
 - I. Nature of lease
 - II. Description of the equipment
 - III. Delivery and re-delivery
 - IV. Period, lease rentals
 - V. Repairs and maintenance
 - VI. Alteration, peaceful possession
 - VII. Charges
 - VIII. Indemnity clause
 - IX. Inspection prohibition of sub-leasing
 - X. Defaults and remedies and so on

Tax Aspects:

The tax aspects of leasing pertain to both income tax and sales tax

The income tax considerations for the lessees are claims for lease rentals and the operating costs of the leased assets being treated as deductible expenses from taxable income. The lease rentals and the incidental expenses such as repairs and maintenance, insurance and finance charge are treated as normal business expenditure

- A lease transaction attracts sales tax at three stages:
 - I. Purchase of equipment by the lessor
 - II. Transfer of the right to a lessee to use the equipment for a lease rental
 - III. Sale of asset by the lessor at the end of the lease period

HIRE PURCHASE

Hire Purchase:

Hire-purchase is a mode of financing the price of goods to be sold on a future date. It is an agreement relating to a transaction in which:

- Goods are let on hire
- The purchase price is to be paid in installments
- Hirer is allowed the option to purchase the goods paying all the installments

Though the option to purchase the goods/assets is allowed in the very beginning, it can be exercised only at the end of the agreement

Essence of the Agreement

The essence of the agreement is that:

- The property in the goods does not pass at the time of the agreement but remains in the intending seller (hire-vendor) and only passes when the option is exercised by the hirer (intending hire-purchaser). In contrast, in installment sale the ownership in the goods passes onto the purchaser simultaneously with the payment of the initial/first installment
- The hire-purchase also differs from the installment sale in terms of the call option and right of termination in the former but not in the latter
- Similarly, hire-purchase and leasing as modes of financing are also differentiated in several respects such as ownership of the asset/equipment, its capitalization, depreciation charge, extent of financing and accounting and reporting

Down payment and Interest:

Under the down payment plan of hire-purchase, the hirer has to make a down payment of 20-25 per cent of the cost and pay the balance in equated monthly installments (EMIs). As an alternative, under a deposit-linked plan the hirer has to invest a specified amount in the fixed deposit of the finance company which is returned together with interest after the payment of the last EMI by the hirer.

The hire-purchase installment has two components: (i) interest/finance charge and (ii) recovery of principal. The interest component is based on a flat rate of interest while effective rate is applied to the declining balance of the original amount to determine the interest component of each installment

During the hire-period, the hirer can opt for early repayment/purchase of the equipment/asset by paying the remaining installments minus an interest rebate. The hirer has the right to terminate the contract after giving due notice

Legislation/ Law:

There is no exclusive legislation dealing with hire purchase transactions in India. The Hire-Purchase Act was passed in 1972. A bill was introduced in 1989 to amend some of the provisions of the Act. However, the Act has not been enforced so far.

- In the absence of any specific law, the hire-purchase transactions are governed by the general laws. The hire-purchase transaction has two aspects:
 - (i) An aspect of bailment of goods which is covered by the Indian Contract Act
 - (ii) An element of sale when the option to purchase is exercised by the hirer which is covered by the Indian Sales of Goods Act. The hire-purchase agreements also contain provisions for the regulation of hire-purchase deals

Taxation:

There are three aspects of taxation of hire-purchase deals:

- (i) Income-tax
 - (ii) Sales tax
 - (iii) Interest tax
- Though the hirer is not the owner of the asset, he is entitled to claim depreciation as a deduction on the entire purchase price.
 - He can also claim deduction on account of consideration for hire, that is, finance charge. The amount of finance charge to be deducted each year is to be spread evenly over the term of the agreement on the basis of a method chosen from amongst the alternatives: SOYD, ERI, SLM. The consideration is viewed as a rental charge rather than interest and no deduction of tax at source is made.

- The hire-purchase transaction can be used as a tax planning device in two ways: (i) by inflating the net income (finance income - interest on borrowings by the finance company) at the rear-end of the deal and (ii) by using hire-purchase as a bridge between the lessor and the lessee, that is, introduction of an intermediate financier instead of a direct lease
- Hire-purchase transaction, as deemed sales, are liable to sales tax. However, hire-purchase transaction structured by finance companies (which are not hire-vendors), being essentially a financing arrangement, do not attract sales tax.
- An interest tax has to be paid on the interest earned less bad debts. The tax is treated as a tax-deductible expense for the purpose of computing the taxable income under the Income-Tax Act.

Evaluation:

The decision-criterion for evaluation of a hire-purchase deal from the point of view of a hirer is the cost of hire-purchase vis-a-vis the cost of leasing. If the discounted cost of hire-purchase is less than the discounted cost of leasing, the hire-purchase alternative should be preferred and vice versa. The preference for the alternative implies that the equipment should be acquired under that alternative. The decision-criteria from the viewpoint of the financial intermediary is based on a comparison of the NPVs of the hire-purchase and the leasing alternatives. The finance company would choose the financing plan with higher NPV

Hire Purchase/ Consumer Credit:

Consumer credit includes all asset-based financing plans offered to primarily individuals to acquire durable consumer goods. In a typical consumer credit deal, the customer pays a fraction of the cash purchase price on delivery of the goods and the balance is paid together with interest over a specified period of time. The consumer credit plans/schemes can be down payment type or deposit-linked type. Such credit usually carries a flat rate of interest. The loan is secured by a first charge on the concerned equipment

VENTURE CAPITAL

Venture capital, as a fund-based financial service, has emerged the world over:

- To fill gaps in the conventional financial mechanism, focusing on new entrepreneurs
- Commercialization of new technologies
- Support to small/medium enterprises in the manufacturing and the service sectors.

Over the years, the concept of venture capital has undergone significant changes. The nascent venture capital industry in India can profitably draw upon the experiences of the developed countries

Features:

The characteristics features of venture capital differentiate it from other capital investments:

- It is basically equity finance in relation to new listed companies and debt financing is only supplementary to ensure running yield on the portfolio of the venture capitalists/capital institution (VCIs)
- It is long-term investment in growth-oriented small/medium firms. There is a substantial degree of active involvement of VCIs with the promoters of venture capital undertakings (VCUs) to provide, through a hands-on approach, managerial skills without interfering in the management
- The venture capital financing involves high risk-return spectrum. It is not technology finance, though technology finance may form a sub-set of such financing. Its scope is much wider

Steps Involved:

The venture investments are generally idea-based and growth-based.

The first step in venture capital financing is the selection of the investment. It includes:

- Stages of financing
- Methods to evaluate deals and the financial instruments to structure a deal

The stages of financing as differentiated in venture capital industry are early stage and later stage.

- ❖ In early stage are seed capital/pre-start-up, start-up and second-round financing.
- ❖ The later stage of venture capital financing covers
 - i. Mezzanine/development capital
 - ii. Bridge/expansion
 - iii. Buyouts
 - iv. Turnarounds

Structuring of Venture Capital:

The structuring of venture capital deals is a mix of the available financial instruments: equity and debt. The equity instruments include ordinary, non-voting, deferred ordinary, preference, warrants, cumulative convertible preference, participating preference and so on. The main types of debt instruments are conventional loan, conditional loan, income notes, NCDs, PCDs, zero interest bonds, secured premium notes and deep discount bonds

After Care Stage:

The after-care stage of Venture capital financing relates to different styles of nurturing, its objectives and techniques. The style of nurturing which refers to the extent of participation by VCs in affairs of the venture falls into three broad categories:

- i. Hands on
- ii. Hands off
- iii. Hands holding

Some of the important techniques to achieve the objectives are personal discussion; plant visit nominee directors, periodic reports and commissioned studies

Valuation:

The valuation of the venture capital portfolio to monitor and evaluate the performance of the equity investment is done by using:

- Cost method
- Market value-based methods consisting of quoted market value method and fair market value method.

The methods of valuing debt instruments vary with the nature of such instruments

Exit:

The last stage in venture capital financing is the exit to realize the investment so as to maximize profit/minimize loss. The alternative routes for disinvestments of equity/quasi-equity instruments are market flotation, earn-out, trade sales, takeout and liquidation.

An Overview:

The venture capital industry in India is of relatively recent origin.

Before its emergence, DFIs had partially been playing the role of venture capitalists by providing assistance for direct equity participation to ventures in the pre-public stage and by selectively supporting new technologies.

The concept of venture capital was institutionalized/operationalized in November 1988 when the CCI issued guidelines for setting up of VCFs for investing in unlisted companies and to a concessional facility of capital gains tax. These guidelines, however, construed venture capital rather narrowly as a vehicle for equity-oriented finance for technological up gradation and commercialization of technology promoted by relatively new entrepreneurs. These were repealed on July 25, 1995.

Recognizing the growing importance of venture capital, the Government announced a policy for governing the establishment of domestic VCFs. They were exempted from tax on income by way of dividends and long-term capital gains from equity investment in the specified manner and in conformity with stipulations in unlisted companies in the manufacturing sector, including software units, but excluding other service industries. To augment the availability of venture capital, guidelines were issued in September, 1995 for overseas venture capital investments in the country. After empowerment to register and regulate VCFs, SEBI issued VCF Regulations, 1996

The VCFs in the country have been sponsored by five groups of financial institutions, namely, central and state-level DFIs, banks, private sector and overseas financial institutions

Lack of Development:

One of the main reasons for the lack of development of venture capital industry in India is the restrictive legal and financial framework. The SEBI (Chandrasekhar) Committee had, in this context, made comprehensive recommendations to promote the growth of the venture capital industry in the country. These related to (1) harmonization of multiplicity of regulations, (2) VCF structure, (3) resource raising, (4) investment-related issues, (5) exit-related issues, (6) SEBI regulations, (7) company law-related issues and others. They have been accepted by Government/ SEBI. Some of these recommendations have been implemented. The SEBI is following up with the Government/RBI for implementation of other recommendations

SECURITIZATION

- Securitization is the process of pooling and repackaging of homogenous illiquid financial assets into marketable securities that can be sold to investors. The process leads to:
 - i. Creation of financial instruments that represent ownership interest in
 - ii. Or are secured by a segregated income producing assets or pool of assets, the pool of assets collateralises securities.

Investors:

- Investors in securitized instruments take a direct exposure on the performance of the underlying collateral and have limited or no recourse to the originator. Hence, they seek additional comfort in the form of credit enhancement in terms of the various means that attempt to buffer investors against losses on the asset collateralising their investment. They are either external (third party) or internal (structural cashflow-driven). The external credit enhancements include insurance, guarantee and letter of credit. The internal credit enhancement comprises of credit tranching, over collateralisation, cash collateral, spread account and triggered amortization.

Parties:

The parties to a securitization transaction are:

- i. Originator
- ii. SPV
- iii. Investors
- iv. Obligors
- v. Rating agency
- vi. Servicer
- vii. Trustee
- viii. Structure.

Instruments & Securities:

The instruments of securitization are pass through certificates and pass through security. The securities fall into two groups : asset-based and mortgage-based.

THANK YOU

and

All the Best

MUTUAL FUND

A mutual fund pools the savings, particularly of the relatively small investors

- Invests them in a well diversified portfolio of sound investment.
- It issues units (securities) to unit holders (investors) according to the quantum of money invested by them.
- The profits/losses are shared by the unit holders in proportion of their investments.

As an investment intermediary, mutual funds offer a variety of services/benefits to the investors: convenience, low risk through diversification, expert management and lower cost due to economies of scales

Constitution and Setup:

- According to the SEBI, mutual funds are funds established in the form of a Trust to raise money through the sale of units to the public under various schemes for investing in securities including money market instruments or gold/gold related instruments or real estate assets.

- A mutual is set up in the form of a trust which has (i) a sponsor, (ii) trustees, (iii) an asset management company (AMC) and (iv) custodians. The sponsors set up the trust as promoters. The trustees hold the property in trust for the benefit of the unit holders. They are vested with general powers of superintendence and direction over the AMC and they monitor their performance and compliance with the SEBI regulations. The AMC manages the funds. The custodian holds the securities of the fund in its custody.

- To carry on their business, mutual funds must be registered with the SEBI, which registration is granted on the fulfillment of the prescribed eligibility criteria for the sponsors in terms of track record, contribution to the net-worth of the AMC; appointment of trustees, AMC and custodian; and so on

- A mutual fund must be constituted in the form of a trust and the instrument of trust should be in the form of a deed duly registered and executed by the sponsor in favor of the trustees. The contents of the trust deed have been prescribed by the SEBI.

Trustee:

A person can be appointed as a trustee on the fulfillment of the prescribed conditions:

- He should be a person of ability, integrity and standing, who has not been guilty of moral turpitude/convicted of any economic offence/violation of any securities laws and so on.
- Two-thirds of the trustees of a mutual fund must be independent persons and not associated with the sponsors in any manner.
- The trustees should enter into an investment management agreement with the AMC for the purpose of making investments.
- The trustees would have the right to obtain from the AMC, all information concerning the operations of the various schemes of the mutual fund managed by it

Sponsor:

The sponsor of the mutual funds/trustees would appoint the AMC, with the prior approval of the SEBI. Its appointment can be terminated by a majority of trustees or 75 per cent of the unit holders of the scheme. The eligibility criteria for the appointment of an AMC include sound track record, adequate professional experience, not guilty of moral turpitude, non-conviction of any economic offence/violation of any securities laws, inclusion of 50 per cent independent directors and net-worth of at least Rs. 10 crore.

AMC:

AMC cannot act as a trustee of a mutual fund. It can undertake other business activities in the nature of portfolio management services, management and advisory services to offshore funds/pension funds/provident funds / venture capital funds, management of insurance funds, financial consultancy and exchange of research on a commercial basis, if any of these activities do not conflict with the activities of the mutual fund

- It is obligatory for an AMC to take all reasonable steps and exercise due diligence to ensure that the investment of funds conforms to the provisions of the SEBI regulations and the trust deed.
- It can purchase/sell securities up-to a maximum of 5 per cent of the total, through a broker associated with the promoter.
- It should disclose details of all transactions with/through the sponsor/associate companies.
- The AMC has to file details of securities transactions by its key personnel in their own name or on behalf of the AMC, to the trustees/SEBI. Details of transactions with associates should also be filed/reported. The AMC has to file details of its directors and transactions with sponsor/associate companies, with the trustees/SEBI. The AMCs are prohibited from appointing as a key personnel, any person found guilty of any economic offence or involved in a violation of securities laws

An AMC can launch a mutual fund scheme after its approval by the trustees and filing of the offer document with the SEBI. The offer document should contain adequate disclosures to enable the investors to make an informed investment decision. All advertisements pertaining to mutual fund schemes should conform to the advertisement code specified by SEBI. The advertisement should also disclose the investment objective of the scheme. The offer document and advertisement materials should not be misleading or contain incorrect/false information

Custodian:

The mutual fund should appoint a custodian to carry out the custodial services for the scheme. A mutual fund cannot appoint a custodian in which 50 per cent or more of the voting rights/directorships is held by the sponsor/associate companies. The custodian agreement, the service contract and term, of appointment require prior approval of the trustees

Close-Ended Scheme:

A close-ended scheme is one in which the maturity period is specified. Every such scheme must be listed on a recognized stock exchange. A close-ended scheme may be converted into an open-ended scheme. All close-ended schemes should be fully redeemed on maturity, but they can be rolled over

Guaranteed Return:

Guaranteed returns can be provided in a scheme if they are fully guaranteed by the AMC. The name of the guarantor and the manner in which the guarantee is to be met should be disclosed in the offer document

Net Asset Value:

- Every mutual fund should compute the NAV of each scheme by dividing the net assets of the scheme by the number of unit outstanding on the valuation date.
- The sale and repurchase price of units should be made available to the investors. The repurchase price should not be lower than 93 per cent and the sale price should not be higher than 107 per cent of the NAV. The repurchase price cannot be lower than 95 per cent of the NAV in a close-ended scheme. The difference between the repurchase and sale price should not exceed 7 per cent of the sale price.

Investments:

- Mutual funds can invest only in transferable securities in the capital/money market or in privately placed debentures or securitised debts in asset-backed securities (ABS) and mortgage-backed securities (MBSs).
- The restrictions on investments by mutual funds relate to ceilings in rated/unrated debt instruments, equity shares, inter-scheme transfers/investments, short-term deployment of funds, investment in unlisted/listed group companies, thinly traded securities and so on

- The ceiling on investment in a rated debt instrument not below investment grade is 15-20 per cent of the NAV in a single instrument.
- The limit for a single unrated debt instrument is 10 per cent and that for the total is 25 per cent.
- The Investments of a mutual fund in equity capital of a company can be upto 10 per cent.
- Inter-scheme transfer of funds are permitted at the prevailing market price and the securities should fit into the investment objectives of the transferee scheme.

- The aggregate inter-scheme investment should not exceed 5 per cent of the NAV of the mutual fund. Mutual funds should buy/sell securities on the basis of delivery.
- Up-to 25 per cent of the net assets of a mutual fund can be invested in unlisted securities/ securities issued by way of placement of an associate company of the sponsor/listed securities of the sponsor.
- Pending deployment of funds in securities, mutual funds can invest funds in short-term deposits with banks.
- The permitted investment in unlisted equity shares/related instruments in case of open-ended and close-ended schemes is 5 per cent and 10 per cent of the NAV of the mutual fund, respectively

Borrowings:

- Mutual funds can borrow only to meet temporary liquidity needs for repurchase/redemption/payment of dividend and so on, up to a maximum of 20 per cent of their net assets, for up-to 6 months.
- They cannot advance any loans but they can lend securities under the stock lending scheme. They cannot enter into option trading/short selling/carry forward transactions. But they can enter into /derivative trading for hedging and portfolio balancing.
- They can also carry on underwriting business.

Valuation of Investment:

The investment valuation norms for mutual funds relate to traded securities, non-traded securities and rights shares.

- Traded securities should be valued at the last closing price on a stock exchange. When a security is not traded on any stock exchange on a particular valuation day, the closing price on the available earliest previous day (i.e., 30 days in case of shares and 15 days in case of a debt security) may be used.

- A non-traded security/scrip means a security not traded for 30 days prior to the valuation date. Such securities should be valued 'in good faith' on the basis of the appropriate valuation models based on the valuation principle approved by the AMC. The selected method should be fair and reasonable. Included in this category are equity instruments, debt instruments, call money/bills/deposits, convertible bonds, warrants and repos.

General Obligations:

The general obligation relate to:

- Maintenance of proper books of accounts/ records
- Fees and expenses on issue of schemes
- Dispatch of warrants and proceeds
- Annual report

- The dividend warrants should be dispatched by the AMC, within 42 days of the declaration of J dividend and the redemption/repurchase proceeds, within 10 days, failing which it would have to pay interest for the period of delay and would also be liable for penalty for such failure.
- The books of accounts/records/documents and infrastructure, systems and procedures of a mutual fund/trustees/AMC can be inspected or their affairs investigated by an inspecting official/auditor appointed by SEBI. In case of default, the SEBI can suspend/cancel the registration of a mutual fund.

Mutual Fund Schemes:

- Mutual fund schemes/relate to (1) product variety and (2) options/plans.
- The funds/schemes, from the point of view of product variety, are categorized into (i) equity, (ii) bonds/debts, (iii) hybrid and (iv) money market.
- Based on the objectives, equity funds are grouped into growth, mid-cap, value, equity-income, index, ETFs, sector and ELSS.
- Bonds/debt/income funds are categorized into: corporate funds, gilt, floating rates and bond index.
- Hybrid funds consist of (1) balanced funds and (2) asset allocation fund.
- The options associated with the various funds are: growth/dividend/reinvestment; SIPs in terms of (i) dollar cost of averaging and (ii) value averaging; SWPs; switch facility; and gift facility.

Merchant Bankers

The framework of operation of the primary market is prescribed by the SEBI. The SEBI's guidelines relate to: merchant bankers/lead managers; underwriters; bankers to an issue; brokers to an issue; registrar to an issue and share transfer agents; debenture trustees; portfolio managers; prohibition fraudulent and unfair trade practices; and insider trading.

The main elements of the SEBI's framework as applicable to merchant bankers are:

- Registration
- Obligation and responsibilities
- Inspection/action in case of default
- Pre-issue and post-issue obligations

Activities:

Merchant banking activities include

- Managing of public issues of capital
- Including international offers of debt and equity (i.e. GDRs/ADRs/FCCBs and so on)
- Private placement of securities
- Corporate advisory services such as takeovers/mergers, project advisory services, loan syndication; portfolio advisory/management services and so on

Registration:

Merchant bankers require compulsory registration with the SEBI. While granting registration, the relevant matters considered by SEBI are:

- Applicant is a body corporate
- It has the necessary infrastructure
- It has at least two experienced persons
- It is not involved in any litigation
- It is a fit and a proper person in terms of SEBI's fit and proper person regulations

The criteria for fit and proper person include financial integrity, absence of conviction/civil liability, competence, good reputation and character, efficiency and honesty, and absence of any disqualification to act as an intermediary by SEBI/other regulatory authorities such as conviction for offence involving moral turpitude, economic offence, securities laws or fraud, order for winding up, insolvency, debarred from dealings, cancellation of registration, financial unsoundness and so on

Obligations and Responsibilities:

The obligations and responsibilities of merchant bankers include:

- Adherence to the requirements under the prescribed code of conduct
- Restriction on asset-based activities
- Maximum number of lead managers
- Responsibilities of lead managers
- Due diligence certificate
- Submission of documents
- Appointment of compliance officer and disclosures to the SEBI

The SEBI can undertake an inspection of the books of accounts, records, and documents of a merchant banker to ensure compliance with the provisions of the SEBI Act/rules/regulations and to investigate complaints into his affairs. Action in case of a default would be in a manner provided under the SEBI Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty Regulation

Pre-issue Obligations:

- The obligations of merchant bankers pertain to pre-issue, post-issue and other requirements.
- The major pre-issue obligations of merchant bankers are due diligence; submission of the following documents:
 1. MOU, inter so allocation of responsibilities,
 2. Due diligence certificate
 3. Certificate in case of further issues
 4. Undertaking and list of promoters' group
 5. Appointment of intermediaries (i.e., merchant banker, and others); underwriting

6. Giving out pre-issue advertisement
7. Making the offer document public
8. Dispatch of issue material
9. No complaints certificate
10. Appointment of mandatory collection centers
11. Appointment of authorized collection agent
12. Releasing advertisement for rights post- issues; appointment of compliance officer
13. Ensuring the agreement with depositories
14. Ensuring that every application form is accompanied by a copy of the abridged prospectus; and branding of securities

Post-issue Obligations:

The major post-issue obligations/requirements of the lead managers/merchant bankers are:

- Ensuring the submission of post-issue monitoring report
- Redress of investors grievances
- Coordination with intermediaries (i.e., underwriters and bankers to an issue)
- Post-issue advertisements
- Ensuring that the basis of allotments is according to the prescribed guidelines, and others

Compliance requirement:

The compliance requirements of merchant banker(s) in relation to operational guidelines cover submission of the draft and final offer document, instruction(s) on post-issue obligations, issue of penalty points and so on

BROKER

- Stockbroker is a member of a recognized stock exchange, who buys/sells/deals in securities.
- He must be registered with the SEBI to carry on his activities.
- He should abide by the code of conduct in terms of the general requirements, duty to investors and relationship with other stockbrokers.
- The SEBI can conduct an inspection/ investigation into the records of the brokers.

- Any broker who contravenes any of the provisions of the SEBI Act/rules/regulations would be liable to any or more of the following actions:

1. Monetary penalty
2. Liability for action under the enquiry proceedings regulation
3. Including suspension/cancellation of registration and prosecution.

The capital adequacy requirements for brokers consist of a base minimum capital and an additional capital related to the volume of business

Sub-broker:

- A sub-broker acts on behalf of a stockbroker, as an agent or otherwise, for assisting investors in buying / selling /dealing in securities through such brokers, but he is not a member of a stock exchange.
- He must be registered with the SEBI.
- The code of conduct applicable to him covers his duty to investors
- His relationship with stock brokers and regulatory authorities.
- The general obligations and responsibilities and inspection and activities in default applicable to brokers are also applicable to sub-brokers

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Thank You