CHAPTER

14

SECURITY MARKET IN INDIA

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*Had there been no security market– undoubtedly, the most facinating segment of the financial market– there won't have been the big MNCs and TNCs in the world. Once the world moves towards the process of globalisation, the potential of this market has increased exponentially–its capacity of resource mobilization is just anybody's guess!**

* As many documents of the WTO, World Bank and OECD have accepted many times.

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DEFINITION

The segment of a financial market of an economy from long-term capital is raised via instruments such as shares, securities, bonds, debentures, mutual funds, and is known as the security market of that economy.

A security market has components such as a security regulator (SEBI in India), stock exchanges, different share indices, brokers, FIIs, jobbers, etc. There are different kinds of transactions which take place in a security market such as badla, reverse badla, future trading, insider trading (not allowed), private placement, etc.

PRIMARY AND SECONDARY MARKETS

Every security market has two complementary markets—primary and the secondary. The market in which the instruments of security market are traded (procured) directly between the capital-raiser and the instrument purchaser is known as the primary market. As for example, a share being directly purchased by anybody from the issuer which may be the company itself. The person is known as the primary shareholder. The market where the instruments of security market are traded among the primary instrument holders is known as the *secondary market.* Such transactions need an institutionalised floor for their trading which is made available by the stock exchanges.

STOCK EXCHANGE

A physically existing institutionalised set-up where instruments of security stock market (shares, bonds, debentures, securities, etc.) are traded. It serves the following major functions:

(i) Makes a floor available to the buyers and sellers of stocks and liquidity comes to the stocks. It is the single most important institution in the secondary market for securities.

(ii) Makes available the prices of trading as an important piece of information to the investors.

(iii) By following institutionalised rules and procedures, it ensures that the participants in the stock market live up to their commitments.

(iv) Passes updated informations to the enlisted companies about their present stockholders (so that they can pass on dividends etc., to them).

(v) By publishing its 'Index', it fulfils the purpose of projecting the moods of the stock market.

World's first stock exchange was established in Antwerp, Belgium (then part of the Netherlands) in 1631, the London Stock Exchange opened in 1773 and then Philadelphia Stock Exchange (the first in the New World) opened in 1790.[1] The first stock exchange in India, the Bombay Stock Exchange known as *The Native share and stock Brokers' Association* was set up in 1870 (under a tree!).[2]

Top five largest stock exchanges (on the basis of market capitalisation) of the world in their decreasing order are—the New York Stock Exchange, the NASDAQ, the Tokyo Stock Exchange, the London Stock Exchange and the Bombay Stock Exchange.[3]

Trading in the stock exchanges takes place via the mediators known as the *brokers,* the *jobbers,* the *market-maker* (discussed later in this chapter).

As per the latest information,[4] presently, there are a total number of 26 stock exchanges operating in India—7 at the national level and

1. Marc Levinson, ***Guide to Financial Markets,*** The Economist, London, 2006, p. 152.
2. V. Raghunathan, ***Stock Exchanges and Investments,*** Tata McGraw-Hill, N. Delhi, 1994, p. 4.
3. Marc Levinson, 2006, op. cit., pp. 153–54; Ministry of Finance, ***Economic Survey 2005–06,*** GoI, N. Delhi.
4. MoF, GoI, dated 22 April, 2013.

rest 19 at the regional level (one of it, Coimbatore Stock Exchange recently sought for withdrawal of recognition, the matter is sub-judice under SEBI). A brief account of the 'national level stock exchanges' is given below.

NSE

The National Stock Exchange of India Ltd. (NSE) was set up in 1992 and became operationalised in 1994. The sponsors of the exchange are financial institutions, including IDBI, LIC and GIC with IDBI as its promotor.

It has a 50 share index and a 500 share index known as S&P CNX-50 (Nifty Fifty) and S&P CNX-500, respectively.

OTCEI

Though the Over the Counter Exchange of India Ltd (OTCEI) was set up in 1989, it could commence trading only in 1992. India's first fully computerised stock exchange was promoted by the UTI, ICICI, SBI Cap among others, in order to overcome problems such as lack of transparency and delays in settlements prevalent in the older stock exchanges. Another important goal of the exchange was to allow stock market exposure to comparatively smaller companies (companies with paid-up capital from Rs. 30 lakh to Rs. 25 crore are enlisted here). Trading in this exchange takes place via market-makers and commission is fixed.

ISE

The Interconnected Stock Exchange of India (ISE) is basically a single floor of India's 15 regional stock exchanges (RSEs), set up in 1998. The RSEs were provided increased reach through this. It is a web-based exchange.

BSE

The Bombay Stock Exchange Ltd. (BSE), earlier a regional stock exchange, converted into a national one in 2002. The *biggest* in India, it accounts for almost 75 per cent of total stocks traded in India and is the *fifth* largest in the world (on the basis of market capitalisation).

There are at present four indices connected with the BSE:

(i) *Sensex:* The sensitive index (i.e., Sensex) is a 30 stocks index of the BSE which was enlarged to include 50 stocks in 2000 but soon was cut down to the original level. This index represents the Indian stock market.

(ii) *BSE-200:* This is a 200 stock share index of the BSE (including the 30 stocks of the Sensex) which has its Dollar version too—*the Dollex.*

(iii) *BSE-500:* In mid-1999, the BSE came up with a 500-stock index representing major industries and many sub-sectors of the economy with information technology getting a significant weightage.

(iv) *National Index:* An index of 100 stocks being quoted nationwide (Bombay, Delhi, Kolkata, etc.) was developed to give broader/wider representation of the stock market since the Sensex consists of only 30 stocks. The 30 stocks of the sensex are included in the National Index.

This index is computed by the Statistics Department of the BSE hence it is called the BSE National Index (BSENI).

Indo Next

A new stock exchange to promote liquidity to the stocks of the small enterprises (SMEs) was launched in 2005 jointly and medium the BSE and the FISE (Federation of Indian Stock Exchanges, representing 18 regional stock exchanges).

It is better known as the *BSE Indo Next.* It was also an effort to rejuvenate the RSEs which were facing falling volumes of trading on their floors.

Due to absence of trading at the RSEs, the stocks of the SME, has become illiquid.

The BSE will transfer all its B1 and B2 groups to this exchange. The RSEs also transfer their enlisted companies to the new exchange.

Now the RSEs will be able to use the BSE network online—the 'Webex'.

SME Exchanges: BSESME and Emerge [5]

SME exchange is a stock exchange dedicated for trading the shares of small and medium scale enterprises (SMEs) who, otherwise, find it difficult to get listed in the main exchanges. The concept originated from the difficulties faced by SMEs in gaining visibility or attracting sufficient trading volumes when listed along with other stocks in the main exchanges.

To be listed on the SME exchange, the post-issue paid-up capital of the company should not exceed Rs. 25 crores. This means that the SME exchange is not limited to the small and medium scale enterprises (which are defined under the 'Micro, Small And Medium Enterprises Development Act, 2006' as enterprises where the investment in plant and machinery does not exceed Rs. 10 crores). As of now, to get listed in the main boards like, National Stock Exchange, the minimum paid-up capital required is Rs. 10 cr and that of the BSE is Rs. 3 cr. Hence, those companies with paid-up capital between Rs. 10 cr to Rs. 25 cr have the option of migrating to the Main Board/or to the SME exchange. The companies listed on the SME exchange are allowed to migrate to the Main Board as and when they meet the listing requirements of the Main Board. There shall be compulsory migration of the SMEs from the SME exchange, in case the post-issue paid-up capital is likely to go beyond the Rs 25 crore limit.

World over, trading platforms/exchanges for the shares of SMEs are known by different names such as Alternate Investment Markets or Growth Enterprises Market, SME Board etc. Some of the known markets for SMEs are *AIM* (Alternate Investment Market) in UK, *TSX Ventures* in Canada, *GEM* (Growth Enterprise's Market) in Hong Kong, *MOTHERS* (Market of the High-Growth and Emerging Stocks) in Japan, *Catalist* in Singapore and *Chinext*, the latest initiative in China [see 'World Federation of Exchanges' for latest comparative idea].

Globally, most of these SME exchanges are still at an evolving stage considering the many hurdles they face —

(i) Declining prices of listed stocks and their illiquidity,

(ii) A gradual reduction in new listings and decline in profits of the exchanges etc., (for instance, *AIM* had three predecessors; *CATALIST* succeeded *SESDAQ* with new regulations and listing requirements).

(iii) In most jurisdictions, idea of a separate exchange for SMEs have become unviable and hence tend to be platforms of existing exchanges, perhaps cross-subsidised by the main board/exchange.

In India, similarly, after the two previous attempts—***OTCEI*** (Over the Counter Exchange of India, 1989) and ***Indonext***—the market regulator, SEBI, on May 18, 2010 permitted setting up of a dedicated stock exchange or a trading platform for SMEs. The existing bourses/stock exchanges in India, BSE and NSE went live on March 13, 2012 with a separate trading platform for small and medium enterprises (SMEs). BSE has named

5. This section is based on various sources – the, SEBI, NSE, BSE, 'World Federation of Exchanges', select issues of *The Economist* and news reportings of *The HT Live Mint, The Business Line and The Economic Times.*

its SME platform as **BSESME**, while NSE has named it as **Emerge**.

Unlike in India, many of these SME exchanges in various countries operate at a global level, due to smallness of the market, allowing for listing by both domestic as well as foreign companies. Though the names suggest that they are set up for SMEs, these exchanges hardly follow the definition of SMEs in their respective jurisdictions. Also, many of them follow a 'Sponsor-supervised' market model, where sponsors or nominated advisors decide if the listing applicant is suitable to be listed or not, i.e., generally no quantitative entry criteria like track record on profitability or minimum paid-up capital or net worth, etc., are specified to be listed in these exchanges. Instead, they are designed as 'buyers beware' markets for informed investors. SEBI has also designed the SME exchanges in a similar format with provisions for ***'market making'*** for the specified securities listed on the SME exchange.

As is the case globally, certain relaxations are also provided to the issuers whose securities are listed on the SME exchange in comparison to the listing requirements in the Main Board (such as in BSE and NSE, in the case of India), which include:

(i) Publication of financial results on 'half yearly basis', instead of 'quarterly basis', making it available on their websites rather than publishing it.

(ii) Option of sending a statement containing the salient features of all the documents instead of sending a full Annual Report.

(iii) No continuous requirement of minimum number of shareholders, though at the time of IPO there needs to be a minimum of 50 investors, etc.

(iv) The existing eligibility norms like track record on profits, net worth/net tangible assets conditions, etc., have been fully relaxed for SMEs as is the case globally.

(v) However, no compromise has been made to corporate governance norms.

Common Facts about the National Stock Exchanges

Before the arrival of national level stock exchanges, India was not having any exchange of national status—better say there was no Indian stock market, but stock markets showing only regional pictures. Besides, the national stock exchanges did solve some major problems of stock market, we may also call their arrivals as part of the stock market reforms in India. The common features of these exchanges are:

(i) all are situated in Mumbai;

(ii) all do screen-based trading (SBT);

(iii) all have their trading terminals in the major cities of the country;

(iv) all are web-enabled;

(v) all are limited liability companies;

(vi) the brokers registered here have no say in either the ownership or the management of the exchanges;

(vii) all are counted among the best and the most technology-equipped stock exchanges in the world.[6]

Players in the Stock Exchanges

Broker

Broker is a registered member of a stock exchange who buys or sells shares/securities on his client's behalf and charges a commission on the gross value of the deal—such brokers are also known as *commission brokers*.

Brokers who offer services such as investment advice, clients' portfolio planning, credit when a client is buying on margin other than their

6. P. Chidambaram while presenting the ***Union Budget 2006–07,*** N. Delhi.

traditional commission job are known as *full service brokers*. In India such brokers are just coming up.

Jobber

A jobber is a broker's broker or one who specialises in specific securities catering to the need of other brokers—in India also known as '*Taravaniwallah*' (in the BSE).[7] A jobber is located at a particular trading post on the floor of the stock exchange and does buying and selling for small price differences, called the *spread*. He has no contact with the investing public.

In the London Stock Exchange he is called a *market-maker* while in the New York Stock Exchange he is called a *specialist*. The Bombay Stock Exchange has made it mandatory for every company with a share capital of over Rs. 3 crore to appoint jobbers or market-makers if it seeks enlistment. Such an arrangement enables investors to buy and sell shares on the stock exchange and thus liquidity increases.

Market-Maker

Functions as an intermediary in the market ready to buy and sell securities. He simultaneously quotes two-way rates—like a jobber basically with the only difference that he quotes two-way rates, for buying and selling at the same time.[8]

On the floor of India's OTCEI, only market-makers are allowed to play. In the money market of India, the Discount and Finance House of India (DFHI) is the chief market-maker.[9]

Since he quotes the selling price while buying a particular share, he makes market for that share, hence such a name.

The NASDAQ of the USA is a market-maker's stock exchange where they are connected by the web-enabled trading terminals.

SEBI

The regulator of Indian stock market, set up under the *Security and Exchange Board of India Act, 1992* (as a non-statutory body set on April 12, 1988 through a government resolution in an effort to give the Indian stock market an organised structure) with its head office in Mumbai. Its initial paid-up capital was Rs. 50 crore provided by the promoters—the IDBI, the IFCI and the ICICI.

The Board of SEBI comprises nine members excluding the chairman—one member each from the Ministries of Finance and Law, one member from the RBI and two other members appointed by the central government. It has four full-time members (including the chairman).

Main functions/powers of the Board as per the *SEBI Act, 1992* are:

(i) Registering and stock exchanges, merchant banks, mutual funds, underwriters, registrars to the issues, brokers, sub-brokers, transfer agents and others.

(ii) Levying various fees and other charges (as 1 per cent of the issue amount of every company issuing shares are kept by it as a caution money in the concerned stock exchange where the company is enlisted).

(iii) Promoting investor education.

(iv) Inspection and audit of stock exchanges and various intermediaries.

7. Surendra Sundararajan, ***Book of Financial Terms,*** Tata Mc Graw-Hill, N.Delhi, 2004, p. 117.
8. Tim Hindle, op. cit., p. 129.
9. Surender Sundararajan, op. cit., p. 134.

(v) Performing other concerned functions as may be prescribed from time to time.

COMMODITY TRADING

Commodity trading happens similar to 'stocks' (shares, securities, debentures, bonds) trading in the stock market. However, commodities are actual physical goods such as corn, silver, gold, crude oil, etc. Futures are contracts for commodities that are traded at a futures exchange like the Chicago Board of Trade (CBOT). Futures contracts have expanded beyond just commodities, now there are futures contracts on financial markets like foreign currencies, interest rates, etc.

Commodity futures serve a great purpose in any economy. As we see in the case of agricultural commodity—their prices play a key role in determining the fortune of the agriculture and food processing industry in India. These prices undergo a *large degree of fluctuation*. Reasons for price fluctuation are crop failure, bad weather, demand-supply imbalance, etc. This fluctuation, in turn, leads to a 'price risk'. This price risk is largely borne by the farmer and the industries where agricultural commodities are used as raw material. Commodity exchanges are associations that determine and enforce rule, and set procedures for trading of commodities. The main objective of the exchange is to protect the participants from adverse movement in prices by facilitating futures trading in commodities.

If the participants *hedge* themselves against this price risk, then they would be able to insulate themselves against the inherent price fluctuations associated with agricultural commodities. One of the methods of doing this would be by using commodity exchanges as a trading platform. Apart from hedging against price risk, a commodity exchange helps in production and procurement planning as one can buy in small lots. Further as the exchange consists of various informed industry participants, *price discovery* is more efficient and discounts the local and global factors.

Let us take a very simple example to understand how trading on commodity exchanges help industry participants. A farmer who is producing wheat can sell 'wheat futures' on a commodity exchange. This will help him lock in a sale price of a specified quantity of wheat at a future date. Hence the farmer would now be able to get an assured price for his produce in future and any decline in the price of wheat would not impact his earnings. On the other hand, a user industry (e.g., a flour mill) could purchase the wheat futures from the exchange. Hence the flour mill would now be able to fix its future purchase cost for a specified quantity of wheat. Therefore, any increase in the price of wheat in future would not impact its cost of production.

However, what needs to be kept in mind is that farmers do not largely operate in the futures market. This is partly due to operational difficulties and lack of knowledge. Though, they observe the price trends emerging from a futures market and then decide what commodity in what proportion to cultivate.

In case of user industries, commodity exchanges help them to plan their production and determine their cost of production. Commodity exchanges are an effective tool to hedge price risk. However, the government needs to improve infrastructure, put in place vigilant governing systems, etc., to encourage trading on these exchanges.

Big money started flowing into commodity futures with the advent of online multi-commodity exchange. The boom, which began when the stock market was sluggish, has surprisingly not waned even after the Sensex crossed 20,000 (by 2004–06). High stakes, long trading hours and comparatively little knowledge about the derivative products have underscored the role of a regulator. The Forward Markets Commission (FMC), which for decades was entrusted with the job to curb forward trades, now has the job to develop and regulate the commodity futures market.

FMC

The Forward Markets Commission is a statutory body set up under the *Forward Contracts (Regulation) Act, 1952*. It functions under the administrative control of the Department of Consumer Affairs, Ministry of Consumer Affairs, Food & Public Distribution. In 2014, the commission was transferred to the Ministry of Finance. Headquartered at Mumbai with one regional office at Kolkata, the commission comprises a Chairman, and two members. The commission provides ***regulatory oversight*** in order to ensure—

(i) Financial integrity (i.e., to prevent systematic risk of default by one major operator or group of operators);

(ii) Market integrity (i.e., to ensure that futures prices are truly aligned with the prospective demand and supply conditions), and

(iii) Protection and promotion of the interest of consumers/non-members.

After assessing the market situation and taking into account the recommendations made by the *Board of Directors of the Commodity Exchange*, the Commission approves the rules and regulations of the ***Commodity Exchanges*** in accordance with which trading is to be conducted. It accords permission for commencement of trading in different contracts, monitors market conditions continuously and takes remedial measures wherever necessary by imposing various regulatory measures. At present, 113 commodities are notified for future trading and there are 21 commodity exchanges in India including three ***'national level'*** exchanges (other being regional) recognised for conducting futures/forward trading. The three national exchanges are:

(i) Multi-commodity Exchange of India Ltd. (MCX), Mumbai. The FTIL, its main promoter, has been asked by the FMC to exit its ownership in it after the firm was found involved in financial irregularities mid-2013 (it has 24 per cent stake in MCX).

(ii) National Commodity and Derivatives Exchange Ltd. (NCDEX), Mumbai.

(iii) National Multi-commodity Exchange of India Ltd. (NMCE), Ahmedabad.

In US, which has the *largest* commodity futures market, there are separate regulators for equities and commodities. Single regulator exists in China, UK, Australia, Hong Kong and Singapore. Japan has a different model for its derivatives market, with multiple product type based regulators.

The GoI decided to merge the FMC with the SEBI (the *Union Budget 2015–16*).

SPOT EXCHANGES

In India, Spot Exchanges refer to electronic trading platforms which facilitate purchase and sale of specified commodities, including agricultural commodities, metals and bullion by providing *spot delivery contracts* in these commodities.

This market segment functions like the equity segment in the main stock exchanges. Alternatively, this can be considered as a guaranteed direct marketing by sellers of the commodities. Spot Exchanges leverage on the latest technology available in the stock exchange framework for the trading of goods. This is an innovative Indian experiment in the trading of goods and is distinct from what is commonly known as 'commodity exchanges' which trade in *futures contracts* in commodities.

Spot exchange has been **defined** by the Warehousing Development and Regulatory Authority (Electronic Warehouse Receipts) Regulations, 2011 as "a body corporate incorporated under the Companies Act, 1956 and engaged in assisting, regulating or controlling the business of trading in electronic warehouse receipts." However, present day spot exchange deals not just with warehouse receipts—this is an electronic market where a farmer or a trader can *discover* the prices of commodities on a national level and can buy or sell goods *immediately* (i.e., on the 'spot') to anyone across the country. All contracts on the exchange are *compulsory delivery contracts*—it means that all outstanding positions at the end of the day are marked for delivery, which implies that seller has to give delivery and buyer has to take the delivery.

The facilities provided by the spot exchange, like a normal stock exchange, include clearing and settlement of trades. Trades are settled on guaranteed basis (i.e., in case of default by any person exchange arranges for the payment of money/good) and the exchange collects various margin payments, to ensure this. The exchange also offers various other services, such as, quality certification, warehousing, warehouse receipt financing, etc.

Spot Exchanges in India: At present, there are **four** spot exchanges operating in the country:

(i) The National Spot Exchange Ltd. (NSEL), set up in 2008, is a national level commodity spot exchange promoted by the Financial Technologies India Ltd (FTIL) and National Agricultural Cooperative Marketing Federation of India Limited (NAFED). After the FTIL was found involved in irregularities, the FMC (Forward Market Commission), by *end-March 2014* asked it to exit the spot exchange.

(ii) NCDEX Spot Exchange Ltd (established in October 2006 by NSE).

(iii) Reliance Spot Exchange Ltd. (R-Next).

(iv) Indian Bullion Spot Exchange Ltd. (an online over the counter spot exchange).

Advantages of Spot Exchanges: Spot exchange provides various advantages over the traditional way of trading in commodities:

(i) Efficient price determination as price is determined by a wider cross-section of people from across the country, unlike the traditional 'mandis' where price discovery for commodities used to happen only through local participation.

(ii) Ensures transparency in price discovery—anonymity ensures convergence of different price perceptions, as the buyer or seller merely expresses their desire to trade without even meeting directly.

(iii) Ensures participation in large numbers by farmers, traders and processors across the country and eliminate the possibility of cartelisation and other such unhealthy practices prevalent in the commodity markets.

(iv) It brings in some best practices in commodity trading like, system of grading for quality, creating network of warehouses with assaying facilities, facilitating trading in relatively smaller quantities, lower transaction cost, etc.

(v) Bank finance available against the goods in the warehouse on easier terms improves holding capacity and can actually incentivise farm production and hence reduce rural poverty.

(vi) Since the trades are guaranteed (by the exchange), counter party risk is avoided.

Raising Capital in the Primary Market

There are three ways in which a company raises capital in the primary market—

Public Issue

A public offer is open for all Indian citizens, the most broad-based method of raising capital and the most prestigious, too (The Reliance Industries Ltd. is the biggest company of India in this category).

Rights Issue

Raising capital from the existing shareholders of a company, it means it is a preferential kind of issue restricted to a certain category of the public only.

Private Placement

Raising capital by selling shares to a select group of investors, usually financial institutions (FIs) but may be to individuals also. This is done through a process of direct negotiations (completely opposite to the public issue). The advantage of this route is the substantial saving a share issuing company makes on marketing expenses (but the risk of shifting loyalties of the investors in this route is also the highest).

Recent times have seen such capital raising by many companies privately placing their shares to the foreign institional investors (FIIs) as a route to source foreign exchange in India, and that too quickly.

Important Terms of Stock Market

Scrip Share

A share given to the existing shareholders without any charge—also known as *bonus share*.

Sweat Share

A share given to the employees of the company without any charge.

Rolling Settlement

An important reform measure started in the Indian stock market in mid-2001 under which all commitments of sale and purchase result into payment/delivery at the end of the 'X' days later (where 'X' stands for 5 days. Some shares have X as one, two or three days, too). Today, all shares are covered under this provision.

Badla

When the buyers want postponement of the transaction—in Western world called *Contango*.

Undha Badla

When the sellers want postponement of the transaction—also known as the *reverse badla* or *backwardation*.

Futures

A trading allowed in shares where a future price is quoted for the shares and the payment and delivery takes place on the pre-determined dates.

Depositories

Started in 1996 under which stocks are converted into ***'paperless form'*** (dematerialisation of shares shortly known as the 'demat'). At present, two public sector depositaries (Mumbai) are functioning in India set up under the *Depositories Act, 1996*—

(i) NSDL (National Securities Depositories Ltd.)

(ii) CDSL (Central Depositories Services Ltd.)

Spread

The difference between the buying and selling prices of a share is called spread. Higher the liquidity of a share lower its spread and vice versa. Also known as Jobber's ***Turn* or *Margin* or *Hair cut.***

Kerb Dealings

The transactions of stocks which take place outside the stock exchanges—unofficially and take place after the normal trading hours.

NSCC

The National Securities Clearing Corporation (NSCC), a public sector company set up in 1996 takes the *counter party risk* of all transactions done at the NSE just as an intermediary guarantees all trades.

Demutualisation

A process started (2002) by SEBI under which ownership, management and trading membership was to be segregated from each other. No broker was to be on the Board of Directors or an office-bearer in a stock exchange.

This has been done in the case of all stock exchanges except three regional stock exchanges (RSEs) in India.

Authorised Capital

The limits upto which shares can be issued by a company—also known as the *nominal* or *registered* capital. This is fixed in the Memorandum of Association (MoA) and the article of association (AoA) of a company as required by the *Companies Act (Law)*.

Paid-up Capital

The part of the authorised capital of a company that has actually been paid by shareholders. A difference may arise because all shares authorised might not be *issued* or issued shares are only partly paid-up.

Subscribed Capital

The amount actually paid by the shareholders or have been committed by them for contribution.

Issued Capital

The amount which is sought by a company to be raised by issuing shares which cannot exceed the authorised capital of the company.

Greenshoe Option

A provision under which a company issuing shares for the first time is allowed to sell some additional shares to the public—usually 15 per cent, is also known as ***over-allotment provision***. It gets its name from the first company (Greenshoe Company, USA) which was allowed such an option.

Penny Stocks

The share which remains low-priced at a stock exchange for a comparatively longer period. Speculators may start hoarding them for hefty margins, this was seen in India in mid-2006. And since such stocks get hoarded, ultimately their market prices increase. The speculators earn profit after offloading (selling) these shares at high prices and others who purchase these shares ultimately might fetch huge losses because price rise of these stocks are unintentional or each intentional manipulation and nothing else.

ESOP

The Employee stock Ownership plan (ESOP) enables a foreign company to offer its shares to employees overseas. It was allowed in India (February 2005) provided that the MNC has minimum 51 per cent holding in its Indian company. Earlier a permission from the RBI was required for such an option.

SBT

Screen Based Trading (SBT) is trading of stock based on the electronic medium, i.e., with the help of computer monitor, internet, etc. First such trading was introduced in New York in 1972 by the bond broker ***Cantor Fitzgerald.*** India introduced it in 1989 at the OTCEI. Now it is carried out at all exchanges.

OFCDs

Debentures are the debt instruments which may be issued by a listed or non-listed firm to raise funds in a security market. They are of many types, viz., *Redeemable, Non-redeemable, Partially Convertible* and *Fully Convertible.* In case of 'fully convertible debentures' an 'option' (that is why the name OFCDs, i.e., Optionally Fully Covertible Debentures) is given to the debenture-holders who may wish to convert their OFCDs into shares (after expiry of the period fixed by the debenture issuing firm—known as 'lock-in' period). But the 'rate', will be decided by the company (e.g., how many shares against how many debentures). For debenture-holders the 'option' to convert debenture into shares is profitable and/or safer once either of the following situations are correct:

(i) The firm is likely to make high profit (so the shareholder can earn higher dividend), or

(ii) Firm's share-price is likely to rise in the share market (profit can be made by selling shares).

But suppose the firm has weak balance sheet (going bankrupt), then it is better to keep hold on the debenture rather than converting them into shares, because when a company is liquidated (i.e., its assets sold off), the debenture holders get *primacy* over shareholders in payment. It means OFCD is a bit **tricky** thing and is the only suitable route to invest in the security market for the investors who have some knowledge and understanding of share prices, company performance, etc.

Recently, the OFCDs issued by **Sahara** (an NBFC under regulatory control of the RBI) were in news due to some irregularities – it was a simple case of certain loopholes in the regulation of OFCDs and some violations by Sahara:

(i) Actually, an OFCD issue process has to be completed within 10 working days (Sahara continued for over two years).

(ii) If the OFCD is being issued through the 'Private Placement' route only 50 individuals/ institutions can subscribe to it (Sahara issued it to over 23 million people and raised over Rs. 24,000 crores). Such a tricky instruments being issued to novice public was a clear case of financial irregularities.

(iii) Unlisted companies do not come under the regulatory control of SEBI. In place they are regulated by the Ministry of Corporate Affairs (both the Sahara firms which issued OFCDs are unlisted). But SEBI contended that it can regulate even an unlisted firm if it issues OFCD, as the SEBI Act, 1992 contains the term OFCDs. There was really some regulatory confusion. This is why the government added a 'clause' in the recently passed *Companies Act, 2012* which gives SEBI **undisputed jurisdiction** over any investment scheme involving more than 50 investors whether the company is listed or unlisted. Menawhile, Sahara has been ordered to return the total capital it raised through OFCDs with an interest of 15 per cent per annum.

DERIVATIVES

Derivative is a product whose value is derived from the value of one or more basic variables, called bases (underlying asset, index or reference rate), in a contractual manner.

The underlying asset can be equity, forex, commodity or any other asset. For example, wheat farmers may wish to sell their harvest at a future date to eliminate the risk of a change in prices by that date. Such a transaction is an example of a derivative. The price of this derivative is driven by the spot price of wheat which is the "underlying".

In the Indian context the *Securities Contracts (Regulation) Act, 1956* [SC(R)A] **defines derivative** to include :

(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.

Derivatives are securities under the SC(R)A and hence the trading of derivatives is governed by the regulatory framework under the SC(R)A and are allowed to be traded on the floors of the stock exchanges.

Indian Depository Receipts (IDRs)

As per the **definition** given in the *Companies (Issue of Indian Depository Receipts) Rules, 2004,* IDR is an instrument in the form of a depository receipt created by the Indian depository in India against the underlying equity shares of the issuing company. In an IDR, foreign companies would issue shares, to an Indian depository [say the National Security Depository Limited (NSDL)], which would in turn issue depository receipts to investors in India. The actual shares underlying IDRs would be held by an Overseas Custodian, which shall authorise the Indian depository to issue of IDRs.

Just try to understand in a simple way. An IDR is a mechanism that allows investors in India to invest in listed foreign companies, including multinational companies, in Indian rupees. IDRs give the holder the opportunity to hold an interest in equity shares in an overseas company. IDRs are denominated in Indian Rupees and issued by a Domestic Depository in India. They can be listed on any Indian stock exchange. Anybody who can invest in an IPO (Initial Public Offer) is/are eligible to invest in IDRs. *In other words, what ADRs/GDRs are for investors abroad with respect to Indian companies, IDRs are for Indian investors with respect to foreign companies.*

But one question comes in mind. How does investing in IDRs differ from investing in shares of foreign company listed on foreign exchanges? Indian individuals can invest in shares of foreign companies listed on foreign exchanges only upto $200,000 and the process is costly and cumbersome as the investor has to open a bank account and demat account outside of India and comply with Know Your Customer (KYC) norms of respective companies. It also involves foreign currency risks. IDR subscription and holding is just like any equity share trading on Indian exchanges and does not involve such hassels.

StanChart is the **first** and the **only** issuer of IDRs in Indian markets which came out with its IDR issue in May 2010 through which it had raised Rs. 2,500 crore on high demand from institutional investors and was listed on the Bombay Stock Exchange and National Stock Exchange. Ten StanChart IDRs represent one underlying equity of the UK-listed bank. StanChart IDRs were due to come up for redemption on June 11, 2011.

SEBI came out with the new guidelines in June 2011which ruled that after the completion of one year from date of issuance of IDRs, redemption of the IDRs will be permitted only if the IDRs are infrequently traded on the stock exchange in India. Sebi rules make it clear that if the annual trading turnover in IDRs in the preceding six calendar months before redemption is less than

5 per cent, then only the company could go into for redemption of IDRs. The regulator had said that the company issuing IDRs would have to test the frequency of trading the instrument on the bourses on a half-yearly basis ending June and December every year.

SHARES 'AT PAR' AND 'AT PREMIUM'

An ordinary share in India, in general, is said to have a ***par value (face value)*** of Rs. 10, though some shares issued earlier still carry a par value of Rs. 100. Par value implies the value at which a share is originally recorded in the balance sheet as 'equity capital' (this is the same as 'ordinary share capital'). SEBI guidelines for *public issues* by new companies established by individual promoters and entrepreneurs, require all new companies to offer their shares to the public *at par,* i.e., at Rs 10. However, a new company set up by existing companies (and of course existing companies themselves) with a track record of *at least five years* of consistent profitability are allowed to issue shares at a **premium.**

When a company issues shares at a premium, it is able to raise the required amount of capital from the public by issuing a fewer number of shares. For example, while a *new company* promoted by first time entrepreneurs intending to raise say, Rs. 1 crore, has to offer 10 lakh ordinary shares at Rs. 10 each (at par), an *existing company* may raise the same amount by offering only 2 lakh shares at Rs. 50 each (close to the market value of its shares). The latter is said to have issued its share at a '*subscription price*' of Rs. 50 (Rs. 10 in the case of the former company), at a premium of Rs. 40 (being the excess of subscription price over par value). In such a situation in India, the company's books of accounts will show Rs. 10 towards *share capital account* and Rs. 40 towards *share premium account.* It means that the higher the premium, the fewer will be the number of shares a company will have to service. For this very reason, following the policy of free pricing of issues in 1993, many companies came out with issues at prices so high that in many cases they were higher than their market prices, leading to under-subscription of such issues. The companies are, however, learning fast about the pitfalls of high pricing of shares and it is only a matter of time before the issue prices become more realistic.

In India, no company is allowed to issue shares at a *discount*, i.e., at a price below par. Again, in India, once a company has issued the shares, it cannot easily reduce its capital base, (i.e., *buy back* or *redeem*) its own shares.

This means that ordinary share capital is a more or less permanent source of capital, which normally a company is never under an obligation to return to the investors, because a shareholder who wishes to *disinvest* (i.e., get back the invested capital) can always do so by selling the shares to other buyers in the secondary market. Also, in India, a company receives no tax benefits for the dividends distributed. In other words, dividends are paid by the companies out of the earnings left after taxes and they get taxed once again at the hands of the investors.

FOREIGN FINANCIAL INVESTORS

Through the Portfolio Invesment Scheme (PIS), the foreign financial investors (FIIs) were allowed to invest in the Indian stock market—the FIIs having good track record register with SEBI as brokers. FIIs make investments in markets on the basis of their *perceptions* of expected returns from such markets. Their perceptions among other things are influenced by :

(i) the prevailing macro-economic environment;
(ii) the growth potential of the economy; and
(iii) the corporate performance in competing countries.

Increased FII inflows into the country during the year 2012 helped the Indian markets become one of the best performing in the world in 2012, recovering sharply from their dismal performance in 2011. At the end of December 2012, **1,759** FIIs were registered with SEBI with their net FII flows to India at US$ 31.01 billion.[10] These flows were largely driven by equity inflows (80 per cent of total flows) which remained buoyant, indicating FII confidence in the performance of the Indian economy in general and Indian markets in particular. The economic and political developments in the *Euro zone area* and the *United States* had their impact on markets around the world including India. The resolution of the **fiscal cliff**[11] in the US had a positive impact on the market worldwide including in India. Further, reform measures recently initiated by the government have been well received by the markets.

New Rules for Foreign Investment

To promote the flow of foreign funds into the economy the RBI, on *January 24, 2013*, further liberalised the provisions of investment in India's security market—

(i) FIIs and ***long-term investors***[12] investment limit in Government Securities (G-Secs) enhanced by US $5 billion (to US $ 25 billion).

(ii) Investment limit in corporate bonds by the above-given entities enhanced by $5 billion (to $50 billion).

(iii) The RBI also relaxed some investment rules by removing the maturity restrictions for first time foreign investors on dated G-Secs (earlier a three-year residual maturity was must for first time foreign investors). But such investments will not be allowed in short-term paper like Treasury Bills.

(iv) Foreign investors restricted from investing in the 'money market' instruments —certificates of deposits (CDs) and commercial paper (CPs).

(v) In the total corporate debt limit of $50 billion, a sub-limit of $25 billion each for infrastructure and other than infrastructure sector bonds has been fixed.

(vi) Rules requiring FIIs to hold infrastructure debt for at least one year has been abolished.

(vii) The qualified foreign investors (QFIs) would continue to be eligible to invest

10. As per the latest ***Economic Survey 2012-13***, op. cit., p. 121.

11. **'Fiscal cliff'** is a term used to describe the crisis that the US government faced at the end of 2012, when the terms of the Budget Control Act of 2011 were scheduled to go into effect – a combination of – i). expiring tax cuts and ii). across-the-board government spending cuts scheduled to become effective December 31, 2012. The idea behind the fiscal cliff was that if the federal government allowed *these two* events to proceed as planned, they would have a detrimental effect on an already shaky economy, perhaps sending it back into an official *recession* as it cut household incomes, increased unemployment rates and undermined consumer and investor confidence [As per the conservative estimates by some US experts, it would have meant a tax increase to the size of which the country had never seen in the last in 60 years].

    Who did first use the term is not clear – some believe that it was first used by Goldman Sachs economist, *Alec Phillips*, while some others credit Federal Reserve Chairman *Ben Bernanke*, still others credit *Safir Ahmed*, a reporter for the *St. Louis Post-Dispatch*, who in 1989 used the term while writing a story detailing the state's education funding. ***Sources:*** The contemporary news reportings and articles which appeared during the time in *The Economist, The Guardian, The New York Times* and *The Newsweek*.

12. 'Long-term investors' include SEBI-registered 'sovereign wealth funds' (SWFs), multilateral agencies, endowment funds, insurance funds, pension funds and foreign central banks.

in *corporate debt securities* (without any lock-in or residual maturity clause) and *mutual fund debt schemes*, subject to a total overall ceiling of \$1 billion (this limit of \$1 billion shall continue to be over and above the revised limit of \$50 billion for investment in corporate debt).

(viii) As a measure of further relaxation, it has been decided to dispense with the condition of one year lock-in period for the limit of \$22 billion (comprising the limits of infrastructure bonds of \$12 billion and \$10 billion for non-resident investment in IDFs) within the overall limit of \$25 billion for foreign investment in infrastructure corporate bond.

(ix) The residual maturity period (at the time of first purchase) requirement for the entire limit of \$22 billion for foreign investment in the infrastructure sector has been uniformly kept at 15 months. The five-year residual maturity requirement for investments by QFIs within the \$3 billion limit has been modified to three years original maturity.

SEBI has classified the foreign financial institutions (FIIs) into three broad categories – and they are allowed to issues PNs in accordance with the provision announced by the SEBI:

Category I: The government entities/ institutions investing in Indian security market on behalf of the Central Bank.

Category II: The financial institutions, mutual funds, etc., which duly regulated in the countries of their origin.

Category III: The financial institutions which do not fall either of the above-given categories.

ANGEL INVESTOR

A new term in India's financial market, introduced in the ***Union Budget 2013-14*** which announced that SEBI will soon prescribe the provisions by which the **angel investor** can be recognised as *Category I AIF* [13] *venture capital funds.*

Angel investor is an investor who provides financial backing to entrepreneurs for 'starting their business'. Angel investors are usually found among an entrepreneur's family and friends but they may be from outside also. The capital they provide can be a one-time injection of seed money or ongoing support to carry the company through difficult times—in exchange they may like owning share in the business or provide capital as loan (in case of a loan they lend at more favorable terms than other lenders, as they are usually investing in the *person* rather than the viability of the business). Other than investible capital, these investors provide technical advices and also help the 'start-up' business with their lucrative contacts.

They are focused on helping the business succeed, rather than reaping a huge profit from their investment. Angel investors are essentially the *exact opposite* of a venture capitalist in their 'intention' (who has high profit prospects as their prime focus). But in one sense both—an *angel investor* and a *venture investor*—serve the same purpose for the entrepreneur (who is in dire need of investible capital).

QFIs SCHEME

In Budget 2011—12, the government, for the first time, permitted qualified foreign investors (QFIs), who meet the know-your-customer (KYC) norms, to invest directly in Indian mutual funds.

13. As per the *SEBI (Alternative Investment Funds) Regulations, 2012 (AIF Regulations),* **Category I AIF** are – those AIFs with 'positive spillover effects' on the economy, for which certain incentives or concessions might be considered by SEBI or the Government of India or other regulators in India; and which shall include *Venture Capital Funds, SME Funds, Social Venture Funds, Infrastructure Funds* and such other *Alternative Investment Funds (AIFs)* as may be specified.

In January 2012, the government expanded this scheme to allow QFIs to directly invest in Indian equity markets. Taking the scheme forward, as announced in *Budget 2012—13*, QFIs have also been permitted to invest in corporate debt securities (CDSs) and MF debt schemes subject to a total overall ceiling of US $ 1 billion.

In *May 2012*, QFIs were allowed to open individual non-interest-bearing rupee bank accounts with authorized dealer banks in India for receiving funds and making payment for transactions in securities they are eligible to invest in. In *June 2012*, the definition of QFI was expanded to include residents of the member countries of the Gulf Cooperation Council (GCC) and European Commission (EC) as the GCC and EC are members of the Financial Action Task Force (FATF).

The speedier moves in the area of promoting higher foreign investment (FIs) in India should be seen in the light of two broad perspectives—

(i) India's rising current account deficit (which crossed an all-time high of 6.7 per cent by *March 2013*) which is creating heavy drain of foreign exchange; and
(ii) The objective of attracting more FIs while the Western economies are under the spell of recession (cashing in the opprtunity).

RFPIs

In *March 2014*, the RBI simplified foreign portfolio investment norms by putting in place an easier registration process and operating framework with an aim to attract inflows. Frow now onwards, the portfolio investor registered in accordance with the SEBI guidelines shall be called Registered Foreign Portfolio Investor (RFPI)—the existing portfolio investor class, namely, Foreign Institutional Investor (FII) and Qualified Foreign Investor (QFI) registered with SEBI shall be subsumed under it. The new guidelines for RFPIs are as given below:

(i) They may purchase and sell shares and convertible debentures of Indian companies through a registered broker on recognised stock exchanges in India as well as purchase shares and convertible debentures, which are offered to public in terms of relevant SEBI guidelines.
(ii) Such investors can acquire shares or convertible debentures in any bid for, or acquisition of, securities in response to an offer for *disinvestment* of shares made by the central government or any state government.
(iii) These entities would be eligible to invest in *government securities* and corporate debt, subject to limits specified by the RBI and SEBI from time to time.
(iv) Such investors would be permitted to trade in all exchange-traded derivative contracts on the stock exchanges, subject to the position limits as specified by SEBI from time to time.
(v) RFPI may offer cash or foreign sovereign securities with AAA rating or corporate bonds or domestic government securities, as collateral to the recognised stock exchanges for their transactions in cash as well as derivative segment of the market.

All investments made by that FIIs/QFIs in accordance with the regulations prior to registration as RFPI shall continue to be valid and taken into account for computation of aggregate limit.

PARTICIPATORY NOTES (PNs)

A Participatory Note (PN or P-Note) in the Indian context, in essence, is a *derivative* instrument issued in foreign jurisdictions, by a SEBI registered foreign institutional investor (FII), against Indian securities—the Indian security instrument may be equity, debt, derivatives or may even be an index. PNs are also known as *Overseas Derivative Instruments*, *Equity Linked Notes*, *Capped Return Notes,* and *Participating Return Notes*, etc.

The investor in PN does not own the underlying Indian security, which is held by the FII who issues the PN. Thus, the investors in PNs derive the economic benefits of investing in the security without actually holding it. They benefit from fluctuations in the price of the underlying security since the value of the PN is linked with the value of the underlying Indian security. The PN holder also does not enjoy any voting rights in relation to security/shares referenced by the PN.

Reasons for the popularity of PNs

The reasons why PNs became such a popular ruote for foreign investors to invest in the Indian security market may be understood through the following points:

(i) One of the primary reasons for the emergence of the PN (an 'off-shore derivative instrument', i.e., an ODI) is the restrictions on foreign investments. For example, a foreign investor intending to make portfolio investments in India was required to seek FII registration for which he is required to meet certain eligibility criteria. Lack of full *Capital Account Convertibility* further enhances the entry barriers from the perspective of a foreign investor. However, Since *January 2012*, The Indian government has taken a decision to give direct access to such prospective 'foreign individual investors' who were hitherto banned to invest in equity of Indian companies.

(ii) The off-shore derivative market allows investors to gain exposure to the local shares without incurring the time and costs involved in investing directly. In return, the foreign investor pays the PN issuer a certain basis *point(s)* of the value of PNs traded by him as *costs*. For instance, directly investing in the Indian securities markets as an FII, has significant cost and time implications for the foreign investor. Apart from seeking FII registration, he is required to establish a domestic broker relationship, a custodian bank relationship, deal in foreign exchange and bear exchange rate fluctuation risk, pay domestic taxes and/or filing tax return, obtain or maintain an investment identity, etc. These investors would rather look for derivatives alternatives to gain a cost-effective exposure to the relevant market.

(iii) Besides reducing transactions costs, PNs also provide customised tools to manage risk, lower financing costs and enhance portfolio yields. For instance, PNs can also be designed for longer maturities than are generally available for exchange-traded derivative.

(iv) PNs also offer an important *hedging tool* to a foreign investor already registered as an FII. For example, an FII may wish to obtain 'long' exposure to a particular Indian security. The FII can hedge the downside exposure to the listed security, already purchased by purchasing a 'cash settled put option'. Although the Indian exchanges offer options contract, these contracts have a maximum life period of three months, beyond which the FII shall have to rollover its positions, i.e., purchase a fresh option contract. Alternatively, it can avail of a PN which can be customised to cater to its hedging requirements.

(v) Potential investors who would like to take direct Indian exposure in future, may make initial investments through the PN route so as to get a flavour of future anticipated returns.

(vi) Further, trading in ODI/PNs gives an opportunity to offshore entities to have a commission based business model. This route provides ease to subscribers as it bypasses the direct route which may be resource heavy for them.

(vii) And ***lastly***, it was a highly 'safe and lucrative route' to invest the 'unaccounted', 'even illegal' money into the Indian security market for huge profits (during the booming period). Experts even imagined that it may be allowing the 'black money' of India (stashed away from India through 'hawala' kind of illegal channels and deposited in the tax havens of the world in 'Swiss Bank' kind of financial institutions) to get invested back in the market. Again, 'terrorist organisations' might have been using this route, too.

PNs are ***thus*** issued, to provide access to a set of foreign investors who intend to reduce their overall costs and the time involved in making investments in India. In other words, the attraction of investing in PNs is primarily one of efficiency (from an infrastructure and time perspective) for which they are willing to forego certain benefits of directly holding the local securities (for example, title and voting rights), whilst also assuming other risks.

REGULATION OF PNs

PNs are market instruments that are created and traded overseas. Hence, Indian regulators cannot ban the issue of PNs. However, they can regulated, as SEBI does—when a PN is traded on an overseas exchange, the regulator in that jurisdiction would be the authority to regulate that trade. PNs have been used by FIIs, since FIIs were permitted to invest in the securities market (1994)—they were not specifically dealt with under the regulations until 2003. According to the *SEBI Regulation, 2004* (and further amended in 2008) with the ***objective*** of tightening regulations in this regard—

(i) PNs can be issued only to those entities which are regulated by the relevant regulatory authority in countries of their incorporation and are subject to compliance of 'know your client' (KYC) norms.

(ii) Down-stream issuance or transfer of the instruments can also be made only to a regulated entity.

(iii) Further, the FIIs who issue PNs against underlying Indian securities are required to *report* the issued and outstanding PNs to SEBI in a prescribed format.

(iv) In addition, SEBI can call for any information from FIIs concerning off-shore derivative instruments (ODIs) issued by it.

(v) In order to monitor the investment through these instruments, SEBI on *October 31, 2001*, advised FIIs to submit information regarding issuance of derivative instruments by them, on a monthly basis. These reports require the communication of details such as name and constitution of the subscribers to PNs, their location, nature of Indian underlying securities, etc.

(vi) FIIs cannot issue PNs to non-resident Indians (NRIs) and those issuing PNs are required to give an undertaking to the effect.

(vii) SEBI has also mandated that QFIs (qualified foreign investors), the recently allowed foreign investor class, shall not issue PNs.

SEBI in consultation with the government had decided in *October 2007*, to place certain restrictions on the issue of PNs by FIIs and their sub-accounts. This decision was taken with a view to moderate the surge in foreign capital inflows into the country and to address the 'know-your-client' concerns for PN holders. However, it was found that such restrictions were ineffective. Therefore, SEBI in October 2008 reviewed its earlier decision and decided to remove these restrictions in the light of the above factors. Rather, more attention is given to effective disclosures. As per a SEBI decision of October 2013, the Category III FIIs are not allowed to issue PNs.

The Concerns related to PNs

Being derivative instruments and freely tradable, PNs can be easily transferred, creating multiple layers, thereby obfuscating the real beneficial owner. It is in this respect that concerns about the ***identity of ultimate beneficial*** owner and the source of funds arises.

For the reason that such instruments are issued outside of India, these transactions are outside the purview of SEBI's surveillance and it is the FII which acts as mini-exchange overseas. The actual transactions in the underlying securities are executed by the FIIs only at its discretion, as and when necessary and there is no one-to-one correspondence between transactions in the underlying instruments and issuance of PNs.

The ex-post reporting requirement enjoined upon the FII in respect of PNs on a monthly basis effectively keeps the transactions in PNs out of the real time market surveillance mechanism and beyond the enforceability jurisdiction of SEBI.

There are also concerns that some of the money coming into the market via PNs could be the ***'unaccounted wealth'*** camouflaged under the guise of FII investment. However, this has not been proved so far. SEBI has indeed been successful in taking action against the FIIs who were non-compliant and those who had misreported offshore derivatives [as happened when SEBI took actions against two FIIs—*Barclays* in December 2009 and *Societe Generale* in January 2010]

At present, PNs are issued by large financial sector conglomerates which not only have strong presence in the global investment banking arena but also have asset management arms which invest across a number of securities markets globally. These entities are originally incorporated in well-regulated and developed jurisdictions like the US, UK, etc. Further, these entities also possess the financial wherewithal to issue PNs, complemented by skilled personnel who are adept at risk management and financial engineering activities.

International Situation

PN like products are not necessarily used to invest in restricted markets, but also reported to be available in the open developed/advanced economies like Japan, Hong Kong, Singapore, Australia, the USA and UK. In response to market manipulation concerns, in December 1999, *Taiwan Securities and Futures Commission* had amended its FII regulations to require periodic disclosure by FIIs of all offshore derivative activities linked to local shares, but this requirement was subsequently removed in June 2000 (as the Ashok Lahiri Committee Report says). *China*'s *Securities Regulatory Commission* requires entities to file reports related to these products with minimal 'reporting requirements that emphasize only on the quota utilised by them'. *Other Asian countries* like Hong Kong, Singapore and Japan have reportedly 'no restrictions' or requirements on PNs. Malaysia, Indonesia and Philippines which are restricted markets though, are having no reporting requirements in this regard.

HEDGE FUND

This term has come up from another term ***hedging***, a process by which businesses insulate themselves from the risk of price changes.[14] Hedge funds are the lot of investible (free floating capital) capital which move very swiftly towards the more profitable sectors of an economy.

At present, such funds easily move from the stock market of one economy to the other—away from the low profit fetching to high profit fetching ones. As stock markets fall and rise such funds change markets accordingly. By nature they are temporary. The period for which they continue flowing into an economy there is naturally a boom time. But when they quit for a more attractive economy, the same economy might not be able to manage the accelerated foreign currency outflow and there are chances of imminent foreign currency crisis. This has been in news for the last two years in India where stock market has been in boom, riding on the FIIs inflow via Participatory Notes (PNs).

SHORT SELLING

Sale of a share which is not owned. This is done by someone after borrowing shares from stockbrokers promising to replace them at a future date on the hope (speculation) that the price will fall by then. He fetches profit if price of the share really fell down by the future date of replacement and sustains a loss if the price increased. Recently, short selling has been allowed in India by SEBI.

BEAR AND BULL

A person who speculates share prices to fall in future and so sells his shares and earns profit is a *bear*. He earns profit out of a falling market. Basically, here he is short selling the shares.

Opposite to bear, bull is a person who speculates share prices to go up in future so either stops selling the select group of shares for that time to be reached (he is basically taking long position on those shares) or starts purchasing that select group of shares.

Thus, a bear increases the number of shares in a stock market activating a general fall in the index—a bearish market. Opposite to it, a bull creates a scarcity of shares in the stock market activating a general rise in the share prices and the index—a bullish market.

Brokers play as a bear for some stocks and as a bull for some other stocks. while a bear broker is a non-entity, a bull is remembered for long time to come—Harshad Mehta was known as the Great Bull.

BOOK BUILDING

A provision allowed by SEBI to all Initial Public offers (IPOs) in which individual investors are reserved and allotted shares by the company. But the issuer has to disclose the price (at which shares have been allotted the size of the issue and the number of shares offered to the public).

IPO

Initial Public Offer (IPO) is an event of share issuing when a company comes up with its share/ securities issued for the first time.

PRICE BAND

A process of public issue where the company gives a price range (known as price band) and it is left upon the share applicants to quote their prices on it—the highest bidders getting the shares. This is a variant of share issue at premium but considered a safer choice.

14. Samuelson and Nordhaus, ***Economics***, op. cit., p. 207.

ECB POLICY

A prospective borrower can access external commercial borrowings (ECBs) under two routes, namely the 'automatic route' and the 'approval route'. ECBs not covered under the automatic route are considered on case-by-case basis by the RBI under the approval route. The High Level Committee on ECB took a number of decisions in *September 2011* to expand the scope of ECBs which include:

(i) High networth individuals (HNIs) who fulfil the criteria prescribed by SEBI can invest in IDFs.

(ii) IFCs have been included as eligible issuers for FII investment in the corporate bonds long-term infra category.

(iii) ECB would be permitted for refinancing of rupee loans of infrastructure projects on the condition that at least 25 per cent of such ECBs shall be used for repayment of the said rupee loan and 75 per cent invested in new projects in the infrastructure sector (but only under the approval route).

(iv) Refinancing of buyer's/supplier's credit through ECBs for the purchase of capital goods by companies in the infrastructure sector was approved. This would also be permitted only under the approval route.

(v) ECBs for interest during construction (IDC) that accumulates on a loan during the project execution phase for companies in the infrastructure sector would be permitted. This would be subject to the condition that the IDC is capitalised and is part of the project cost.

(vi) Renminbi (RMB)—the Chinese currency —was approved as an ***acceptable currency*** for raising ECBs subject to/ limit of US $ 1 billion within the existing ECB ceiling (allowed only through the approval route).

(vii) The existing ***ECB limits*** under the automatic route were enhanced from US $ 500 million to US$ 750 million for eligible corporates. For borrowers in the *services sector,* the limit has been enhanced from US$ 100 million to US$ 200 million and for *NGOs* engaged in *micro-finance* activities from the existing US$ 5 million to US$ 10 million.

(viii) INR (rupee) denominated ECBs would be permitted from foreign equity holders to 'all eligible borrowers' except in the case of ECBs availed of by NGOs under the automatic route.

During the financial year ***2014–15 and early 2015–16*** the external commercial borrowings (ECB) policy was further liberalised via the following steps :

(i) Enhancing the limit for refinancing rupee loans through ECB from 25 per cent to 40 per cent for Indian companies in the power sector;

(ii) Allowing ECB for capital expenditure on the maintenance and operation of toll systems for roads and highways so long as they are a part of the original project subject to certain conditions, and also for low cost housing projects;

(iii) Reducing the withholding tax from 20 per cent to 5 per cent for a period of three years (July 2012—June 2015) on interest payments on ECBs;

(iv) Introducing a new ECB scheme of US $10 billion for companies in the manufacturing and infrastructure sectors;

(v) Permitting the Small Industries Development Bank (SIDBI) as an eligible borrower for accessing ECB for on-lending to the micro, small and medium enterprises (MSMEs); and

(vi) Permitting the National Housing Bank (NHB)/Housing Finance Companies to avail themselves of ECBs for financing prospective owners of low cost /affordable housing units.

RGESS

On *November 23, 2012*, the government notified a new tax saving scheme called the Rajiv Gandhi Equity Savings Scheme (RGESS), ***exclusively for first-time retail investors*** in the securities market. This scheme provides 50 per cent deduction of the amount invested from taxable income for that year to new investors who invest up to Rs. 50,000 and whose annual income is below Rs. 10 lakh.The Rajiv Gandhi Equity Saving Scheme (RGESS) will give tax benefits to new investors whose annual income is up to Rs. 10 lakh for investments up to a maximum of Rs. 50,000. The investor will get 50 per cent deduction of the amount invested from taxable income for that year. Salient features of the scheme are as follows :

(i) The scheme is open to new retail investors identified on the basis of their permanent account numbers (PAN).

(ii) The tax deduction allowed will be over and above the Rs. 1 lakh limit permitted allowed under Section 80 C of the IncomeTax Act.

(iii) In addition to the 50 per cent tax deduction for investments, dividend income is also tax free.

(iv) Stocks listed under BSE 100 or CNX 100, or stocks of public-sector undertakings (PSUs) that are Navratnas, Maharatnas, and Miniratnas will be eligible under the scheme. Follow-on public offers (FPOs) of these companies will also be eligible.

(v) IPOs of PSUs, which are scheduled to get listed in the relevant financial year and whose annual turnover is not less than Rs. 4,000 crore for each of the immediate past three years, will also be eligible.

(vi) Exchange-traded funds (ETFs) and MFs that have RGESS-eligible securities have also been brought under the RGESS.

(vii) To benefit small investors, investments are allowed in instalments in the year in which tax claims are made.

(viii) The total lock-in period for investments will be three years including an initial blanket lock-in of one year. After the first year, investors will be allowed to trade in the securities.

The broad provisions of the scheme and the income tax benefits under it have already been incorporated as a new *Section-80CCG* of the Income Tax Act 1961, as amended by the Finance Act 2012. The operational guidelines were issued by SEBI on *December 6, 2012*.

CREDIT DEFAULT SWAP (CDS)

CDS is in operation in India since October 2011 – launched in only corporate bonds. The eligible participants are commercial banks, primary dealers, NBFCs, insurance companies and mutual funds.

CDS is a credit derivative transaction in which two parties enter into an agreement, whereby one party (called as the 'protection buyer') pays the other party (called as the 'protection seller') periodic payments for the specified life of the agreement. The protection seller makes no payment unless a credit event relating to a pre-determined reference asset occurs. If such an event occurs, it triggers the Protection Seller's settlement obligation, which can be either cash or physical (India follows physical settlement). It means, ***CDS is a credit derivative that can be used to transfer credit risk from the investor exposed to the risk*** (called protection buyer) ***to an investor willing to take risk*** (called protection seller).

It operates like an insurance policy. In an insurance policy, the insurance firm pays the loss amount to the insured party. Similarly, the buyer of the CDS—the bank or institution that has invested in a corporate bond issue—seeks to mitigate the losses it may suffer on account of a default by the bond issuer. Credit default swaps allow one party to 'buy' protection from another party for losses that might be incurred as a result of default by a specified reference instrument (a bond issue in India). The 'buyer' of protection pays a premium to the seller, and the 'seller' of protection agrees to compensate the buyer for losses incurred upon the occurrence of any one of the several specified 'credit events'. *Thus CDS offers the buyer a chance to transfer the credit risk of financial assets to the seller without actually transferring ownership of the assets themselves.*

Let us try to understand it by an example. Suppose Punjab National Bank (PNB) invests in Rs. 150 crore bond issued by TISCO. If PNB wishes to *hedge* losses that may arise from a default of TISCO, then PNB may buy a credit default swap from a financial institute, suppose, Templeton. PNB will pay fixed periodic payments to Templeton, in exchange for default protection (just like premium of an insurance policy).

CDS can be *used for different purposes* in a financial system, viz.,

(i) Protection buyers can use it to hedge their credit exposure while protection sellers can use it to participate in credit markets, without actually owning assets.

(ii) The protection buyer can transfer credit risk on an entity without transferring the under lying instrument, reap regular benefit in terms of lower capital charge, seek reduction of specific concentrations in credit portfolio and go short on credit risk.

(iii) The protection seller will be able to diversify his portfolio, create exposure to a particular credit, have access to an asset which may not otherwise be available, and increase the yield on his portfolio.

(iv) Banks can use it to transfer risk to other risk takers, create capital for more lending.

(v) Distribute risk widely throughout the system and prevent concentrations of risk.

Some analysts have serious **apprehensions** about CDS. *George Akerlof*, Nobel prize-winning economist, in 1993, predicted that the next meltdown will be caused by CDS. In 2003 investment legend *Warren Buffet* called them as 'weapons of mass destruction'. The former US Federal Reserve Chairman *Alan Greenspan*, who betted big on CDS said after the 'sub prime' crisis that 'CDS are dangerous'. A leading US weekly the *Newsweek* described CDS, 'the monster that ate Wall Street'. Many Indian experts had the opinion that 'CDS will not stabilise the economy rather could lead to destabilisation'.

CDS contract are dangerous because they can be manipulated for mischief. It's all about the insurable interest which is never there as it is used for *speculation*. A derivative that amounts to an insurance contract with no insurable interest is bad. But do the speculators have insurable interest? No they don't have any. The US 'sub prime' crisis was a fallout of such CDS contracts—one defaulting and another claiming the 'protection' finally resulting into the defaulter of the insuring company—overnight the biggest US insurance giant, AIG went bankrupt. So happened with many US banks also.

The most damaging aspect of CDS is that the credit risk of one country/region gets exported to another country/region very smoothly and silently – thus there is a serious chance of 'contagion effect' suppose there are defaulters there – the thing which happened during the US 'sub prime' crisis.

SECURITISATION

This is the process of issuing 'marketable securities' backed by a pool of existing assets such as auto or home loans. After an asset is converted into a marketable security, it is sold to an investor who then receives interest and principal out of the cash flow generated from servicing of the loan. Financial institutions such as NBFCs and microfinance companies convert their loans into marketable securities and sell them to investors. This helps them get liquid cash out of assets that otherwise would be stuck on their balance sheets.

Global experience shows that if the value of the underlying asset falls then securitised assets lose value as it had happened during the US 'sub-prime crisis'—home loans against which securitised assets were sold to insurance companies and banks lost value, which in turn resulted in a crisis. To prevent such crises, the RBI has taken some precautionary steps in this regard. It has asked companies to hold securities for a certain minimum period:

(i) While NBFCs need to keep assets for six months, a minimum retention requirement of 5–10 per cent to ensure that they have a continuing stake in the performance of securitised assets.

(ii) Micro Finance Institutions (MFIs) need to hold them for three months.

Since it was allowed in India by the RBI, it has been in news – whether the 'securitisations trusts' will need to pay tax on it. Meanwhile, the *Union Budget 2013–14* has cleared the air on the issue. There should not be any additional income-tax if the income distributed by the trust is received by a person who is exempted from tax. This is expected to bring back mutual funds into the securitisation market.

CORPORATE BOND IN INDIA

Economic vibrancy coupled with sophisticated state–of–the–art financial infrastructure has contributed to rapid growth in the equity market in India. In terms of market features and depth, the Indian equity market ranks among the best in the world. In parallel, the government securities market has also evolved over the years and expanded, given the increasing borrowing requirements of the government. In contrast, the corporate bond market has languished both in terms of market participation and structure. NBCs are the main issuers and very small amounts of finance are raised by companies directly. The ***Economic Survey 2010–11*** (p. 116), cites many reasons for the less-developed bond market in India—

(i) Predominance of banks loans;

(ii) FII's participation is limited;

(iii) Pensions and insurance companies and household are limited participants because of lack of investor confidence; and

(iv) Crowding out by government bonds.

The ***Economic Survey 2011–12*** concluded[15] that there is now ample empirical research to corroborate Schumpeter's conjecture that financial

15. **Economic Survey 2011-12** (p.34) quotes many contemporary references to bring the point home –
a). R. Rajan, and L. Zingales (1998), 'Financial Dependence and Growth,' *American Economic Review*, vol. 88; **b).** S. Banerji, K. Gangopadhyay, I. Patnaik, and A, Shah (2012), 'New Thinking on Corporate Debt in India', mimeo.; **c).** C. K. G. Nair, (2012) 'Financial Sector Reforms: Refining the Architecture,' in R. Malhotra (ed.), *A Critical Decade: Policies for India's Development,* Oxford University Press, New Delhi; **d).** T. A. Bhavani, and N. R. Bhanumurthy (2012), *Financial Access in Post-Reform India,* Oxford University Press, New Delhi, Chapter 12; **e).** P. Bolton, and X. Freixas, 'How can Emerging Market Economies Benefit from a Corporate Bond Market?', in E. Borzenstein, K. Cowan, B. Eichengreen, and U. Panizza,(eds) (2008), *Bond Markets in Latin America*, MIT Press.

development facilitates real economic growth. The depth of the financial markets and availability of diverse products should, therefore, not be treated as mere adornment, but as critical ingredients of inclusive growth.

Banks in India accounted for 14.4 per cent of the financing of large firms in 2000–01, which rose further to 17.8 per cent in 2010–11. The *bond market*, on the other hand, has been miniscule in comparison. The thinness of the bond market has been somewhat compensated by foreign borrowing done by Indians, which rose sharply over the last decade. Further, India is characterised by a disproportionate amount of secured borrowing. The small size of unsecured borrowing may, at first sight, not seem to be a matter of concern, but it could be a reflection of the weakness of contract enforcement and lack of adequate information. If contracts were quickly enforced and lenders had information on borrowers, they would be more willing to give unsecured loans. This would give a nimbleness to the financial markets which they presently lack.

There are ***many reasons*** why bond markets are important for an emerging economy. Prominent among these is the fact that they lead to more efficient entrepreneurship and greater value creation. When an entrepreneur takes a loan or issues bonds, all additional profit over and above the pre-fixed repayment amount accrues to the entrepreneur. So he or she is better incentivised to take sharper decisions. By having a weak bond market, we may be foregoing this efficiency. And further, this efficiency gap may well mean that there is less lending and hence less investment and entrepreneurship in the economy than is feasible. Further, as India tries to garner 500 billion dollars from the private sector in the Twelfth Plan for investment in the infrastructure sector, having an active bond market would be a valuable avenue for raising money.

There can be many reasons why, despite these advantages, the bond market has not developed adequately. One reason has to do with what economists call 'multiple equilibria'. Consider a situation where the bond market is small. If someone buys bonds and later wish to sell these off, he anticipates difficulty. Since the bond market is not active, he may not easily be able to sell the bonds and thus he will hold simply because he cannot find a buyer. Hence, this may lead to discourage someone from buying the bonds in the first place. If everybody reasons like this, the bond market remains thin. Hence, the need is for a push that nudges the market to another equilibrium, where people readily buy bonds because they know that they can easily sell these off and this becomes a self-fulfilling prophesy and sustains the large bond market.

There is effort currently on to try to boost India's debt and bond markets, and success in this can give another fillip to growth. With the intervention of the ***Patil Committee*** recommendations, the corporate bond market is slowly evolving. With bank finance drying up for long term infrastructure projects, in view of asset liability problems faced by the banking system, the need for further development of a deep and vibrant corporate bond market can hardly be overemphasised. Recent initiatives for further development of corporate bond markets, taken in the year ***2012–13*** are as given below :

(i) Banks allowed to take limited membership in SEBI-approved stock exchanges for the purpose of undertaking proprietary transactions in the corporate bond markets.

(ii) To enhance liquidity in the corporate bond markets, the IRDA has permitted insurance companies to participate in the repo market. The IRDA has also permitted insurance companies to become users of *'credit default swap'* (CDS).

(iii) The minimum **haircut**[16] (i.e., the difference between prices at which a market maker can buy and sell a security) requirement in corporate debt repo have been reduced from the existing 10 per cent; 12 per cent; 15 per cent to 7.5 per cent; 8.5 per cent; 10 per cent for AAA/AA+/AA-rated corporate bonds.

(iv) MFs have been permitted to participate in CDS in corporate debt securities, as users.

(v) Revised guidelines on CDS for corporate bonds by the RBI provide that in addition to listed corporate bonds, CDS shall also be permitted on *unlisted* but rated corporate bonds even for issues other than infrastructure companies.

(vi) Users shall be allowed to **unwind**[17] their CDS-bought position with the original protection seller at a mutually agreeable or FIMMDA (Fixed Income Money Market and Derivatives Association of India) price. If no agreement is reached, then unwinding has to be done with the original protection seller at FIMMDA price.

(vii) CDS shall be permitted on securities with original maturity up to *one year* like CPs, certificates of deposit, and non-convertible debentures with original maturity less than one year.

Economic Survey 2012–13 comments: A reasonably well-developed corporate bond market is very much required in any economy to supplement banking credit and the equity market and to facilitate the long-term funding requirement of corporate sector as well as infrastructure development in the country. Though, the development of the corporate bond market has been an important area and has received greater policy attention in recent times, it is yet to take off in a significant manner. Some of the issues that ***need to be addressed*** in this regard include:

(i) Drawing up a roadmap for a structural shift from a *bank-dominated* financial system to a more diverse financial system where top-rated corporates access finance from capital markets;

(ii) Strengthening of the *legal framework* for regulation of corporate debt by necessary amendments in rules/regulations, and

(iii) Relaxation of investment *guidelines* for pension, provident, and insurance funds

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16. ***Haircut*** is the difference between prices at which a *market maker* can buy and sell a security. The term comes from the fact that market makers can trade at such a *thin spread*. It also means that the percentage by which an asset's market value is reduced for the purpose of calculating capital requirement, margin and collateral. When they are used as collateral, securities will generally be devalued since a cushion is required by the lending parties in case the market value falls.

17. ***Unwind*** is used to close out a position that has offsetting investments or the correction of an error. Unwinds occur when, for example, a broker mistakenly sells part of a position when an investor wanted to add to it. The broker would have to unwind the transaction by selling the erroneously purchased stock and buying the proper stock. One type of investing that features unwind trading is *arbitrage investing (as happens in the CDS)*. If, for the sake of illustration, an investor takes a long position in stocks, while at the same time selling puts on the same issue, he will need to unwind those trades at some point. Of course, this entails covering the options and selling the underlying stock. A similar process would be followed by a broker attempting to correct a buying or selling error.

to enable the participation of longterm investors in the corporate bond market.

Introduction of new products and making nascent products such as covered bonds, municipal bonds, credit default swaps, credit enhancements, and securitisation receipts more attractive may be considered for public issuance of bonds at reduced cost. Improving the market infrastructure for enabling liquidity, transparency in price discovery, and stimulating growth in trading volumes also need to be suitably addressed.

INFLATION-INDEXED BONDS

To protect the returns of investors from the vagaries of inflation, the Reserve Bank of India plans to introduce inflation-indexed bonds (IIBs)—it was proposed by the ***Union Budget 2013–14***. The government hopes this will help increase *financial savings instead of buying gold*. In the recent years, the rate of return on debt investments has often been below inflation, which effectively means that inflation was eroding savings. Inflation indexed bonds provide returns that are always in excess of inflation, ensuring that price rise does not erode the value of savings.

In 2013–14, RBI launched two such bonds —the first one in June 2013 linked with the WPI which had a very weak retail response and second one in *December 2013* linked with CPI. The latter one is called as **Inflation Indexed National Savings Securities-Cumulative (IINSS-C)** with a 10 years tenure. These are internationally known as *inflation-linked securities* or simply *linkers*. Interest rate on these securities would be linked to final combined consumer price index [CPI (Base: 2010=100)]. Interest rate would comprise two parts: fixed rate (1.5 per cent) and inflation rate, based on three-month lag to CPI – thus, if a bond is being valued in December, the reference rate will be CPI of September. The new offering should attract higher attention from savers, especially due to its link to CPI instead of wholesale price index (WPI), which is a less accurate gauge of inflation. CPI is considered a more accurate gauge of the impact of inflation on consumers because it takes into account increases in the cost of education, food, transportation, housing and medical care; in WPI, the emphasis is on measuring the prices of traded goods and services.

It was in 1997 that the IIBs were issued for the first time in India—named as the *Capital Indexed Bonds (CIBs)*. But there remains a difference between these two bonds. While the CIBs provided inflation protection only to principal the new product IIBs provides inflation protection to both the components—principal and interest payments.

GOLD EXCHNAGE TRADED FUNDS

Gold Exchange Traded Funds (ETFs) are *open-ended mutual fund schemes* that closely track the price of physical gold. Each unit represents *one gram* of gold having 0.995 purity, and the ETF is listed on stock exchanges. The net asset value of each unit is calculated based on the prices of physical gold prevailing on that day and is designed to provide returns that would closely track the returns from physical gold.

E-GOLD

e-Gold is another purchase option, involving investments in units traded on the National Stock Exchange (NSEL). Here, the investor is required to have a demat account with an affiliate of NSEL. e-Gold's brokerage and transaction charges are lower than *gold ETFs* as there are no fund management charges. One can take delivery of gold or sell it in the exchange.

But there is also a *negative point* here from the tax angle—under e-Gold, one has to hold the yellow metal for 36 months to enjoy *long-term capital gain* benefits, and this is taxed at 20 per cent. For ETFs (Exchange Traded Funds) and gold funds, the holding period to be classified as long-term is only one year. After a year, ETF and gold funds will suffer 10 per cent tax without indexation and 20 per cent after indexation. For a small investor, gold ETF would appear to be the best option, as it meets his needs without difficulties in terms of creating a separate demat account, tax implications and wealth tax.

CPSE ETF

The Central Public Sector Enterprises Exchange Traded Fund (CPSE ETF) comprising the shares of 10 blue chip PSUs was listed on the BSE and NSE platforms on April 4, 2014. The Government of India expected to raise a corpus of Rs. 3,000 crore through the fund while it got over-subscribed to the tune of Rs. 4,300 crores.

This scheme is conceived by the GoI as a means to *disinvest* a part of its holding in Public Sector Units (PSUs) and would be managed by ***Goldman Sachs Asset Management (India) Pvt. Ltd.***, a *mutual fund company* that specialises in managing exchange traded funds.

ETF is a security that tracks an index, a commodity or a basket of assets such as an index fund, but trades like a stock on an exchange – the CPSE ETF tracks the CPSE Index (of 10 PSUs included in the ETF). CPSE Index has been constructed by including companies that meet the following criteria:

(i) Owned 55 per cent or more by the GoI and listed on the NSE;

(ii) Large PSUs (those having more than Rs.1,000 crores as average free float market capitalisation for six months period ending June 2013); and

(iii) With a consistent dividend payment record (at least 4 per cent for 7 years immediately prior to or 7 out of 8/9 years immediately prior to June 2013).

The ten blue-chip PSUs which meet the above criteria and their weightages are: ONGC (26.72 per cent); GAIL (India) (18.48 per cent); Coal India (17.75 per cent); REC (7.16 per cent); Oil India (7.04 per cent); IOC (6.82 per cent); Power Finance Corp. (6.49 per cent); Container Corp. (6.40 per cent); Bharat Electronics (2 per cent) and Engineers India Ltd. (1.13 per cent).

CPSE ETF will invest the corpus in the above-given companies as per the given weightage. Hence, subject to the tracking error and expenses, CPSE ETF's returns will closely correspond to the CPSE Index returns.

ETFs were introduced in India in 2001. At present (by **May 2014**), there are about 33 ETFs with assets under management of close to Rs. 11,500 crore held by 6.20 lakh investors. *Gold ETFs* dominate the market in India.

PENSION SECTOR REFORMS

Pension has been the integral part of government jobs in India. Pension serves two important socio-economic objectives—

(i) It facilitates the flow of long-term savings for development, i.e., *nation-building*; and

(ii) Also helps establish a credible and sustainable *social security system* in the country.

The New Pension System (NPS) was introduced for the new recruits who join government service on or after ***January 1, 2004***. Although the NPS is perhaps one of the cheapest financial products available in the country, in order to make it affordable for the economically disadvantaged, the government in September 2010 introduced a lower cost version, known as ***Swavalamban Scheme***, which enables groups of people to join the NPS at a substantially reduced cost. As per existing scheme under NPS, Swavalamban could be availed either in 'unorganised sector' or in ***'NPS Lite'***. NPS Lite is a model specifically designed to bring NPS within easy reach of the economically disadvantaged sections of the society —it is extremely affordable and viable due to its optimised functionalities, available at reduced charges. Under the Swavalamban scheme, the government provides subsidy to each NPS account holder and the scheme has been extended until 2016–17.

A customised version of the core NPS model, known as the *NPS Corporate Sector Model* was also introduced from December 2011 to enable 'organised-sector' entities to move their existing and prospective employees to the NPS under its Corporate Model. All pubic sector banks have been asked to provide a link on their website to enable individual subscribers to open online NPS accounts.

As per the ***Economic Survey 2012–13,*** the pension reforms in India have generated widespread interest internationally but before universal inclusion of poorer sections of Indian society into the pension network is a reality, the economy needs to solve the following *major challenges* :

(i) Lower levels of financial literacy, particularly among workers in the unorganised sector;

(ii) Non-availability of even moderate surplus;

(iii) Lukewarm response so far from most of the state/UT governments to a co-contributory Swavalamban Scheme; and

(iv) Lack of awareness, on the supply side, about the NPS and of access points for people to open their accounts individually have been major inhibiting factors.

Financial Stability and Development Council (FSDC)

An apex level Financial Stability and Development Council (FSDC) was set up by the GoI in December 2010, 'in line with the G-20 initiatives' with the following ***objectives***:

(i) To strengthen and institutionalise the mechanism for maintaining financial stability,

(ii) To enhance inter-regulatory coordination, and

(iii) to promote financial-sector development.

The council is *chaired* by the Finance Minister and has *heads* of financial-sector regulatory authorities, the Finance Secretary and/or Secretary of the Department of Economic Affairs, Secretary of the Department of Financial Services, and the Chief Economic Adviser as members. Without prejudice to the autonomy of regulators, the Council ***monitors***—

(i) macro-prudential supervision of the economy, including functioning of large financial conglomerates,

(ii) inter-regulatory coordination and financial-sector development issues, and

(iii) *financial literacy* and *financial inclusion*.

FINANCIAL SECTOR ASSESSMENT PROGRAMME (FSAP)

The *IMF Board* decided in September 2010, to include 25 *systemically* important economies, including India, under the Financial Stability Assessment Programme (FSAP) for members with systemically important financial sectors. The joint IMF-World Bank Financial Stability Assessment Programme (FSAP) was conducted for India in *January 2013* which assessed Indian financial system in relation to the highest international standards. The **assessment** recognises that the Indian financial system remained *largely stable* on account of a sound regulatory and supervisory regime. However, the assessment identifies *some gaps* in[18]—

(i) International and domestic supervisory information sharing and co-operation;
(ii) Consolidated supervision of financial conglomerates; and
(iii) Some limits on the *de jure* independence of the regulators (RBI and IRDA).

Despite having reservations on few issues, overall the Indian authorities expect the FSAP exercise to play a *significant role* in shaping India's post-crisis initiatives to strengthen the regulatory and supervisory architecture based on the evolving international consensus as well as careful examination of their relevance in the India-specific context. As a member of the FSB[19], BCBS[20] and IMF[21], India is actively participating in post-crisis reforms of the international regulatory and supervisory framework under the aegis of the **G20**. India remains committed to adoption of international standards and best practices, in a phased manner and calibrated to local conditions, wherever necessary, as it is a country characterised by complex and diverse socio-political and economic conditions.

Financial Stability and Development Council (FSDC)

As a follow-up to the announcement made in the Budget 2010–11, with the ***objective*** to strengthening and institutionalising the mechanism for maintaining financial stability and enhancing inter-regulatory coordination, an apex-level Financial Stability and Development Council under the Chairmanship of the Finance Minister has been set up.

A sub-committee of the FSDC has also been set up under the chairmanship of the Governor RBI. Under the aegis of the FSDC, two empowered Technical Groups (i.e., Technical Group on Financial Literacy and Financial Inclusion and Inter-Regulatory Technical Group) have been formed.

18. RBI, 16th January, 2013
19. The **FSB** was established in April 2009 as the successor to the Financial Stability Forum (FSF). The FSF was founded in 1999 by the G–7 for enhancing cooperation among the various national and international supervisory bodies and international financial institutions so as to promote stability in the international financial system. In November 2008, the leaders of the G–20 countries called for a larger membership of the FSF. As announced in the G–20 Leaders Summit of *April 2009*, the expanded FSF was re-established as the *Financial Stability Board (FSB)* with a broadened mandate to promote financial stability. The FSB is chaired by *Mark Carney*, Governor of the Bank of Canada. Its secretariat is located in Basel, Switzerland, and hosted by the Bank for International Settlements.

    Its ***objective*** is to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. [*Source*: Financial Stability Board Secretariat, Bank for International Settlements, Basel , Switzerland].
20. The **BCBS** (Basel Committee on Banking Supervision) provides a forum for regular cooperation on banking supervisory matters. The Committee's members, today, come from 27 nations including India. The present Chairman of the Committee is *Stefan Ingves*, Governor of Sveriges Riksbank. It is located at the Bank for International Settlements (BIS) in Basel, Switzerland.

    Its ***objective*** is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. At times, the Committee uses this common understanding to develop guidelines and supervisory standards in areas where they are considered desirable. In this regard, the Committee is ***best known*** for its international standards on ***Capital Adequacy*** *(i.e Basel I, Basel II and Basel III, by now)*; the ***Core Principles for Effective Banking Supervision***; and the ***Concordat*** on cross-border banking supervision.

    The *Committee* encourages contacts and cooperation among its members and other banking supervisory authorities. It circulates to supervisors throughout the world both published and unpublished papers providing guidance on banking supervisory matters. Contacts have been further strengthened by an *International Conference of Banking Supervisors (ICBS)* which takes place every two years. [*Source*: BIS, Basel, Switzerlad].
21. See **Chapter 16** for detailed discussion on the **IMF** (International Monetary Fund).

FINANCIAL SECTOR LEGISLATIVE REFORMS COMMISSION (FSLRC)

Fulfilling the announcement of the Budget of 2010–11, to ***rewrite*** and ***harmonise*** financial sector legislations, rules and regulations the GoI constituted the FSLRC under the chairmanship of Justice (Retd.) B. N. Srikrishna in March 2011 (tenure is 2 years). This had become necessary as the institutional framework governing India's financial sector was built over a century.

There are over 60 Acts and multiple Rules/ Regulations in the sector and many of them are decades old, when the financial landscape was very different from what it is obtaining today. Large number of amendments made in in these Acts over time has increased the *ambiguity* and *complexity* of the system.

The commission would simplify and re-write financial sector legislations, including subordinate legislations, to bring them in line with the requirements of the sector to achieve harmony and synergy among them, making them more coherent and dynamic and help cater to the requirements of a large and fast growing economy in tune with the changing financial landscape in an inter-connected financial world. In the long-term, it would help usher in the *next generation of reforms,* contribute to efficient financial intermediation enhancing the growth potential of the nation. The commission handed over its report end-March 2013 (see *Chapter 11* sub-topic 'Financial Regulators').

FINANCIAL ACTION TASK FORCE (FATF)

The FATF is an inter-governmental policy making body that has a ministerial mandate to establish international standards for combating *money laundering* and *terrorist financing. India joined the FATF as its 34th member in June 2010. At present, the FATF has 36 members comprising 34 countries and two organisations (European Union and Gulf Cooperation Council).*

REAL ESTATE & INFRASTRUCTURE INVESTEMNT TRUSTS

The SEBI firmed up regulations that will govern Real Estate Investment Trusts (REITs), and the Infrastructure Investment Trusts (InvITs).[22] The long-pending proposal of 2008, the trusts have the **objective** of enabling the cash-strapped real estate and infrastruture developers to have easy access to funds. They create a new investment avenue for institutions and high net worth individuals, and eventually ordinary investors.

REITs

Major provisions announced by the SEBI for the REITs are as given below:

(i) To be close-ended real estate investment schemes that will invest in property with the aim of providing returns to unit holders.

(ii) The returns will be derived mainly from rental income or capital gains from real estate.

(iii) Allowed to invest in commercial real estate assets, either directly or through special purpose vehicles (SPVs). In SPVs, a REIT must have a controlling interest of at least 50 per cent of the share capital and will have to hold at least

22. **SEBI Press Release**, September 26, 2014.

80 per cent of their assets directly in properties.

(iv) To raise funds only through an initial offering and units of REITs have to be mandatorily listed on a stock exchange, similar to initial public offering (IPO) and listing for equity shares.

(v) Required to have assets worth at least Rs.500 crore at the time of an initial offer and the minimum issue size has to be Rs.250 crore. The minimum subscription size for units of a REIT on offer will be Rs.2 lakh and at least 25 per cent of the units have to be offered to the public.

(vi) Will be able to raise money through follow-on offers, rights issues or qualified institutional placements and the trading lot for such units will be Rs.1 lakh.

According to the norms, although a REIT may raise funds from any type of investors, resident or foreign, initially only wealthy individuals and institutions will be allowed to subscribe to REIT unit offers. The market regulator said a REIT may have up to three sponsors, with each holding at least 5 per cent and collectively holding at least 25 per cent for a period of at least three years from the date of listing. Subsequently, the sponsors' combined holding has to be at least 15 per cent throughout the life of the REIT.

Similar to the practice in the US, Australia, Singapore and other nations where REITs are common, Sebi has decided to allow these trusts to invest primarily in completed revenue-generating properties. To ensure that REITs generate continuous returns, Sebi said at least 80 per cent of the REIT's assets has to be invested in completed and revenue generating properties. And only up to 20 per cent of assets can be invested in properties that are being developed, mortgage-backed securities, debt of companies in the real estate sector, equity shares of listed companies that derive at least 75 per cent of their income from real estate, government securities, or money market instruments. No REIT can invest more than 10 per cent in properties that are under construction.

InvITs

The SEBI also announced the launch of **InvITs** which are *somewhat similar* to REITs. However, an initial offer will not be mandatory for InvITs though listing will be mandatory for both publicly and privately placed InvITs. *Major provisions* are as given below:

(i) It can invest in infrastructure projects, either directly or through an SPV (Specila Purpose vehicle). In case of public-private-partnership (PPP) projects, such investments will be only through an SPV.

(ii) While listing, the collective holding of sponsors of an InvIT has to be at least 25 per cent for at least three years.

(iii) Required to have a holding worth at least Rs.500 crore in the underlying assets, and the initial offer size of the InvIT has to be at least Rs.250 crore.

(iv) Any InvIT, which looks to invest at least 80 per cent of its assets in completed and revenue generating infrastructure assets, has to raise funds only through a public issue of units, with a minimum 25 per cent public float and at least 20 investors.

(v) The minimum subscription size and trading lot of such a listed InvIT has to be Rs.10 lakh and Rs.5 lakh, respectively. A publicly offered InvIT may invest the remaining 20 per cent in under-construction infrastructure projects and other permissible investments.

An InvIT that proposes to invest more than 10 per cent of its assets in under-construction infrastructure projects can raise funds only through private placement from qualified institutional buyers with a minimum investment and trading lot of Rs.1 crore and from at least five investors, where single holding cannot be more than 25 per cent.

The *Union Budget 2014–15* promised a friendlier tax norms for the *REITs* and *InvTs*. These are yet to be announced by the government.