REVISIONARY TEST PAPER

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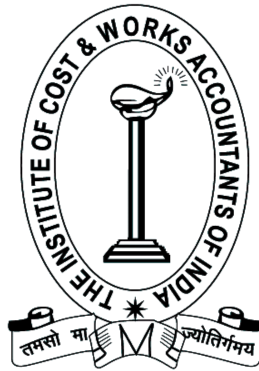
GROUP III



DIRECTORATE OF STUDIES

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GROUP - III

Paper-11 : CAPITAL MARKET ANALYSIS & CORPORATE LAWS

FINAL EXAMINATION

(REVISED SYLLABUS - 2008)

GROUP - III

Paper-11 : CAPITAL MARKET ANALYSIS & CORPORATE LAWS

Section I : Capital Market Analysis

Q. 1. (a) Fill up the blanks with appropriate answers :

(i) The external factor that affects the industry as a whole is termed as _____________ risk, in capital market analysis.

(ii) The entire pre-issue share capital, other than locked in as promoter's contribution, shall be locked-in for a period of _____________ .

(iii) Every recognized stock exchange is required to furnish to _____________ with a copy of the Annual report with prescribed particulars as per the requirements of the Securities Contracts (Regulation) Act, 1956.e-mail, Communication.

(iv) SBTS stands for _____________ .

(v) The Cyber Law of India is contained in _____________ Act _____________ .

(vi) In the context of Capital Adequacy Ratio (CAR) of banks, Tier II Capital _____________ be more than Tier-I Capital.

(vii) _____________ is regarded as the father of modern portfolio theory.

(viii) For liquid securities, the VaR margins are based on the _____________ of the security.

(ix) The trading members can participate in the Exchange initiated auctions by entering orders as a _____________ .

(x) Fixed Deposit Receipts (FDRs) issued by approved banks can be submitted as an _____________ to NSCCL by trading members.

Answer 1. (a)

(i) Systematic
(ii) One year
(iii) SEBI
(iv) Screen Based Trading System
(v) Information Technology Act, 2000
(vi) Can not
(vii) Hary Markowiz
(viii) Volatility
(ix) Solicitor
(x) Additional Base Capital

Q. 1. (b)

(i) The stock of ABB Ltd. (Face Value Rs 10.00) quotes Rs 520.00 on NSE and the 3 months future price quotes at Rs 532. The borrowing rate is given as 15% p.a. What would be the theoretical price of 3 month ABB future if the expected annual dividend yield is 25% p.a. payable before expiry?

A. Rs 540.00

B. Rs 539.00

C. Rs 537.00

D. Insufficient data

(ii) Ms. Rathore can earn a return of 20% by investing in equity shares on her own. Now she is considering a recently announced Equity based mutual fund scheme in which initial expenses and annual recurring expenses are 5 per cent and 1.5 per cent respectively. How much should the mutual fund earn to provide Mrs. Rathore, a return of 20%?

A. 18.43%

B. 22.55%

C. 21.50%

D. Insufficient data.

(iii) The Beta co-efficient of equity stock of Loyalty Ltd. is 1.6. The risk free rate of return is 12% and the required rate of return is 18% on the market portfolio. If the dividend expected during the coming year is Rs 2.50 and the growth rate of dividend and earnings is 8%, at what price the stock of Loyalty Ltd. can be sold (based on CAPM)?

A. Rs 18.38

B. Rs 15.60

C. Rs 12.50

(iv) Mr. Sanyal purchased 100 shares of NITCO Ltd. Futures @ Rs 2500 on 10th June . Expiry date is 26 th of June. His total investment was Rs 2,50,000 and the initial margin paid was Rs 37,500. On 26th of June shares of NITCO Ltd. was closed at Rs 2000. How much will be the gain / loss on the shares?

A. Rs 25,000

B. Rs 50,000

C. Rs 35,000

D. None of the above.

(v) The NAV of each unit of a closed –end fund at the beginning of the year was Rs 15. By the year end, its NAV equals Rs 15.40. At the beginning of the year, each unit was selling at a 3% premium to NAV. By the end of the year, each unit is selling at a 5% discount to NAV. The fund paid year end distribution of Income and Capital gains of Rs 2.40 on each unit. The rate to return to the investor in the fund during the year is;

A. 9.861%

B. 10.226%

C. 11.512%

D. 11.916%

(vi) Eureka Ltd. has both European call and put options traded on NSE. Both options have an expiration date 6 months and exercise price of Rs 30. The call and put are currently selling for Rs 10 and Rs 4 respectively. If the risk-free rate of interest is 6% p.a., what would be the stock price of Eureka Ltd? [Given PVIF (6%, 0.5 Years = 0.9709]

A. Rs 35.13

B. Rs 40.87

C. Rs 45.50

D. Incomparable information

(vii) Stock W has an expected return of 18% and a standard deviation of 30%. Stock X has an expected return of 12% and a standard deviation of 36%. The correlation between the two stocks is 0.25. If a portfolio is formed, where anyone puts 40% of the money in stock W and 60% in X, what is the standard deviation for the portfolio?

A. 27.206%

B. 25.416%

C. 23.312%

D. 28.913%

(viii) Voltas Ltd. has a beta of 0.865. If the expected market return is 17.50 and the risk free rate of return is 8.50%, what is the appropriate required rate of return of the co.? (use the CAPM)

A. 16.825%

B. 16.582%

C. 16.285%

D. 16.258%

(ix) Berger Paints Ltd. issued right shares that increased the market value of the shares of the company by Rs 160 crore. The existing Base year average (old base year Avg.) is Rs 900 crore. If the aggregate market value of all the shares included in the index before the right issue is Rs 1,800 crore, the new Base year average will be;

A. Rs 782.50 crore

B. Rs 980.00 crore

C. Rs 911.17 crore

D. None of the above.

(x) Mr. Sinha is considering the purchase of a stock that has a beta coefficient of 0.75. He estimates the expected market return to be 0.12 while T-Bills yield 0.08. What rate should he expect and require on the stock according to the SML (Security Market Line)

A. 0.11

B. 0.12

C. 0.13

D. 0.14

Answer 1. (b)

(i) **C.** Rs 537.00

Theoritical price of 3 month ABB Ltd. Future is;

Spot + Cost of Carry – Dividend

= 520 + 520 × 0.15 × 0.25 – 2.50 (25% of FV Rs 10)

= 520 + 19.50 – 2.50

= Rs 537.

(ii) **B.** 22.55%

R_2 = [1/1 – Initial Expenses (%) R_1] + Recurring Expenses (%)

Where R_2 = Mutual Fund earnings

R_1 = Personal earnings of Ms. Rathore

= [(1 / 1-0.05) × 20%] + 1.5%

= 0.2150 + 0.015

= 22.55%.

(iii) **A.** Rs 18.38

Expected rate of return: (By applying CAPM)

$R_e = R_f + ß_i (R_m – R_f)$

= 12% + 1.6 (18% –12%)

= 12% + 9.6%

= 21.6%

Price of Stock; (with the use of dividend growth model formulae)

$R_e = D_1 / P_0 = g$

0.216 = 2.50 / P_0 + 0.08

So, P_0 = 2.50 / (0.216 – 0.08)

= 2.50 / 0.136

= Rs 18.38.

(iv) **B.** Rs 50,000

Loss to Mr. Sanyal (2500 – 2000) × 100 = Rs 50,000.

(v) **B.** 10.226%

The price of unit at the beginning of the year is ;15 × 1.03 = Rs 15.45

The price of the unit at the end of the year is ;

Rs 15.40 × 0.95 = 14.63

The price of the fund fell by; (14.63 – 15.45) = – 0.82

Rate of return (2.40 – 0.82) / 15.45 = 10.226%.

(vi) **A.** Rs 35.13

According to call- put parity;

$C_0 = P_0 + S_0 – PV(E)$

Where C= 10, P=4and PV(E) = PV of E;

$C_0 = P_0 + S_0 – PV(E)$

Where C= 10, P = 4and PV(E) = PV of Exercise Price

Putting the values, we get;

10 = 4 + S_0 – 30 × 0.9709,

S_0 = 10-4+29.127

= 35.127 or Rs 35.13.

(vii) **A.** 27.206%

$S_p^2 = 0.4^2 \times 0.3^2 + 0.6^2 \times 0.36^2 + 2 \times 0.4 \times 0.6 \times 0.3 \times 0.36 \times 0.25$

$= 0.0740$

$S_p = \sqrt{(0.0740)^{\frac{1}{2}}} = 27.206\%.$

(viii) **C.** 16.285%

Required rate of return;

= 8.50% + (17.5% – 8.5%) × 0.865

= 8.50% + 9.0% × 0.865

= 8.50% + 7.785%

= 16.285%.

(ix) **B**. Rs 980.00 crore

New Base year Average;

Old Base year Average × (New Market Value / Old Market Value)

= 900 × (1800 +160) / 1800

= 17,64,000 / 1800

= Rs 980 crore.

(x) **A.** 0.11

E (R) = 0.08 + 0.75 (0.12 – 0.08)

= 0.11.

Q. 2. Write Short notes on the following :

(a) Green Shoe Option
(b) Qualified Institutional Buyers (QIB)
(c) Stock invest
(d) Certificate of deposit
(e) Fringe Market
(f) Elliot Wave Principle
(g) Credit Wrapping
(h) Stale Prices

Answer 2. (a)

Green Shoe Option — Green shoe option denote an option of allocating shares in excess of the shares included in the public issue. It is an option that allows the underwriting of an IPO to sell additional shares if the demand is high. It can be understood as an option that allows the underwriter for a new issue to buy and resell additional shares up to a certain pre-determined quantity. Lo0king to the exceptional interest of investors in terms of over subscription of the issue, certain provisions are made to issue additional shares or bonds to underwriters for distribution. The issuer authorizes for additional shares or bonds. In common parlance, it is retention of over subscription to a certain extent. It is a special feature of EURO issues. In the Indian context, Green shoe option has a limited connotation. In the SEBI guidelines governing public issue, certain appropriate provisions for accepting over-subscription subject to a ceiling, say 15% of the offer made to public is provided. In certain cases, the Green shoe option can be even more than 15%. The Green shoe option facility would bring in price stability of initial public offering.

Answer 2. (b)

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

- Public Financial Institution as defined in section 4A of the Companies Act of 1956,
- Scheduled Commercial Banks,
- Mutual Funds,
- Foreign Institutional Investors registered with SEBI,
- Multilateral and Bilateral Development Financial Institutions,
- Venture Capital Funds registered with SEBI,
- State Industrial Development Corporations,
- Insurance Companies registered with the Insurance Regulatory and Development Authority (IRDA),
- Provident Funds with minimum corpus of Rs 25 crores,
- Pension Funds with minimum corpus of Rs 25 crores.

Answer 2. (c)

Stock invest — In case of over subscription of issue, there have been inordinate delay in refund of excess application money and large amounts of investors' funds remain locked up in companies for long periods affecting the liquidity of the investing public. To overcome the said problem a new instrument called 'stock invest' is introduced.

The stock invest is a non-negotiable bank instrument issued by the bank in different denominations. The investor who has a savings or current account with the bank will obtain the stock invest in required denominations and will have to enclose it with share / debenture application. On the face of the instrument provides for space for the investor to indicate the name of the issues, the number and amount of shares/ debentures applied for and the signature of the investor. The stock invests issued by the bank will be signed by it and the date of issue will also be indicated on the instruments. Simultaneously, with the issue of stock invest, the bank will mark a lien for the amounts of stock invest issued in the deposit account of the investor. On full or partial allotment of shares to the investor, the Registrar to issue will fill the columns of stock invest indicating the entitlement for allotment of shares / debentures, in terms of number, amount and application number and send it for clearing.

The investors' bank account would get debited only after the shares / debentures allotted. In respect of unsuccessful applicants, the funds continue to remain in their account and earn interest if the account is a savings or a term deposit. The excess application money of partly successful applicants also, will remain in their accounts.

There will be lien on the funds for a maximum of four months period. The stock invest is intended to be utilized only by the account holders and the stock invest should not be handed over to any third party for use. In case the cancelled / partly utilized stock invest is not received by the issuing branch on expiry of four months from the date of issue against an indemnity bond from the investor.

Answer 2. (d)

Certificate of deposit — Certificates of Deposit (CDs) is a negotiable money market instrument issued in dematerialized form or as a usuance Promissory Note, for funds deposited at a bank or other eligible financial institution for a specified time period. Guidelines for issue of CDs are presently governed by various directives issued by the Reserve Bank of India, as amended from time to time. CDs can be issued by ;

- scheduled commercial banks excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs); and
- select all-India Financial Institutions that have been permitted by RBI to raise short-term resources

within the umbrella limit fixed by RBI. Banks have the freedom to issue CDs depending on their requirements. An FI may issue CDs within the overall umbrella limit fixed by RBI, i.e., issue of CD together with other instruments viz., term money, term deposits, commercial papers and inter-corporate deposits should not exceed 100 per cent of its net owned funds, as per the latest audited balance sheet.

Answer 2. (e)

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

Answer 2. (f)

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

Answer 2. (g)

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

Answer 2. (h)

Stale Prices — Supposing, we look at the closing price of an index. It is reflecting the state of the stock market at 3:30 pm on NSE and say, an illiquid stock is in the index. The last traded price (LTP) of the stock might be an hour, or a day, or a week old! The index is supposed to show how the stock market perceives the future of the corporate sector at 3:30 pm. When an illiquid stock injects these 'stale prices' into the calculation of an index, it makes the index more stale. It reduces the accuracy with which the index reflects information.

Q. 3. (a) Enumerate the main features of Venture Capital Financing

(b) Using the Capital Asset Pricing Model (CAPM), estimate the appropriate required rate of return for the three stocks listed below. Risk-free rate is 6% and the expected rate of return for the market is 18 %.

Stock	***Beta***
Unitech Ltd.	**1.40**
Supertech Ltd.	**0.90**
Hitech Ltd.	**0.75**

Answer 3. (a)

Venture capital is long term risk capital to finance high technology project which involves risk but at the same time has strong potential for growth.

Some of the features of venture capital financing are :

(i) Venture capital is usually used in the form of equity participation. It may also take the form of convertible debt or long term loan.

(ii) Investment is made only in high risk but growth potential projects.

(iii) Venture capital is available only in high risk but high growth potential projects.

(iv) Venture capital joins the entrepreneurs as a co-promoter in project and shares the risk and rewards of the enterprise.

(v) There is continuous involvement in business after making an investment by the investor.

(vi) Once the venture has reached the full potential the venture capitalist disinvests his holdings either to the promoters or in the market.

(vii) Venture capital; is not just injection of money but also an input needed to set to the firm design its marketing strategy and organize and manage it.

(viii) Investment is usually made in small and medium scale enterprises.

Answer 3. (b)

Approximate rate of returns are:

Unitech Ltd.; 6% + 1.40 (18% – 6%) = 22.8%

Supertech Ltd.; 6% + 0.90 (18% – 6%) = 16.8%

Hitech Ltd.; 6% + 0.75 (18% – 6%) = 15%

Q. 4. (a) What are the principle weakness of Indian Stock Market?

(b) Sun Mutual Fund (an approved mutual fund) sponsored an open ended, equity oriented scheme "LT Opportunity Fund". There were three plans namely;

A-Dividend Reinvestment Plan

B-Bonus Plan

C-Growth Plan.

At the time of New Fund Offer on 1.4.1998, Mr. Hari, Mr. Saxena and Mrs. Rawat invested Rs 1,00,000 each and chosen Plan B, C and A respectively. The face value of the units was Rs 10 each. The detailed history of the fund is as follows:

Date	Dividend (%)	Bonus ratio	Net Asset	Value per	(F.V. Rs 10)
28.07.2002	20	—	30.70	31.40	33.42
31.03.2003	70	5:4	58.42	31.05	70.05
30.10.2006	40	—	42.18	25.02	56.15
15.01.2007	25	—	46.45	29.10	64.28
31.01.2007	—	1:3	42.18	20.05	60.12
24.02.2008	40	1:4	48.10	19.95	72.40
31.03.2008	—	—	53.75	22.98	82.07

On 31.03.2008 , all three investors redeemed all the balance units.

You are required to calculate the annual rate return for Mr. Hari, Mr. Saxena and Mrs. Rawat after taking into consideration the following information:

(i) Long term capital gain is exempt from Income-tax,

(ii) Short term capital gain is subject to 10% Income tax,

(iii) Security Transaction Tax @ 0.2% only on sale / redemption of units.

Ignore Education Cess and Service Tax

[You may use the formula $\frac{1}{(1+r)^n}$ for determining PVIF (at r -rate of return), n years]

Answer 4. (a)

The principle weakness of Indian Stock Market are enumerated below :

Scarcity of floating stock; Financial institutions, banks and insurance companies own 80% of the equity capital of the private sector,

Speculation; 85% of the transactions on the NSE and BSE are speculative in nature,

Price rigging; Evident in relatively unknown and low quality scripts causes short term fluctuations in theprice,

Insider trading; Obtaining market sensitive information to make money in the markets.

Answer 4. (b)

SUN MUTUAL FUND

Mrs. Rawat's Investment in Plan-A (Dividend Reinvestment)

Date	Particulars	No. of Unit	NAV (Rs)
01.04.98	Purchase for Rs 1,00,000	10,000.00	10.00
28.07.02	[Dividend @ 20% on (10000 × Rs 10)] / 30.70	651.47	30.70
		10,651.47	
31.03.03	[Dividend @ 70% on (10651.47 × Rs 10)] / 58.42	1,276.28	42.18
30.10.06	[Dividend @ 40% on (11927.47 × Rs 10)] / 42.18	11,927.75	
		1,131.13	42.18
		13,058.88	
15.01.07	[Dividend @ 25% on (13058.88 × Rs 10)] / 46.45	702.85	46.45
31.01.07	Balance Units	13,761.73	42.18
24.02.08	[Dividend @ 40% on (13761.73 × Rs 10)] / 48.10	1144.43	48.10
31.03.08	Balance Units	14,906.16	53.75

Redemption value : 14906.16 × Rs 53.75	Rs 801206.10
Less- Short term capital gain	Nil
	801206.10
Less-Security Transaction Tax (STT) @ 0.2%	1,602.41
Net Proceeds (Return)	799603.69

Calculation of Annual Rate of Return :

Rate of return = *n* years √{Total Return (Net proceeds) / Total initial investment} - 1

= $(799603.69 \div 100{,}000)^{1/10} - 1$

= 0.2311 OR 23.11%.

Q. 5. (a) What is Investor Protection Fund (IPF) at Stock Exchanges?

(b) The expected market return for the general market is 15.50 per cent, and the risk premium is 7.50 per cent. ABC, XYZ, RDX have betas of 0.75, 0.87 and 1.20 respectively. What are the appropriate required rates of return for these securities?

(c) The equity stock of Ranbaxy Ltd. is currently selling for Rs 30 per share. The dividend expected next year is Rs 2.00. The investors' required rate of return on this stock is 15 per cent. If the constant growth model applies to Ranbaxy Ltd., what is the expected growth rate?

Answer 5. (a)

Investor Protection Fund is the fund set up by the Stock Exchanges to meet the legitimate investment claims of the clients of the defaulting members that are not of speculative nature.

SEBI has prescribed guidelines for utilization of IPF at the Stock Exchanges. The Stock Exchanges have been permitted to fix suitable compensation limits, in consultation with the IPF / CPF Trust. It has been perceived that the amount of compensation available against a single claim of an investor arising out of default by a member broker of a Stock Exchange shall not be less than Rs 1 Lakh in case of major Stock Exchages viz; BSE and NSE and Rs 50,000 in case of other stock exchanges.

Answer 5. (b)

If the expected market return is 15.50 per cent and the risk premium is 7.50%, the riskless rate of return is 8.00% (15.50% – 7.50%).

Therefore **;**

ABC = 8.00% +(15.50% – 7.50%) × 0.75 = 14.00%

XYZ = 8.00% + (15.50% – 7.50%) × 0.87 = 14.96%

RDX = 8.00% + (15.50% – 7.50%) × 1.20 = 17.60%.

Answer 5. (c)

According to the constant growth model,

$P_0 = D_1 / r\text{-}g$,

This means, $g = r\text{-}(D_1 / P_0)$

Hence, the expected growth rate (g) for Ranbaxy Ltd. is;

g = 0.15 – (2.00 / 30.00)

= .083 or 8.3 per cent.

Q. 6. Stocks of TelcoLtd. and Tisco Ltd. have the following historical returns :

Year	***Telco Ltd's Return***	***Tisco Ltd's Return***
2000	**(10.00%)**	**(3.00%)**
2001	**18.50**	**21.29**
2002	**38.67**	**44.25**
2003	**14.33**	**3.67**
2004	**33.00**	**28.30**

(a) Calculate the average rate of return for each stock during the period 2000 to 2004. Assume that someone held a portfolio consisting of 50 percent of stock of Telco Ltd. and 50 percent of Stock of Tisco Ltd. What would have been the realized rate of return on the portfolio in each year from 2000 to 2004? What would have been the average return on the portfolio during this period?

(b) Now calculate the standard deviation of returns for each stock for the portfolio.

(c) Looking at the annual returns data on the two stocks, would you guess that the correlation coefficient between returns on the two stocks is closer to 0.9 or to – 0.9?

(d) If you added more stocks at random to the portfolio, which of the following is the most accurate statement of what would happen to σp?

(i) σ_p would remain constant.

(ii) σ_p would decline to somewhere in the vicinity of 21 per cent.

(iii) σ_p would decline to zero if enough stocks were included.

Answer 6. (a)

The average rate of return for each stock is calculated simply by averaging the returns over the 5-year period. The average return for each stock is 18.90 per cent, calculated for Stock of Telco Ltd. as follows;

R_{AVG} = (– 10.00% + 18.50% + 38.67% + 14.33% + 33.00%) /5

= 18.90%

The related rate of return on a portfolio made up of stock of Telco Ltd. and Stock of Tisco Ltd. would be calculated by finding the average return in each year as R_{AVG} (% of Stock of Telco Ltd.) + R $_{AVG}$(5 of Stock of Tisco Ltd.) and then averaging three yearly returns :

Year	Portfolio Telco Ltd. Return Tisco Ltd.
2000	(6.50%)
2001	19.90
2002	41.46
2003	9.00
2004	30.65
	R_{AVG} = 18.90%

Answer 6. (b)

The standard deviation of returns is estimated as follows :

For Telco Ltd., the estimated ó is 19.0 per cent :

$\sigma_{ABC} = \sqrt{}(-10.00–18.90)^2 + (18.50 – 18.90)^2 +\ldots\ldots\ldots.+ (33.00 – 18.90)^2 /5\text{-}1$

$= \sqrt{}1,445.92/4$

= 19.00%

The standard deviation of returns for Stocks of Telco Ltd. and for the portfolio are similarly determined and they are as follows :

	Telco Ltd.	Tisco Ltd.	Portfolio
Standard deviation	19.00	19.00	18.60

Answer 6. (c)

Because the risk reduction from diversification is small (σ_p) falls only from 19.00 to 18.60 per cent, the most likely value of the correlation coefficient is 0.9. If the correlation coefficient were -0.9, the risk reduction would be much larger. In fact, the correlation coefficient between stocks of Telco Ltd. & Tisco Ltd is 0.92.

Answer 6. (d)

If more randomly selected stocks were added to a portfolio, σ_p would decline to somewhere in the vicinity of 20 per cent. σ_p would remain constant only if the correlation coefficient were + 1.0, which is most unlikely. σ_p would decline to zero only if the correlation coefficient, r, were equal to zero and a large

number of stocks were added to the portfolio or if the proper proportions were held in a two-stocks portfolio with r = – 1.0.

Q. 7. (a) There are two portfolios L and M, known to be on the minimum various set for a population of three securities A,B and C. The weights for each portfolios are given below :

	WA	*WB*	*WC*
Portfolio L	**0.18**	**0.63**	**0.19**
Portfolio M	**0.24**	**0.60**	**0.16**

Ascertain the stock weights for a portfolio made up with investment of Rs 3000 in L AND Rs 2000 in M.

(b) Explain how a trader who has bought an option can exit the trade.

(c) What is a load fund? How are Net Asset Values, public offer price and redemption price calculated?

(d) Janak Constructions Ltd. had received an e-mail from Hiroshi Ltd. emanating from the company's official website, accepting the former's offer. Later on, Hiroshi Ltd. failed to fulfil their promise. Can Janak Construction Ltd. launch proceedings against Hiroshi Ltd. on the strength of the e-mail? What precaution should Janak Constructions Ltd. have taken in this regard?

Answer 7. (a)

It is given that Rs 3000 is invested in portfolio L and Rs 2000 in portfolio M the investment committed in each will be :

Particulars	**A**	**B**	**C**	**Total**
1	**2**	**3**	**4**	**5**
Portfolio L	540	1890	570	3000
Portfolio M	480	1200	320	2000
Combined Portfolio Stock weights for combined portfolio of earlier row	1020 Column 2/5	3090 Column 3/5	890 Column 4/5	5000
i.e	0.204	0.618	0.178	

Answer 7. (b)

Liquidating Option Positions :

When a trader buys an option, he can exit the trade in two ways :

- Sell the option and collect whatever the premium is – If the premium is more than what is initially cost plus commission, there's a profit. If the premium is less, it's a loss, but keeping some money is better than losing all the money.
- Exercise the option, covering it into a future position-The broker must be notified before options expire. Not all options have an automatic exercise provision. Therefore, an in-the-money option that expires without any action taken, loses the buyer money (a seller somewhere will be very happy). An option can be exercised if the trader feels the market will continue to move favourable to the trader's position or an option can be exercised if the trading in the option is not very liquid. The trader, in this case feels he can exercise and then liquidate the futures more economically than selling his option position.
- Ride the option into the dust- Let it expire worthless, especially if getting out will cost more than the premium is worth.

When a trader sells an option, he or she can exit the trade by buying the option back. If the premium is higher, the option seller has lost money. The option seller cannot exercise his or her option.

Answer 7. (c)

Load Fund : A Load Fund is one that charges from the investor a percentage of NAV for entry or exit. This means that, each time one buys or sells units in the fund, a charge will be payable. This charge is used by the mutual fund for marketing and distribution expenses.

Net Asset Value (NAV):

NAV is calculated as follows;

NAV = (Fair Market Value of scheme's investments + Receivables + Accrued Income + Other assets – Accrued expenses – Payable – Other liabilities) / Number of units outstanding

Calculation of Public Offer Price (POP):

Public Offer Price = Net Asset Value / 1-Front –End load

Calculation of Redemption price:

Redemption = Net Asset Value /1- Back-end Load.

Answer 7. (d)

The Information Technology Act, would come to the rescue of Janak Constructions Ltd.

Section 4 and 5 of the said Act may be referred to in this context. Section 4 accords legal recognition of electronic records. As per this section, where any law provides that information or any other matter shall be in writing or in the typewritten or printed form, then, notwithstanding anything contained in such law, such requirement shall be deemed to have been satisfied if such information or matter is;

(i) Rendered or made available in an electronic form, and

(ii) Accessible so as to be for a subsequent reference.

Section 5 speaks of legal recognition of digital signatures. Accordingly, where any law provides that information or any other matter shall be authenticated by affixing the signature or any document shall be signed or bear the signature of any person then, notwithstanding anything contained therein in such law, such requirement shall be deemed to have been satisfied, if such information or matter is authenticated by means of digital signature affixed in such manner as may be prescribed by the Central Government. The Explanation to this section states that for the purposes of this section, "signed", with its grammatical variations an cognate expressions, shall, with reference to a person, mean affixing of his hand written Janak Constructions Ltd. can proceed against Hiroshi Ltd. on the strength of these provisions.

Janak Constructions Ltd should ensure that in respect of important e-mails / e-documents / e-records, the sender affixes his digital signature. A digitally signed document is a perfect piece of legal evidence as to its timing, contents, integrity and authenticity.

Q. 8. (a) Under what circumstances can a company registered as a collective investment management company raise funds from the public.

(b) Explain the difference between forward contract and future contract.

(c) Consider the following investments :

Stock	Qty.	Price	Expected Return
W	400	34	12%
X	600	22	16%
Y	300	78	15%
Z	500	53	15%

What is the expected return from the portfolio?

Answer 8. (a)

A registered Collective Investment Management Company is eligible to raise funds from the public by launching schemes,

Such schemes have to be compulsorily credit rated as well as appraised by an appraising agency,

The schemes also have to be approved by the Trustee and contain disclosures, as provided in the regulations, which would enable the investors to make informed decision,

A copy of the offer document of the scheme has to be filed with SEBI and if no modifications are suggested by SEBI within 21 days from the date of filing then the collective investment Management Company is entitled to issue the offer document to the public for raising funds from them.

Answer 8. (b)

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

Forward Contract	Future Contract
The contract price is not privately disclosed and hence not transparent	The contract price is transparent
The contract is exposed to default risk by counter party.	The contract has effective safeguards against defaults in the form of clearing corporation and guarantees for trades and daily mark to market adjustments to the accounts of trading members based on daily price change.
Each contract is unique in terms of size, expiration date and asset type / quality	Contracts are standardized in terms of size, expiration date and all other features.
The contract is exposed to the problem of liquidity	There is no liquidity problem in the contract.
Settlement of the contract is done by delivery of the asset on the expiration date.	Settlement of the contract is done on cash basis.

Answer 8. (c)

Portfolio Value = 400 (Rs 34) + 600 (Rs 22) + 300 (Rs 78) +500 (Rs 53)

= Rs 76,700.

W_W = 400 (Rs 34) /Rs 76,700 = 0.1773

W_X = 600 (Rs 22) / Rs 76,700 = 0.1721

W_Y = 300 (Rs 78) / Rs 76,700 = 0.3051

W_Z = 500 (Rs 53) / Rs 76,700 = 0.3455

So, the expected return;

E[R] = 0.1773(0.12) + 0.1721 (0.16) +0.3051(0.15) + 0.3455 (0.15) = 14.64%.

Q. 9. Suppose the standard deviations, betas and average rates of return of several managed portfolio are given below, along with the standard deviation and average rate of return of the market index is assumed to be 1. Further assume the T-bills rate averaged 7% during the time period performance measurement. Compare these funds on performance using the Sharpe, Treynor and Jensen measures.

Fund	Average Return	Std. Deviation	Beta
A	0.15	0.25	1.25
B	0.12	0.30	0.75
C	0.10	0.20	1.00
$\tilde{R}_m$	0.12	0.25	1.00

Answer 9.

Fund A has the best Reward-to-Variability Ratio (Sharpe measure), while Fund B has the best Reward- to Volatility Ratio (Treynor measure). Fund C is the worst on all these counts. Fund A has a better Reward-to-Variability ratio than the market: 0.32 compared to (0.12 – 0.07) / 0.25 = 0.2. Fund A also has a better reward to volatility ratio than the market; 0.64 compared to (0.12-0.07) /1 = 0.05. Also the alpha (Jensen measure) is positive thus fund A outperformed the market with all measures. Fund B outperformed the market using the Reward-to-Volatility and alpha measures, but not the Reward-to-Variability ratio. Fund C underperformed the market according to all three measures.

Fund	Reward to Variability	Reward to Volatility	Alpha
A	(0.15-0.07) /0.25=0.32	(0.15-0.07) /1.25=0.064	(0.15-0.07)-1.25(0.12- 0.07) = 0.0175
B	(0.12-0.07) /0.30=0.167	(0.12-0.07) /0.75=0.067	(0.12-0.07)-0.75(0.12-0.07) = 0.0125
C	(0.10-0.07) /0.20=0.150	(0.10-0.07) /1.00=0.03	(0.10-0.07)-1.00(0.12-0.07) = 0.0200

[Treynor Ratio Formula; (Average Return of the Portfolio – Average Return of the Risk-free rate) / Beta of the Portfolio.

Sharpe Ratio Formula; $r_p - r_f / \sigma p$,

Where, r_p = Expected Portfolio Return,

r_f = Risk Free Rate

σ_p = Portfolio Standard Deviation.]

Q. 10. (a) When does a market-wise circuit breaker system apply?

(b) Explain the term 'Beta' as a systematic risk of a security.

Answer 10. (a)

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

The index-based market-wide system applies at 3 stages of the index movement, either way viz; at 10%, 15% and 20%. These circuit breakers when triggered, bring about a coordinated trading halt in all equity and equity derivative markets nationwide.

The market-wide circuit breakers are triggered by movement of either the BSE Sensex or the NSE S & P CNX Nifty, whichever is breached earlier. The percentage movement of the index and the time frame of the trading halt is given below :

10% movement – a one-hour market half if the movement takes place before 1.00 p.m.

– at or after 1.00 p.m. but before 2.30 p.m., a trading halt for ½ hour

– at or after 2.30 p.m. there will be no trading halt and market shall continue trading

15% movement-a two-hour halt if the movement takes place before 1 p.m.

– on or after 1.00 p.m., but before 2.00 p.m.., a trading halt of one hour

– on or after 2.00 p.m. the trading shall halt for remainder of the day.

20% movement- trading shall be halted for the remainder of the day.

Answer 10. (b)

"Beta' as a measure of the systematic risk of a security :

Beta is a measure of systematic risk of security that cannot be avoided through diversification. Beta is a relative measure of risk of an individual stock relative to the market portfolio of all stocks. If the security's return move more (less) than the market's return as the latter changes, the security's return's have more (less) volatility (fluctuation in price) than those of the market. It is important to note that beta measures a security's volatility or fluctuations in price, relative to a benchmark, the market portfolio of all stocks.

Securities with different slopes have different sensitivities to the returns of the market index. If the slope of this relationship for a particular security is a 45 degree angle, the beta is 1.0.This means that for every one per cent change in the market's return, on average this security's return change 1 per cent. The market portfolio has a beta of 1.0.

A security with beta of 1.5 indicates that, on average, security returns are 1.5 times as volatile as market returns, both up and down. This would be considered an aggressive security because when the overall market return rises or falls 10 per cent, this security, on average, would rise or fall 15 per cent. Stocks having a beta of less than 1.0 would be considered more conservative investments than the overall market.

Beta is useful for comparing the relative systematic risk of different stocks and in practice, is used by investors to judge a stock's riskiness. Stocks can be ranked by their betas. Because the variance of the market is constant across all securities for a particular period, ranking stocks by beta is the same as ranking them by their absolute systematic risk. Stocks with high betas are said to be high-risk securities.

Q. 11. (a) What do you mean by "Impact Cost"?

(b) A stock that pays no dividend is currently selling at Rs 100.00. The possible prices for which the stock might sell at the end of one year, with associated probabilities are :

End-of-year Price	***Probability***
Rs 90.00	**0.1**
Rs 100.00	**0.2**
Rs 110.00	**0.4**
Rs 120.00	**0.2**
Rs 130.00	**0.1**

(i) Calculate the expected rate of return by year end,

(ii) Calculate the standard deviations of the expected rate of return.

Answer 11. (a)

Market impact cost is the best measure or the liquidity of a stock. It accurately reflects the costs faced when actually trading an index. Supposing a stock trades at bid 99 and ask 101. We say the 'ideal' price is Rs. 100. Now, supposing, a buy order for 1000 shares goes through at Rs. 102. Then it can be said that the market impact cost at 1000 shares is 2.

Likewise, if a buy order for 2000 shares goes through at Rs. 104, it is said that the market impact cost at 2000 shares is 4%. For a stock to qualify, for possible inclusion into the S&P CNX Nifty, it has to reliably have market impact cost or below 0.75% when doing S&P CNX Nifty trades of half a crore rupees.

Answer 11. (b)

(i)

Probable	0.1	0.2	0.4	0.2	0.1
Return	– 10	0	10	20	30

E (R) = 0.1 (– 10) + 0.2 (0) + 0.4 (10) + 0.2 (20) + 0.1 (30)

= -1.0 + 0 4.0 + 4 + 3.0

= 10.0%

(ii) $\sigma = [0.1 (-10 - 10)^2 + 0.2 (0 - 10)^2 + 0.4 (10 - 10)^2 + 0.2 (20 - 10)^2 + 0.1 (30 - 10)^2]^{.5}$

= 10.95%.

Q. 12. (a) Suppose that a stock now selling for Rs. 100 will either increase in value by 1.5 % by year end with probability 0.5, or fall in value by 5% with probability 0.5, or fall in value by 5 % with probability 0.5. The stock pays no dividends.

(i) What are the geometric and arithmatic mean returns on the stock?

(ii) What is the expected end of year value of the share?

(iii) Which measure of expected return is superior?

(b) You have invested Rs 50,000, 30 per cent of which is invested in Zee Telefilms Ltd., which has a expected rate of return of 15 per cent and 70 per cent of which is invested in Star Network Ltd., with an expected return of 12 per cent.

(i) What is the return on your portfolio?

(ii) What is the expected percentage rate of return?

Answer 12. (a)

(i) Expected geometric return = [(1.15) (0.95)] ½-1 = 0.045

Expected arithmetic mean return = [0.15 + (-0.05) ½] = 0.05

(ii) The expected stock price is (115 + 95) /2 =105

(iii) The expected rate of return on the stock is 5%, equal to expected arithmetic mean return on the stock.

Answer 12. (b)

(i) The rate of return is the percentage of the amount invested in a stock multiplied by its expected rate of return. Thus, of the Rs 50,000 invested,

For Zee Tele films Ltd**;** 30 per cent of total with 15 per cent rate of return:

.30 × Rs 50,000 × .15 = Rs 2,250

For Star Network; 70 per cent with a 12 per cent rate of return:

.70 × Rs 50,000 × .12 = Rs 4,200

The total return is Rs 6450 (i.e. Rs 2250 + Rs 4200)

(ii) The expected percentage rate of return is the total return, divided by the amount invested :

R = Total Return / Total Amount invested,

R = Rs 6450 / Rs 50,000

= 12.90%.

Q. 13. (a) Mr. Sharma's equity shares currently sells for Rs 22.50 per share. The finance manager of Mr. Sharma anticipates a constant growth rate of 12 per cent and an end-of-year dividend of Rs 2.50.

(i) What is your expected rate of return if you buy the stock for Rs 25?

(ii) If you require a 18 per cent return, should you purchase the stock?

(b) Compute a call option price by applying the Black-Scholes option pricing model on the following values :

Strike price	**= Rs 45,**
Time remaining to expiration	**= 183 days,**
Current stock price	**= Rs 47,**
Expected price volatility/standard deviation	**= 25,**
Risk free rate	**= 10%.**

Answer 13. (a)

(i) Expected Rate of Return = Dividend in year 1 / Market price + Growth rate

= Rs 2.50/ Rs 25 + .12

= .22 = .22%

(ii) V_e = Rs 2.50 /.18 – .12 = Rs 41.67

Yes, purchasing of equity shares will prove worthy.

Answer 13. (b)

Applying the Black- Scholes formula :

$V_e = P_S \{Nd_1] - P_X / e^{(RF)(T)}) \ [Nd_2]$

$d_1 = l_n [47 / 45] + [0.10 + 0.5 (0.25)^2] 0.5 / 0.25 \sqrt{0.5}$

$= 0.6172$

$d_2 = 0.6172 - 0.25 / \sqrt{0.5}$

$= 0.4404$

From a normal distribution table;

N (0.6172) = 0.7315 and

N (0.4404) = 0.6702,

So, C = 47 (0.7315) – 45 ($e^{-(0.10)(0.5)}$) (0.6702)

= Rs 5.69

Q. 14. (a) What should a stock market index be?

(b) Why are indices important?

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

Answer 14. (a)

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

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

- It is a lead indicator of the performance of the overall economy or a sector of the economy,
- Stock indexes reflect highly up to date information,
- They provide a historical comparison of returns on money invested in the stock market against other forms of investments such as gold or debt,
- They can be used as a standard against which to compare the performance of an equity fund,
- Modern financial applications such as Index Funds, Index Futures, Index Options play an important role in financial investments and risk management.

Answer 14. (b)

By looking at an index we know how the market is faring. The index is a lead indicator of how the overall portfolio will fare. Owing to direct applications in finance, in the form of index funds and index derivatives, in recent years, indices have gained more popularity. Index funds are funds which passively 'invest in the index'. Index derivatives allow people to cheaply alter their risk exposure to an index (which is called hedging) and to implement forecasts about index movements (which are called speculation). Using index derivatives, as hedging, has become a central part of risk management in the modern economy. These applications are now a multi-trillion dollar industry worldwide, and they are critically linked up to market indices. Finally, indices serve as a benchmark for measuring the performance of fund managers. For e.g., an all-equity fund, should obtain returns like the overall stock market index. A 50:50 debt: equity fund should obtain returns close to those obtained by an investment of 50% in the index and 50% in fixed income.

Answer 14. (c)

It is easy to create a portfolio, which will reliably get the same returns as the index. i.e. if the index goes up by 4%, this portfolio will also go up by 4%. Suppose an index is made of two stocks, one with a market cap of Rs. 1000 crore and another with a market cap of Rs.3000 crore. Then the index portfolio will assign a weight of 25% to the first and 75% weight to the second. If we form a portfolio of the two stocks, with a weight of 25% on the first and 75% on the second, then the portfolio returns will equal the index returns. So, if anybody want to buy Rs. 1 lakh of this two-stock index, the person would buy Rs.25,000 of the first and Rs.75,000 stock index. A stock market index is hence just like other price indices in showing what is happening on the overall indices, the wholesale price index is a comparable example. Additionally, the stock market index is attainable as a portfolio.

Q. 15. The following table gives an analyst's expected return on two stocks for particular market returns:

Market Return	*Aggressive Stock*	*Defensive Stock*
6%	2%	8%
20	30	16

(a) What are the betas of the two stocks?

(b) What is the expected return on each stock if the market return is equally likely to be 6% or 20%?

(c) If the risk-free rate is 7% and the market return is equally likely to be 6% or 20% what is the SML?

(d) What are the alphas of the two stocks?

Answer 15. (a)

The betas of the two stocks are :

Aggressive stock = 30% - 2% / 20% -6%

= 2

Defensive stock = 16% - 8% /20% -6%

= 0.571

Answer 15. (b)

The expect return of the two stocks are :

Aggressive stock = 0.5 × 2% + 0.5 × 30%

= 16%

Defensive stock = 0.5 x 8% + 0.5 × 16%

= 12%

Answer 15. (c)

The expected return on the market portfolio is

0.5 × 6% + 0.5 × 20%

= 13%

Since the risk-free is 7%, the market risk premium is 13% – 7% = 6%

So, the SML, is

Required return i = 7% + ßi x 6%

Answer 15. (d)

The alphas of the two stocks are calculated below

Stock A; Expected return = 16%, Beta =2

Required return = 7% +2 x 6% =19%

Alpha = 16% -19% = -3%

Stock B; Expected return=12%, Beta = 0.571, Required return = 7% + 0.571 x 6%

=10.426%

Alpha = 12% -10.426% = 1.574%

Q. 16. (a) An investor has Rs 1,00,000 to be invested in a portfolio. He used his funds to acquire shares of A Ltd. for Rs 80,000 and shares of B Ltd. for Rs 20,000. The proportion of A Ltd. shares in the portfolio is 0.8 (X_1) and that of B Ltd. shares is 0.2 (X_2). the rate of return expected from A Ltd. is 20% (R_1). The corresponding figure for B Ltd. is 15% (R_2). Find out the rate of return from the portfolio (R_P).

(b) What are the risks relevant while investing?

(c) An investor buys a September put futures option on gold. The contract is for grams and strike price is Rs 10,000. Show the outcome of contract if the investor exercised the option in July when gold futures price is Rs 9,500 and closes out the short futures position in August when gold futures price is Rs 9,550.

Answer 16. (a)

Earning from investment in A Ltd. shares = Rs 80,000 × 20% = Rs 16,000

Earning from investment in B Ltd. shares = Rs 20,000 × 15% = Rs 3,000

Earnings from portfolio = Rs 80,000 × 20% + Rs 20,000 × 15% = Rs 19,000

Rate of return from portfolio = 80,000 × 20% + 20,000 × 15% / 100,000

= 0.8 × 20% + 0.2 × 15%

= 19%

[$R_P = X_1 R_1 + X_2 R_2$]

Answer 16. (b)

The relevant risks are as follows :

(i) Interest rate risk – Interest rates and prices vary inversely,

(ii) Business Risk – Change in business cycles & bull/bear market phase affect,

(iii) Purchasing power risk – Inflation tend to reduce the returns generated.

(ii) Financial risk – Decision of company to alter the capital structure etc. affect.

Answer 16. (c)

On exercise of the put futures option, the investor gets a short futures contract at strike price Rs 9,500 plus price differential Rs 500 (Rs 10,000 – Rs 9,500).

On closing out of the short futures contract, the investor pays price differential Rs 50 (Rs 9,550- Rs 9,500). Total gain realized by the investor is Rs 450 less premium paid.

Q. 17. (a) The beta coefficient of TIL Ltd. Is 1.4. The company has been maintaining 8 per cent rate of growth in dividends and earnings. The last dividend paid was Rs. 4 per share. The return on government securities is 10 per cent while the return on market protfolio is 15 per cent. The current market price of one share of TIL Ltd. is Rs. 36.

(i) What will be the equilibrium price per share of TIL Ltd.

(ii) Would you advise purchasing the share?

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

Answer 17. (a)

(i) The required rate of return (K_e) = R_f + b (K_m – R_f) = 10% + 1.4 (15% – 10%) = 17 per cent.

Equilibrium price per share (P_0) = D_1 / K_e – g = Rs. 4 (1.08) / 17% – 8% = Rs. 48.

(ii) The share of TIL Ltd. is worth buying as it is undervalued.

Answer 17. (b)

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

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

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

Applications of ETF are :

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

Q. 18. (a) What is Investor Protection Fund (IPF) at Stock Exchanges?

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

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

Answer 18. (a)

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

Answer 18. (b)

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

Process for preferring arbitration :

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

Answer 18. (c)

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

Section II : Corporate Law & Corporate Governance

Q. 1. (a) Choose the most appropriate answer from the stated options and write it down (Only indicate A,B,C,D, as you think correct) :

(i) Which of the following items requires special resolutions in a general meeting under the Companies Act 1956?

A. Issue of shares at a premium

B. Adoption of Statutory Report

C. Appointment of Managing / Whole time Director

D. Reduction of Share Capital.

(ii) Under the Companies Act, 1956, the first directors shall hold office upto

A. The end of the statutory meeting

B. The end of the period as prescribed by the articles of the company

C. The end of three years from the date of appointment

D. Till the first Annual General Meeting.

(iii) In the context of classification of risk, tax risks will fall under

A. Credit Risks

B. Liquidity Risks

C. Disaster Risks

D. Legal Risks.

(iv) An ordinary resolution is one which is passed in a general meeting by

A. A simple majority of votes including the casting of the chairman

B. ¾ th majority of votes

C. 2/3 rd majority of votes

D. None of the above.

(v) In the context of Corporate Governance, Narayana Murthy Committee was formed in the year

A. 2002

B. 2003

C. 2004

D. 1999

(vi) Under Competition Act, 2002, penalty for offences in relation to furnishing of information is

A. Rs 5 lakh

B. Rs 10 lakh

C. Rs 25 lakh

D. Rs 50 lakh.

(vii) As per section 292A of the Companies Act, 1956, every public company shall constitute a committee of the Board known as Audit Committee, whose paid up capital is not less than

A. Rs 50 lakh

B. Rs 25 lakh

C. Rs 5 crore

D. Rs 10 crore.

(viii) The concept of Corporate Governance was initialed on the recommendations of

A. The report by the Confederation of Indian Industry (CII)

B. The Report by Dr Y.V.Reddy

C. The Report by Mr. Kumarmangalam Birla

D. The report by Mr. Narayana Murthy

(ix) A public Information Officer shall as expeditiously as possible provide information the date of receipt of request but in any case within

A. 15 days

B. B. 30 days

C. C. 45 days

D. D. 60 days

(x) A listed company is required to furnish their unaudited results to the stock exchange on a

A. Annual basis

B. Half-yearly basis

C. Quarterly basis

D. Monthly basis.

Answer 1. (a)

(i) D

(ii) D

(iii) B

(iv) A

(v) B

(vi) B

(vii) C

(viii) C

(ix) A

(x) C

Q. 1. (b) State whether each of the following statements is True (T) or False (F).

(i) Without the sanction of the Tribunal, the liquidator of a company can appoint an agent to do any business which he is unable to do himself.

(ii) An index of members must be maintained by a company when its membership exceeds 100.

(iii) Risk management is not a linear process, it is the balancing of a number of interwoven elements.

(iv) According to clause 49 of the listing agreement on Corporate Governance, the Audit Committee shall meet at least twice a year.

(v) The qualification shares required to be taken up by a director must be purchased from the company.

(vi) The Companies Act 1956 provides a positive definition of the taerm "Independent Director".

(vii) Related party transactions means a transfer resource or obligations between related parties regardless of whether or not a price is charged.

(viii) Independent director can not be an executive of the company in the last five years.

(ix) Buy back of equity shares in a financial year shall not exceed 30% of its total paid up equity capital in the financial year.

(x) For the alteration of the Articles of Association of a company, a special resolution is required to be passed.

Answer 1. (b)

(i) True
(ii) False
(iii) True
(iv) False
(v) False
(vi) False
(vii) True
(viii) False
(ix) True
(x) True

Q. 2. Write Short notes on the following :

(i) Shelf prospectus
(ii) Issue of Sweat Equity Shares
(iii) Exchange Rate Risk
(iv) Secured Debenture
(v) Investor Education and Protection Fund
(vi) Audit Committee

Answer 2.

(i) Shelf prospectus :

'Shelf prospectus' means a prospectus issued by any financial institution or bank for one or more issues of the securities or class or securities specified in that prospectus.

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

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

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

(ii) Issue of Sweat Equity Shares :

For the purposes of Sec. 79-A, the expression 'sweat equity shares' means equity shares issued at a discount or for consideration other than cash for providing know-how or making available rights in the

nature of intellectual property rights or value additions by whatever name called [Explanation II to Sec. 79-A(1)].

The expression "a company" means the company incorporated, formed and registered under the Companies Act, 1956 and includes its subsidiary company incorporated in a country outside India [Explanation I to Sec. 79-A (1)].

Issue of sweat equity shares— Notwithstanding anything contained in Sec. 79 (which deals with the powr of a company to issue shares at a discount), a company may issue sweat equity shares of a class of shares already issued if the following conditions are fulfilled, namely —

(a) the issue of sweat equity shares is authorised by a resolution passed by the company in the general meeting;

(b) the resolution specifies the number of shares, current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;

(c) not less than one year has at the date of the issue elapsed since the date on which the company was entitled to commence business;

(d) the sweat equity shares of the listed company are issued in accordance with the regulations made by the Securities and Exchange Board of India in this behalf [Sec. 79-A (1)].

(iii) Exchange Rate Risk :

All investors who invest internationally in today's increasingly global investment arena face the prospect of uncertainty in the returns after they convert the foreign gains back to their own currency. Unlike the past when most U.S. investors ignored international investing alternatives, investors today must recognize and understand exchange rate risk, which can be defined as the variability in returns on securities caused by currency fluctuations. Exchange rate risk is sometimes called currency risk. For example, a U.S. investor who buys a German stock denominated in marks must ultimately convert the returns from this stock back to dollars. If the exchange rate has moved against the investor, losses from these exchange rate movements can partially or totally negate the original return earned. Obviously, U.S. investors who invest only in U.S. stocks on U.S. markets do not face this risk, but in today's global environment where investors increasingly consider alternatives from other countries, this factor has become relevant. Currency risk affects international mutual funds, global mutual funds, closed-end single country funds, American Depository Receipts, foreign stocks, and foreign bonds.

(iv) Secured Debenture :

When any particular or specified property of the company is offered as security to the debenture holders and when the company can deal with it only subject to the prior right of the debenture holders, fixed charge is said to have been created. On the other hand, when the debenture holders have a charge on the undertaking of the company i.e., on the whole of the property of the company, both present and future, and when it can deal with the property in the ordinary course of business until the charge crystallises i.e., when the company goes into liquidation or when a receiver is appointed, the charge is said to be a floating charge. When the floating charge crystallises, the debenture holders have a right to be paid out of the sale proceeds of the assets subject to the right of the preferential creditor but prior to making any payment to unsecured creditors.

(v) Investor Education and Protection Fund :

Investor Education and Protection Fund (IEPF) is for promotion of investors' awareness and protection of the interests of investors. There shall be credited to the Fund the following amounts, namely :

(i) Amounts in the unpaid dividend accounts of companies;

(ii) The application moneys received by companies for allotment of any securities and due for refund;

(iii) Matured deposits with companies;

(iv) Matured debentures with companies;

(v) The interest accrued on the amounts referred in clause (i) to (iv);

(vi) Grants and donations given to the Fund by the Central Government, State Governments. companies or any other institutions for the purposes of the Fund; and

(vii) The interest or other income received out of the investments made from the Fund.

The Fund shall be utilized for promotion of investors' awareness and protection of the interests of investors in accordance with such rules as may be prescribed.

The Central Government shall. by notification in the Official Gazette, specify an authority or committee. with such members as the Central Government may appoint, to administer the Fund, and maintain separate accounts and other relevant records in relation to the Fund in such form as may be prescribed in consultation with the Comptroller and Auditor-General of India.

It shall be competent for the authority or Committee appointed under sub-section (4) to spend moneys out of the Fund for carrying out the objects for which the Fund has been established.

(vi) Audit Committee :

An audit committee is an operating committee of the Board of Directors charged with oversight of financial reporting and disclosure. Section 292A of the Act requires every public company having paid-up capital of not less than rupees five crores to constitute an audit committee as a committee of the Board of Directors. This Committee shall consist of such number of directors as its members, as may be determined by the Board.

However, the number shall not be less than three. Audit committees are typically empowered to acquire the consulting resources and expertise deemed necessary to perform their responsibilities. The role of audit committees continues to evolve as a result of the passage of the Sarbanes-Oxley Act of 2002. Many audit committees also have oversight of regulatory compliance and risk management activities. Not for profit entities may also have an audit committee.

Responsibilities oCthe audit committee typically include :

- Overseeing the findncial reporting and disclosure process.
- Monitoring choice of accounting policies and principles.
- Overseeing hiring, performance and independence orthe external auditors.
- Oversight of regulatory compliance, ethics, and whistleblower hotlines.
- Monitoring the internal control process.
- Overseeing the perrormnnce of the internal audit function.
- Discussing risk management policies and practices with management.

Q. 3. (a) State the importance of a remuneration committee in the context of Corporate Governance. What are the responsibilities normally assigned to such committee?

(b) What are the additional requirements stipulated in section 292 A of the Companies Act, 1956, which are silent in clause 49 of the Listing Agreement?

(c) It is said that after the risk identification takes place, the actions involved in pinpointing suitable responses to the risk are broadly of five types. Elaborate on these five types of actions.

Answer 3. (a)

Remuneration Committee :

It is now a universally accepted proposition of corporate governance practice that Boards of Directors of companies appoint appropriately composed remuneration committees to work out executive remuneration o their behalf.

The combined code of the UK says that the remuneration committee will be responsible for working out remuneration package 'to attract, retain and motivate executives of the quality required". The committee should decide where to position their company relative to other companies and take account of comparable remuneration and relative performance. With regard to the composition of the committee, as overwhelming majority of guidelines suggest that it be composed exclusively of independent non-executive directors. The committee would make it well considered recommendations to the board for final decision. The following responsibilities are normally assigned to a remuneration committee, which should have a written terms of reference:

(i) Remuneration packages and service contracts of the CEO and others senior executives,

(ii) Remuneration packages for non-executive directors,

(iii) Remuneration policies and practice of the company,

(iv) Any company share and other incentive schemes,

(v) Company superannuation and pension arrangements.

Answer 3. (b)

Additional requirements stipulated as per Section 292 A:

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

(i) The audit committee constituted shall act in accordance with terms of reference to be specified in writing by the Board.

(ii) The recommendations of the audit committee on any matter relating to financial management including the audit report, shall be binding on the board.

(iii) If the Board does not accept the recommendation of the audit committee, it shall record the reasons therefore and communicate such reasons to the shareholders.

Answer 3. (c)

Risk identification :

This step identifies the potential risks (or opportunities) facing the project. It is important not to judge the likelihood of a risk at this early time. This is done in a controlled manner in a later step. Attempt in to form judgements while 'brainstorming' a list of potential risks may lead to hurried and incorrect decision to exclude some risks.

Once identified, risks are all entered in the risk log. This contains details of all risks, their assessment, owners and status. The risk log is a control tool for the Project Manager, providing a quick reference to the key risks facing the project, what monitoring activities should be taking place an by whom. Reference to it can lead to entries.

The actions break into broadly five types, as shown below :

(i) *Prevention terminates the risk* - by doing things differently and thus removing the risk where it is feasible to do so. Countermeasures are put in place that either stop the threat or problem from occurring or prevent it having any impact in the project or business.

(ii) *Reduction threat the risk* - take action to control it in some way where the actions either reduce the likelihood of the risk developing or limit the impact on the project to acceptable levels.

(iii) *Transference* - this is a specialist form of risk reduction where the management of the risk is passed to a third party via, for instance, an insurance policy or penalty clause, such that the impact of the risk is no longer an issue for the health of the project. Not all risk can be transferred in this way.

(iv) *Acceptance* - tolerate the risk- perhaps because nothing can be done at a reasonable cost to migrate it or likelihood and impact or the risk occurring are at an acceptable level.

(v) *Contingency* - these are actions planned and organized to come into force as and when the risk occurs.

Any given risk could have appropriate actions available to deal with a risk, in which case the risk must be accepted or the justification for the project revisited (to review whether the project is too risky), possibly resulting in the termination of the project.

The results of the risk evaluation activities are documented in the Risk Log. If the project is part of a programme, project risk should be examined for any impact on the programme (and vice versa). Where any cross-impact is found, the risk should be added to the other Risk Log.

Q. 4. State the reasons for passing the Competition Act, 2002.

Answer 4.

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

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

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

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

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

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

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

Q. 5. (a) A private company which is not a subsidiary of any public company, does not furnish the details of its investments in Indian companies as required by note (1) Schedule VI to the Companies Act, 1956. The contention of the company is that Section 372 of the Act is not applicable in its entirely to all the companies, i.e. public and private. Is the contention of the private company in accordance with law?

(b) Can a company keep its books of accounts at more than one place in India other than its registered office in pursuance of the provision of sub-section (1) of section 209 of the Companies Act, 1956?

Answer 5. (a)

Section 211 states that balance sheet of a company shall, subject to the provision of this section, be in the form set out in Part I of Schedule VI or as near thereto or as per central government directions in a particular case.

No exemption is given for private company as such. The exemption from compliance with any of the requirements in Schedule VI can be granted to any company by the central government when it is in the public interest. In the given case the contention of the private company is not in accordance with law.

Answer 5. (b)

According to provision of Section 209 of Companies Act 1956, the Board of Directors of a company may decide to keep all or any of the books of accounts of the company at any other place in India other than the registered office, but the company shall within 7 days of the decision, file with the ROC a notice in writing giving full address of such other places.

Q. 6. "The power of the Registrar of Companies to strike off the name of a defunct company is meant to be used in cases where a company is not legally dissolved when it should be so dissolved". Comment.

Answer 6.

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

Procedure to be followed by the Registrar :

(i) Letter by Registrar to inquire if company is in operation. Where the Registrar has reasonable cause to believe that a company is not carrying on business or is not in opeation, he shall send to the company by post, a letter inquiring whether the company is carrying on business or is in operation.

(ii) Registered letter if no reply received within one month. If the Registrar does not receive an answer within one month of the sending of the letter, he shall, within 14 days after the expiry of the month, send to the company by post, a registered letter referring to the first letter, and stating that no answer thereto has been received. He shall further mention in the letter that if no reply is received to the second letter within one month, a notice will be published in the Official Gazette with a view to striking the name of the company off the Register.

(iii) Publication in the Official Gazette to strike off name. If the Registrar either receives an answer that the company is not carrying on business, or does not receive any answer within one month of the sending of the registered letter, he may publish in the Official Gazette and send to the company by registered post, a notice that at the expiration of 3 months from the date of that notice, the name of the company will be struck off the Register and the company will be dissolved. The company may, however, within three months show cause why it should not be dissolved.

(iv) Same procedure in winding up if no liquidator is acting or no return is received. The above procedure is also followed where a company is being wound up and the Registrar has reasonable cause to believe either that no liquidator is acting, or that the affairs of the company have been completely wound up, and returns required to be made by the liquidator have not been made for a period of 6 consecutive months.

Q. 7. "No dividend can be paid by a company except out of profits". Comment.

Answer 7.

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

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

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

(a) out of profits of the company for that year arrived at after providing for depreciation in the manner laid down in the Act, or

(b) out of the profits of the company for any previous financial year of years arrived at after providing of depreciation, and remaining undistributed, or

(c) out of both, or

(d) out of moneys provided by the Central Government or a State Government for the payment of dividend in pursuance of a guarantee given by that Government.

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

Q. 8. (a) What do you mean "right to information" by the RTI Act,2004? What are the Objectives of the said Act?

(b) Briefly discuss the provisions of the Competition Act, 2002 relating to:

(i) Power of Central Government to exempt,

(ii) Restriction on disclosure of information.

Answer 8. (a)

A Bill to operationalise the right to information by setting out the practical regime for people to secure access to information under the control of public authorities, consistent with public interest, in order to promote openness, transparency and accountability and in relation to matters connected therewith or incidental thereto.

(i) This Act may be called the Right to Information Act 2004,

(ii) It extends to the whole of India except the State of Jammu and Kashmir,

(iii) It shall come into force within 120 days of it being enacted,

(iv) Where State legislation exists dealing with the right to access information; a person will have the right to seek information under the State law as well as under this Act, if the information pertains to a subject under the State List in Schedule 7 of the Constitution of India.

Objectives of the Act :

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

Answer 8. (b)

(i) The Central Government may, by notification, exempt from the application of the Competition, Act, 2002, or any provisions thereof, and for such period as it may specify in such notification —

(a) Any class of enterprises if such exemption is necessary in the interest of security of the State or public interst;

(b) Any practice or agreement arising out of an in accordance with any obligation as-summed by India under any treaty, agreement or convention with any other country or countries;

(c) Any enterprise which performs a sovereign function on behalf of the Central Government or a State Government;

Provided that in case an enterprise is engaged in any activity including the activity relatable to the sovereign functions of the Government, the Central Government may grant exemption only in respect of activity relatable to the sovereign functions.

(ii) No information relating to any enterprise, being an information which has been obtained by or on behalf of the Commission for the purpose of the Competition Act, shall, without the previous permission in writing of the enterprise, be disclosed otherwise than in compliance with or for the purpose of the Act or any other law for the time being force.

Q. 9. State the CII (Confederation of Indian Industries) Code for desirable Corporate Governance with 14 key aspects.

Answer 9.

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

(i) Annual operating plans and budgets together with updated long-term plans,

(ii) Capital budgets, manpower and overhead budgets,

(iii) Quarterly results for the company as a whole and its operating divisions for business segments,

(iv) Show cause, demand and prosecution notices received from the revenue authorities which are considered to be materially important,

(v) Internal audit reports, including cases of theft and dishonesty of a material nature,

(vi) Fatal or serious accidents, dangerous occurrences, and any affluent or pollution problems,

(vii) Default in payment of interest or nonpayment of the principal on any public deposit, and/or to any secured creditors or financial institutions,

(viii) Defaults such as nonpayment of inter-corporate deposits by or to the company, or materially substantial non-payments for goods sold by the company,

(ix) Any issue which involves possible public or product liability claims of a substantial nature, including any judgment or order which may have either passed, strictures on the conduct of the company, or taken an adverse view regarding another enterprise that can have negative implications for the company,

(x) Details of any joint venture or collaboration agreement,

(xi) Transactions that involve substantial payment towards goodwill, brand equity, or intellectual property,

(xii) Recruitment and remuneration of senior officers just below the board level, including appointment for removal of the Chief Financial Officer and the Company Secretary,

(xiii) Labour problems and their proposed solutions,

(xiv) Quarterly details of foreign exchange exposure and the steps taken by management to limit the risk of adverse exchange rate movement, if material.

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

Q. 10. "A good Corporate Governance should have certain basic principles", Enumerate them.

Answer 10.

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

(i) **Review of Operation**—There should be review of operations of the company at a regular interval. It may include comparison of monthly/quarterly production and sales targets with actual, cash flow analysis, etc.

(ii) **Compliance with Statutory and Regulatory Requirements**— The Board should ensure compliance with various statutory and regulatory requirements. It may include clearance of statutory dues, compliance with FERA regulations, following suitable accounting policies and standards, etc.

(iii) **Appointment of various committees**—There should be appointment of various committee to look after different matters. There can be following committees—(a) Audit Committee, (b) Grievance Committees, (c) Remuneration Committee and (d) Investment Committee, etc.

(a) *Audit committee*—It should meet periodically to review the effectiveness of the system of internal controls and reports to shareholders.

(b) *Grievance committee*—It should look after the grievances from customers, suppliers, creditors in respect of price, quality, discount, etc. It should also look after the problems of executives/ employees of the organization.

(c) *Remuneration committee*—Its role should be to fix remuneration of non-executive directors. It may be fixed in relation to company performance.

(d) *Investment committee*—It should look after the investment decisions. It should be in accordance with the guidelines approved by the Board. Shareholders expect that investment decisions are judicious and do not incur any losses, which affect shareholder's interest.

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

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

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

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

Q. 11. (a) Can a limited liability company become a partner of a partnership firm?

(b) Can a company hold two AGMs on the same day?

(c) State the provision of restriction on employment of Chairperson and other Members under The Competition Act, 2002.

(d) Who can not be appointed as Cost Auditors? What are the additional disqualifications notified by ICWAI regarding cost auditor?

Answer 11. (a)

A company being a juristic person is capable of contracting in its own name. Since partnership, as per section 4 of the Partnership Act, 1932, is a contractual relationship between persons, there should be no objection to a partnership being created with or by a company. The only doubt that may arise is that the liability of a partner being unlimited, can a limited liability company become a partner? To this the simple reply shall be that it is the liability of the members of a limited company which is limited and not that of the company itself. Thus, there should be no objection to a limited company becoming a partner of a partnership firm. However, the Department of Company Affairs, in this regard has opined that the objects clause must contain a facilitating provision in this regard. Thus, in the opinion of the Department of Company Affairs, a company may become a partner only if the Memorandum of Association thereof specifically allows it.

Answer 11. (b)

There is no provision in the Companies Act prohibiting the holding of two AGMs on the same day. If the Articles do not contain any provision to the contrary, AGM for the current year as also for the previous year can be held on the same day. There should, however, be separate notices for each meeting and they should be held at different timings.

Answer 11. (c)

The Chairperson and other Members shall not, for a period of one year from the ' date on which they cease to hold office, accept any employment in, or connected with the management or administration of, any enterprise which has been a party to a proceeding before the Commission under this Act :

Provided that nothing contained in this section shall apply to any employment under the Central Government or a State Government or local authority or in any statutory authority or any corporation established by or under any Central, State or Provincial Act or a Government company as defined in section 617 of the Companies Act, 1956 (1 of 1956).

Answer 11. (d)

A person cannot be appointed as a cost auditor of a company if he attracts any of the disqualifications listed in sub-sections (3) and (4) of section 226 of the Act. Thus, the following cannot be appointed as cost auditors :

(i) A body corporate;

(ii) An officer or employee of the company;

(iii) A person who is a partner or who is in the employment of an officer or employee of the company;

(iv) A person who is indebted to the company for an amount exceeding Rs. 1,000 or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding Rs. 1,000 ;

(v) A person holding any vote carrying security of the company ;

(vi) A person who is disqualified to be the cost auditor of its subsidiary or holding company or of another subsidiary of its holding company ;

(vii) A person appointed under section 224 as an auditor of a company [Section 233B (5)(b)].

If a person appointed for conducting the audit of cost accounts of a company becomes subject, after his appointment to any of the aforesaid disqualifications, he shall on and from the date on which he becomes so subject, cease to conduct the audit of the cost accounts of the company [Section 233B(5)(c)].

Additional disqualification – In addition to the aforesaid disqualifications the Institute of Cost and Works Accountants of India has notified that any cost accountant who accepts an appointment as the cost auditor of a company in the following situations shall be deemed to be guilty of professional misconduct :

(i) If he is an employee of the company's auditor appointed under section 224;

(ii) If he is an employee of any of the partners of a firm of chartered accountants which is appointed as company's auditor under section 224.

Q. 12. Distinction between :

(a) Shareholder and Member

(b) Bonus Issue and Right Issue of Shares

(c) Memorandum & Articles of association

(d) Public company & Private company

(e) Debenture & Debenture Stock

Answer 12. (a)

Shareholder and Member :

The 'members' or 'shareholders' of a company are the person who collectively constitute the company as a corporate entity. The terms 'member' and 'shareholder' and 'holder of a share' are used interchangeably. They are synonymous in the case of a company limited by shares, a company limited by guarantee and having a share capital and an unlimited company whose capital is held in definite shares. But in the case of an unlimited company or a company limited by guarantee, a member may not be a shareholder, for, such a company may not have a share capital.

Answer 12. (b)

Bonus Issue of Shares & Right Issure of Share :

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

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

Answer 12. (c)

Memorandum of Association & Articles of Association :

Memorandum of Association :

(i) It is the charter of the company indicating the nature of its business, its nationality, and its capital. It also defines the company's relationship with outside world.

(ii) If defines the scope of the activities of the company, or the area beyond which the actions of the company cannot go.

(iii) It, being the charter of the company, is the supreme document.

(iv) Every company must have its own Memorandum.

(v) There are strict restrictions on its alteration. Some of the conditions of incorporation containd in it cannot be altered except with the sanction of the Company Law Board.

(vi) Any act of the company which is ultra vires the Memorandum is wholly void and cannot be ratified even by the whole body of shareholders.

Articles of Association:

(i) They are the regulations for the internal management of the company and the subsidiary to the Memorandum.

(ii) They are are the rules for carrying out the objects of the company as set out in the Memorandum.

(iii) They are subordinate to the Memorandum. If there is a conflict between the Articles and the Memorandum, the latter prevails.

(iv) A company limited by shares need not have Articles of its own. In such a case, Table A applies.

(v) They can be altered by a special resolution, to any extent, provided they do not conflict with the Memorandum and the Companies Act.

Any act of the company which is ultra vires the Articles (but is intra vires the Memorandum) can be confirmed by the shareholders.

Answer 12. (d)

Public company and a Private company :

(i) **Minimum capital.** A private company must have a minimum paid-up capital of Rs. 1,00,000 whereas a public limited company must have a minimum paid-up capital of Rs. 5,00,000.

(ii) **Minimum number.** The minimum number of persons required to form a public company is 7. It is 2 in case of private company.

(iii) **Maximum number.** There is no restriction on maximum number of members in a public company, whereas the maximum number cannot exced 50 in a private company.

(iv) **Number of directors.** A public company must have at least 3 directors whereas a private company must have at least 2 directors (Sec. 252).

(v) **Restriction on appointment of directors.** In the case of a public company, the directors must file with the Registrar a consent to act as directors or sign undertaking for their qualification shares. The directors of a private company need not do so (Sec. 266).

(vi) **Restriction on invitation to subscribe for shares.** A public company invites the general public to subscribe for the shares in, or the debentures of, the company. A private company by its Articles prohibits any such invitation to the public.

(vii) **Transferability of shares/debentures.** In a public company, the shares and debentures are freely transferable (Sec. 82). In a private company the right to transfer shares and debentures is restricted by the Articles.

(viii) **Special privileges.** A private company enjoys some special privileges. A public company enjoys no such privileges.

(ix) **Quorum.** If the Articles of a company do not provide for a larger quorum, 5 members personally present in the case of a public company are quorum for a meeting of the company. It is 2 in the case of a private company (Sec. 174).

(x) **Managerial remuneration.** Total managerial remuneration in a public company cannot exceed 11 per cent of the net profits (Sec. 198). No such restriction applies to a private company.

Answer 12. (e)

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

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