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Further, in the Elective Papers which are Case Study based, the solutions have been worked out on the basis of certain assumptions/views derived from the facts given in the question or language used in the question. It may be possible to work out the solution to the case studies in a different manner based on the assumptions made or views taken.

PAPER-6B – FINANCIAL SERVICES AND CAPITAL MARKETS

The Question paper comprises five case study questions. The candidates are required to answer any four case study questions out of five.

Answers in respect of Multiple Choice Questions are to be indicated in capital letters, i.e. A or B or C or D as the case may be.

Case Study: 1

- (A) Given below are the data pertaining to XYZ Mutual Fund as at 31st March, 2021. You are a Mutual Fund Advisor for the XYZ Mutual Fund. Mr. W visits your office to seek advice on investing in Mutual Fund and understanding the various concepts of Mutual fund. Since you are a Mutual Fund Advisor for the XYZ Mutual Fund and are having data as at 31st March, 2021. During discussions many questions/queries raised by Mr. W were discussed, Mr. W was, apprised that Average expenses ratio (including management fees) comes to 2.79% including GST:

Particulars	Quantity (No's)	Value (₹) ('000)
Unit Capital:		
Outstanding at the beginning of the year	3,45,41,899,760	3,45,418
Issued during the year	7,25,36,310,229	7,25,363
Redeemed during the year	89,88,725,450	89,887
Outstanding at the end of the year	9,80,89,484,539	9,80,894
Reserve & Surplus		
Unit Premium Reserve		
Balance at the beginning of the year		(4,205)
Net Premium /Discount on issue/redemption of units		1,08,026
Balance at the end of the year		1,03,821
Unrealized Appreciation Reserve		
Balance at the beginning of the year		6,650
Change in unrealized appreciation in value of Investments		15,072
Balance at the end of the year		21,722
Retained Surplus		
Balance at the beginning of the year		8,23,521
Transferred to Revenue account		(2,235)
Surplus transferred from revenue account		20,55,254

<i>Balance at the end of the year</i>		28,81,010
<i>Total Reserves</i>		30,06,553
<i>Current Liabilities</i>		
<i>Amount due to AMC for Management Fees</i>		2,125
<i>Others</i>		55
<i>Sundry Creditors of units redeemed by investors</i>		
<i>Lateral Shift Payable</i>		513
<i>Others</i>		23
<i>Contract for purchase of investments</i>		3,53,825
<i>Unit Application pending allotment</i>		75
<i>Investor education expenses provision</i>		66
Other Current Liabilities		2989
<i>Investments</i>		
<i>Listed Debentures and Bonds</i>		15,25,775
<i>Government Securities</i>		23,41,287
<i>Total</i>		38,67,062
<i>Other Current Assets</i>		
<i>Balances with Banks in Current Accounts</i>		8,681
<i>Sundry debtors for units issued to investors</i>		
- <i>Lateral shift receivable</i>		53
- <i>Others</i>		26
<i>Inter-scheme receivables</i>		775
<i>Outstanding and accrued income</i>		95,266
<i>Collateralized Lending</i>		3,75,255
<i>Total</i>		4,80,05.6
<i>Money market Instruments</i>		225
<i>Debentures and Bonds</i>		66,428
<i>Deposits</i>		55,265
<i>Government Securities (Including Treasury Bills)</i>		1,25,625
<i>Collateralized Lending</i>		7,750
<i>Total</i>		2,55,293

- (B) Mr. X, an industrial chemist with 15 years of experience, has recently been appointed to the post of Chief Executive Officer (CEO) of P Ltd., a listed company. He has previously been employed in the company as Research Director. In preparation for his new

assignment he has been trying to get to grips with the concept of corporate governance and all that it entails. The board of P Ltd. comprises of total ten directors (including one woman director), six non-executive directors and five were considered independent. The board is responsible for overseeing strategy, approving major corporate initiatives and reviewing performance. There are three board committees - the Audit Committee, Remuneration Committee and Investors Grievance Committees. However, there is no Nomination Committee. As you being the Chartered Accountant and Compliance Officer of P Ltd., Mr. X is seeking your assistance to clarify some issues of concern in respect of the Companies Act, 2013 and SEBI (LODR) Regulations, 2015.

Provide the correct option to the following questions:

- 1.1 Which is not the type of Mutual Fund on the basis of "Structure" ?
- (A) Equity Schemes;
 - (B) Debt Schemes;
 - (C) Open Ended Funds;
 - (D) Equity and Debt Schemes. (2 Marks)
- 1.2 Which ratio instead of measuring it against any type of risk, measures it against only downside risk in the portfolio?
- (A) Sharpe Ratio;
 - (B) Treynor Ratio;
 - (C) Sortino Ratio;
 - (D) None of the options. (2 Marks)
- 1.3 Minimum Net worth requirement of the Asset Management Company (AMC) as per SEBI (Mutual Funds) Regulations, 1996:
- (A) ₹ 50 Million;
 - (B) ₹ 50 Billion;
 - (C) ₹ 50 Lacs;
 - (D) ₹ 50 Crores. (2 Marks)
- 1.4 Net assets of a Mutual Fund Scheme will consider:
- (A) Market Value of Investments;
 - (B) Book Value of Investments;
 - (C) Market Value of the Investments adjusted for expected credit losses;
 - (D) Book Value of the Investments without adjusting for credit losses. (2 Marks)

- 1.5 Under a Systematic Investment Plan, which of the following is NOT TRUE:
- (A) Unit holders can invest on a monthly basis whatever amount they can save;
 - (B) Investors can invest only a pre-specified amount every period, say monthly, quarterly or half yearly;
 - (C) If an investor has subscribed ₹ 3,000 in quarterly payments for a 3 years SIP, he can choose to step up this amount to ₹ 4,000 from the second year;
 - (D) Even where the SIP amount in a financial year does not exceed ₹ 50,000 an investor cannot invest in cash. **(2 Marks)**

Answer the following:

- 1.6 (a) On inquiry regarding investment in Treasury Bills, you apprised that fund had invested in Treasury Bills of face value ₹1,50,000 each amounting to ₹ 10 Crores, Mr. W suggested if the average annualized yield calculated based on 90 days as on 31st March, 2021 was 9.37%. Comment upon the statement of Mr. W. **(3 Marks)**
- (b) During discussions of Mr. W with you, Mr. W was keen to know the drawbacks in investing in Mutual Funds, whilst he is keen to know all the issues relating to return and concentration of risk in particular. Explain briefly. **(3 Marks)**
- (c) Considering the scenario of XYZ Mutual Fund is currently placed (Under performing), Mr. W had already made an investment in XYZ Mutual Fund, advise Mr. W if he should exit the Mutual Fund Scheme. He also wants to know what are all the various situations in which exits should be considered from a Mutual Fund Scheme for future reference. **(3 Marks)**
- (d) Mr. W inquired why there is a fraction amount in the number of units column in Mutual Fund Product ? **(2 Marks)**
- 1.7 You have been asked to prepare a brief report for Mr. X on the board composition of P Ltd. with respect to the Companies Act, 2013 and SEBI (LODR) Regulations, 2015. Also advise whether Mr. X should be Chairman of the Company. **(4 Marks)**

ANSWER CASE STUDY-1

- 1.1 C
- 1.2 C
- 1.3 D
- 1.4 A
- 1.5 A

ANSWER 1.6 (a)

Mr. W suggested that the average annualized yield calculated based on 90 days as on 31.03.2021 was 9.37%. Then, in response to his statement, eventually, the average purchase price of the investments of the face value of ₹1,50,000 each in Treasury Bills would be as under:

$$\begin{aligned} \text{Yield} &= \frac{(\text{FV} - \text{Price})}{\text{Price}} \times \frac{365}{90} \\ = 9.37\% &= \frac{(1,50,000 - \text{Price})}{\text{Price}} \times \frac{365}{90} \\ &= 9.37\% \times \text{Price} \times 90 = 5,47,50,000 - 365 \text{ Price} \\ &= 0.0937 \times \text{Price} \times 90 + 365 \text{ Price} = 5,47,50,000 \\ 8.433 \text{ Price} + 365 \text{ Price} &= 5,47,50,000 \\ \text{Price} &= 5,47,50,000 / 373.433 \\ \text{Price} &= 1,46,612.64 \text{ or } \underline{\underline{1,46,613.}} \end{aligned}$$

ANSWER : 1.6(b)**DRAWBACKS IN INVESTING IN MUTUAL FUNDS:**

The drawbacks in investing in mutual funds vis-a-vis issues relating to returns and concentration of risk in particular is summarized as below:

(1) NO GUARANTEE OF RETURN

Mutual funds do not offer fixed guaranteed returns. In other words, mutual funds entail a wide range of price fluctuations. Professional management of a fund by a team of experts does not insulate you from bad performance of your fund. All mutual funds cannot be winners. A mutual fund may perform better than the stock market but this does not necessarily lead to a gain for the investor. The investor may forgive if the return is not adequate, but they will not do so if the principal is eroded - mutual fund investment may depreciate in value. Therefore, there is no guarantee of assured returns.

(2) DIVERSIFIED PORTFOLIO, BUT NO MAXIMUM RETURNS

Diversification is often cited as one of the main advantages of a mutual fund. However, there is always the risk of over diversification, which may increase the operating cost of a fund, demands greater due diligence and dilutes the relative advantages of diversification. In other words, Mutual Fund helps to create a diversified portfolio. Though diversification minimizes risk, it does

not ensure maximizing returns. The returns that mutual funds offer could be less than what an investor can achieve.

(3) SELECTION OF PROPER FUND

It may be easier to select the right share rather than the right fund. For stocks, one can base his selection on the parameters of economic, industry and company analysis. In case of mutual funds, past performance is the only criteria to fall back upon, but past cannot predict the future. Ratings and advertisements issued by Companies are only an indicator of the past performance of a fund. It is important to note that robust past performance of a fund is not a guarantee of a similar performance in the future.

(4) NO CONTROL

All types of mutual funds are managed by fund managers. In many cases, the fund manager may be supported by a team of analysts. Consequently, as an investor, you do not have any control over your investment. All major decisions concerning your fund are taken by your fund manager.

(5) COST FACTOR AND UNETHICAL PRACTICES

The value of a mutual fund may fluctuate depending on the changing market conditions. Furthermore, there are fees and expenses involved towards professional management of a mutual fund which is not the case for buying stocks or securities directly in the market. There is an entry load which has to be borne by an investor when buying a mutual fund. Furthermore, some Companies charge an exit cost as well when an investor chooses to exit from a mutual fund. Further, Mutual funds may not play a fair game. Each scheme may sell some of the holdings to its sister concerns for substantive notional gains and posting NAVs in a formalized manner.

(6) NON-CONSIDERATION OF PERSONAL TAXES

When making decisions about money for the investors, fund managers do not consider the personal tax situations of each investors.

(7) CAGR

The performance of a mutual fund vis-a-vis the compounded annualised growth rate (CAGR) neither provides investors adequate information about the amount of risk facing a mutual fund nor the process of investment involved. It is therefore, only one of the indicators to gauge the performance of a fund but is far from being comprehensive.

(8) FLEXIBILITY

If an investor is running their own portfolio, they can run their own strategies. Whereas, in mutual funds, they need to follow the Fund Manager.

(9) TRANSFER DIFFICULTIES

Complications arise with Mutual funds when a managed portfolio switches to a different financial firm.

(10) FUND EVALUATION

Many investors may find it difficult to extensively research and evaluate the value of different funds. A mutual fund's net asset value (NAV) provides investors the value of a fund's portfolio. However, investors have to study various parameters such as sharpe ratio and standard deviation among others to ascertain how one fund has fared compared to another which can be complicated to some extent.

ANSWER 1.6 (c)**VARIOUS SITUATIONS IN WHICH "EXITS" SHOULD BE CONSIDERED FROM THE MUTUAL FUND SCHEME**

- (1) When the mutual fund consistently under performs the broad based index, it is high time that the investor should get out of the scheme. It would be better to invest in the index itself either by investing in the constituents of the index or buying into an index fund.
- (2) When the mutual fund consistently under performs its peer group instead of it being at the top. In such a case, it would have to pay to get out of the scheme and then invest in the winning schemes.
- (3) When the mutual fund changes its objectives, e.g, instead of providing a regular income to the investor, the composition of the portfolio has changed to a growth fund mode which is not in tune with the investor's risk preferences.
- (4) When the investor changes his objective of investing in a mutual fund which is no longer beneficial to him.
- (5) When the fund manager, handling the mutual fund schemes, has been replaced by a new manager whose image is not known.

ANSWER 1.6 (d)

During the NFO (New Fund Offer), the quantities are whole numbers. However, when investors ask for redemption of a fixed sum or invest a fixed sum, they will have to divide that fixed sum by the prevailing NAV at that date and hence the decimal is an inevitable occurrence. Moreover, when the dividend is reinvested, it is done at the prevailing NAV rates and hence there are allotments in decimals. It is optional for an investor to enter into a scheme for a fixed round sum rather than units. That sum, when converted into units by dividing by a fractional NAV price results is a purchase of fractional number of holding.

Also, there is a fractional amount in the number of units column in mutual fund product because when the value of the securities changes, NAV of the units are not in whole number. Accordingly, when we divide the amount received by the NAV, sometimes we get the amount in fractions.

ANSWER 1.7

Brief report for Mr. X on the Board Composition of P Ltd with respect to the Companies Act, 2013 and SEBI(LODR) Regulations, 2015 based on the inputs given in the facts of the Case Study:

UNDER THE COMPANIES ACT, 2013

Board Composition:

Section 149(1) of the Companies Act 2013 provides that every Company shall have a Board of Directors consisting of individuals as directors and shall have :

- A **minimum number of three directors** in the case of a **Public Company**,
- At least **two directors** in the case of a **Private Company**, and
- At least **one director** in the case of a **One Person Company**; and
- A **maximum of fifteen directors** provided that a Company may appoint more than fifteen directors after passing a special resolution.
- At least **one women director** shall be on the Board of such class or classes of Companies as has been prescribed in Rule 3 of the Companies (Appointment and Qualification of Directors) Rules, 2014 (Second proviso to Section 149(1))

Every Company shall have atleast **one resident director** who stays in India for a total period of not less than **182 days** during the financial year.

Section 149(4) provides that every public listed company shall have **atleast one third of total number of directors as Independent Directors.**

The Board of directors may comprise both Executive and Non-Executive Directors.

UNDER THE SEBI (LISTING OBLIGATIONS AND DISCLOSURE REQUIREMENTS) REGULATIONS, 2015

Regulation 17(1)(a) of SEBI LODR Regulations, 2015 provides that Board of Directors shall have an **optimum combination of Executive and Non-Executive Directors with at least one woman director and not less than fifty per cent of the board of directors shall comprise of non-executive directors.**

Regulation 17 specifies that where the Chairperson of the Board of directors is a non-executive director, **atleast 1/3rd of the Board of Directors shall comprise of Independent Directors.**

Where the listed entity does not have a regular non-executive Chairperson, **atleast half of the Board shall comprise of Independent Directors.**

Provided that where the regular, non-executive Chairperson **is a Promoter** of the listed entity or is related to any promoter or person occupying management positions at the Board level or at one level below the Board, **atleast half of the Board of the listed entity shall consist of Independent Directors.**

The Board of P Ltd. comprises of total ten directors (including one women director), six non-executive directors and five were considered independent. The total number of directors is more than the minimum required directors and satisfied the condition that at- least one third of total number of directors shall be independent directors. Also as per SEBI (LODR) Regulations, 2015 more than fifty per cent of the board of directors comprises of non- executive directors and one women director. **Therefore, the Board composition of P Ltd. is optimum as per the Companies Act, 2013 and SEBI(LODR) Regulations, 2015.**

Whether Mr.X should be the Chairman of the Company ?

First proviso to Section 203(1) of the Companies Act, 2013 provides for the separation of role of Chairman and Chief Executive Officer subject to conditions thereunder. It specifies that an individual shall not be appointed or re-appointed as the Chairperson of the Company, in pursuance of the Articles of the Company, as well as the Managing Director or Chief Executive Officer of the Company at the same time after the date of commencement of this Act unless, -

- (a) the Articles of such a Company provide otherwise;
- (b) the Company does not carry multiple businesses:

Regulation 17(1B) of SEBI (LODR) Regulations, 2015 provides that effective from April 1, 2022, the top 500 listed entities shall ensure that the Chairperson of the board of such listed entity shall -

- (a) be a non-executive director;
- (b) not be related to the Managing Director or the Chief Executive Officer as per the definition of the term "relative" defined under the Companies Act,2013:

Also, it is perceived that separating the roles of Chairman and Chief Executive Officer (CEO) increases the effectiveness of a Company's Board. It is the Board's and Chairman's job to monitor and evaluate a Company's performance.

A CEO, on the other hand, represents the management team. If the two roles are performed by the same person, then there is less accountability. A clear demarcation of the roles and responsibilities of the Chairman of the Board and that of the Managing Director/CEO promotes balance of power.

The benefits of separation of roles of Chairman and CEO can be:

Effective Communication: A separate Chairman provides a more effective channel for the Board to express its views on management.

Guidance: A separate Chairman can provide the CEO with guidance and feedback on his/her performance.

Shareholders' interest: The Chairman can focus on shareholder interests, while the CEO manages the Company.

Governance: A separate Chairman allows the Board to more effectively fulfill its regulatory requirements.

Long-Term Outlook: Separating the position allows the Chairman to focus on the long-term strategy while the CEO focuses on short-term profitability.

Succession Planning: A separate Chairman can more effectively concentrate on corporate succession plans.

Therefore, on the basis of abovementioned laws and regulations and the potential benefits of separating Chairman and CEO, Mr X should not be made Chairman of the Company as he is already CEO of the Company.

Case Study: 2

XCS Ltd., a company involved and engaged in the profession of Topographical surveys, geotechnical investigation, river survey and preparation of detailed project reports and detailed engineering works for various Infrastructure projects. Mr. PKK is the CEO & Managing Director of the company. XCS Ltd. also designs and builds highly engineered products for Automation and dredging work. With its impeccable design, engineering and manufacturing facilities in Bhutan, China and India, the company is able to meet customers' requirements in many countries. XCS Ltd. has 1000 employees across all of its locations. There are 50 companies in the XCS Ltd. corporate family.

Everything was going well in the company. However, in a surprising development capital market regulator ordered the impounding of about ₹ 10 crore from XCS Ltd. Managing Director and CEO Mr. PKK in an insider trading case.

The reason for this impounding order was that a sum of ₹ 10 crore being the notional loss avoided on account of trades carried out during the period when the price sensitive information is unpublished. The watchdog had conducted an investigation into possible insider trading in the shares of XCS Ltd. during the period from August-November 2018.

During the probe, it was found that Mr. PKK, being the CEO and Managing Director of XCS Ltd., had traded the company's shares while being in possession of UPSI (Unpublished Price Sensitive Information).

It was observed that the consolidated quarterly financial results of XCS Ltd. were communicated to the stock exchanges after the trading hours on November 11, 2018, and XCS Ltd. shares fell on the immediate succeeding trading day on November 15, 2018.

It was also alleged that Mr. PKK, having traded on the basis of UPSI, avoided loss on account of fall in price of shares due to the announcement of the said quarterly consolidated financial results of XCS Ltd. Therefore, the amount of loss avoided by Mr. PKK in aggregate, including interest through trading in shares of XCS Ltd, amounted to over ₹ 10 crore.

It was, prima facie, observed that the pre-trading approval was not taken for the required number of shares for which sale order was placed. Further, a designated person shall not apply for pre-clearance of any proposed trade if such person is in possession of UPSI even if the trading window is open, the watchdog said in its order.

Since Mr. PKK was the Managing Director and a connected person', prima facie, he violated the provisions of SEBI (Prohibition of Insider Trading).

Regulations, 2015, the order said. In view of the above, it can be said that Mr. PKK engaged in insider trading, which helped him to avoid loss due to a fall in stock prices of the company after its consolidated quarterly report was published.

Insider trading takes place when the buyer happens to have additional information about stock performance that is not available to the general public. It can be both legal and illegal, depending on when the trade is taking place. It is deemed unethical when trading happens when the information is still private, tilting the trade in favour of one party. These types of trading come with harsh consequences and may attract penalty from regulators. SEBI being the regulator keeps close monitoring to track such trades to prevent few traders from manipulating the market.

In the case of XCS Ltd., the regulator was investigating a case from 2018. The SEBI (Prohibition of Insider Trading) Regulations, 2015, which clearly states that insider trading is an unethical practice resorted by those in possession of certain unpublished information relating to a company to profit against general investors who don't have access to such information. It has listed the following people in its monitoring list in connection with any insider trading activity:

- *Directors of the company*
- *Key personnel in Managerial positions*
- *People in the positions of Vice Presidents, General Managers, Dy. General Managers, Asst. General Managers*

- Employees who have access to sensitive financial information/documents. All employees from Finance, Legal & Company Secretarial, HR & IT departments irrespective of grade will come under monitoring.
- All Personal Assistants and Secretaries to the Directors and Other Senior Officials.
- Dependents of all the employees of the above categories.

Impounding order by SEBI in insider trading case is announced against MD and CEO of XCS Ltd. as per the above list of people. It suggests that he used the UPSI knowledge to trade stocks to avoid a loss that occurred the following day when stock prices topped after company's performance report was published.

On November 11, 2018, company's financial performance report was shared with the exchange after trading hours, following which stock prices of XCS Ltd. shares tumbled on November 15. In the case of XCS Ltd. CEO, no pre-trading approval was taken, which led to the inquiry and subsequent seizing order for XCS Ltd.

Brief financials of the company as at year ending

(₹ in Lacs)

Particulars	31st March 2021	31st March 2020	31st March 2019	31st March 2018	31st March 2017
Assets	1624.00	1571.68	1584.00	1304.76	1134.67
Liabilities	1624.00	1571.68	1584.00	1304.76	1134.67
Equity	242.58	242.58	242.58	242.58	242.58
Net Profit	95.68	70.61	137.95	136.68	157.49
Cash from Operating activities	86.87	75.79	(35.47)	17.33	(5.16)
Revenue	1010.56	945.56	1065.73	1174.93	1258.63
Expenses	906.79	829.06	852.54	936.13	986.68
ROE(%)	3.68	2.90	5.69	5.63	6.49

Shareholding Summary for XCS Ltd.

Type	Holding
Promoter	48.8
MF	10.6
FII	14.4

Public 26.2

In a related development the SEBI during investigation under the provisions of SEBI (Prohibition of Insider Trading) Regulations, 2015 found XYZ Bank Limited ("Bank") a bank listed on BSE Limited for violation of the regulations. It was found that some of the employees of the Bank, who were in possession of unpublished price sensitive information ("UPSI") of the Bank and other listed companies including XCS Ltd. with whom the Bank deals, after which they were consequently restricted from dealing in securities of the Bank and such other listed companies including XCS Ltd.

Multiple Choice Questions:

Choose the most appropriate answer:

- 2.1 It was alleged that Mr. PKK, having traded on the basis of UPSI, on account of fall in price of shares due to the announcement of the said quarterly consolidated financial results of XCS Ltd:
- (A) avoided loss;
 - (B) made loss;
 - (C) avoided profit;
 - (D) None of these. **(2 Marks)**
- 2.2 The meaning of "Board" as defined in SEBI (Prohibition of Insider Trading) Regulations, 2015 means:
- (A) Board of Directors of Company;
 - (B) Securities and Exchange Board of India;
 - (C) Stock Exchange;
 - (D) None of the options. **(2 Marks)**
- 2.3 The reason Mr. PKK violated the provisions of SEBI (Prohibition of Insider Trading) Regulations, 2015 was
- (A) Delayed pre-trading approval was taken for the required number of shares for which the sale order was placed;
 - (B) Pre-trading approval was not taken for the required number of shares for which the sale order was placed;
 - (C) Post-trading approval was taken for the required number of shares for which the sale order was placed;
 - (D) No approval was taken at all for the required number of shares for which the sale order was placed. **(2 Marks)**

- 2.4 Under which Act words and expressions used and not defined in SEBI (Prohibition of Insider Trading) Regulation, 2015 shall not have the same meaning as assigned in this legislation :
- (A) The Depositories' Act, 1996;
 - (B) The Companies Act, 2013;
 - (C) The Securities Contract (Regulation) Act, 1956;
 - (D) The Income Tax Act, 1961. **(2 Marks)**
- 2.5 An insider who is continuously in possession of unpublished price sensitive information is entitled to formulate a trading plan and present it to the for approval.
- (A) Stock Exchange;
 - (B) SEBI;
 - (C) Compliance Officer;
 - (D) Audit Committee. **(2 Marks)**
- 2.6 Is there any obligation imposed on the CEO and the MD of XCS Limited under the SEBI (Prohibition of Insider Trading) Regulations, 2015 ? If yes, then explain with the help of the SEBI Regulations. **(4 Marks)**
- 2.7 (a) Is there a bar on insiders from trading in securities of a company when in possession of UPSI under the SEBI (Prohibition of Insider Trading) Regulations, 2015 ("PIT Regulations") ? **(2 Marks)**
- (b) What is the presumption under the PIT Regulations regarding trading in securities by an insider (employees of the Bank) when he is in possession of UPSI ? Explain in detail the circumstances of Innocence. **(5 Marks)**
- (c) Are deals under the Discretionary Portfolio Management Scheme on behalf of the employees of the Bank or their relatives in compliance with the provisions of the PIT Regulations ? **(4 Marks)**

ANSWER CASE STUDY-2

- 2.1 (A)
- 2.2 (B)
- 2.3 (B)
- 2.4 (D)
- 2.5 (C)

ANSWER 2.6

There are obligations stipulated under **Regulation 7(1) and 7(2) of SEBI (Prohibition of Insider Trading) Regulations, 2015**, imposed on the CEO and the MD of XCS Limited:-

(1) Initial Disclosures.

- (a) Every promoter, key managerial personnel and director of every company whose securities are listed on any recognised stock exchange shall disclose his holding of securities of the Company as on the date of these regulations taking effect, to the Company **within thirty days** of these Regulations taking effect;
- (b) Every person on appointment as a key managerial personnel or a director of the Company or upon becoming a promoter shall disclose his holding of securities of the Company as on the date of appointment or becoming a promoter, to the Company **within seven days** of such appointment or becoming a promoter.

(2) Continual Disclosures.

- (a) Every promoter, employee and director of every Company shall disclose to the Company the number of such securities acquired or disposed of within two trading days of such transaction if the value of the securities traded, whether in one transaction or a series of transactions over any calendar quarter, aggregates to a traded value **in excess of ten lakh rupees** or such other value as may be specified.
- (b) Every Company shall notify the particulars of such trading to the Stock Exchange on which the securities are listed **within two trading days** of receipt of the disclosure or from becoming aware of such information.

ANSWER 2.7

(a) Yes, there is a bar on insiders from trading in securities of a Company when in possession of Unpublished Price Sensitive Information (UPSI).

Regulation 4(1) of the SEBI (PIT) Regulations, 2015 states that **no insider shall deal** in securities that are listed or proposed to be listed on a stock exchange when in possession of UPSI.

The explanatory note to Regulation 4 provides a presumption that trades executed by a person in possession of UPSI have been motivated by the knowledge and awareness of such information in his possession. When a person who has traded in securities has been in possession of unpublished price sensitive information, his trades would be presumed to have been motivated by the knowledge and awareness of such information in his possession.

ANSWER 2.7(b)**PRESUMPTION:**

The reasons for which an insider trades or the purposes to which he applies the proceeds of the transactions are not intended to be relevant for determining whether a person has violated the SEBI(PIT) Regulations. He traded when in possession of unpublished price sensitive information is what would need to be demonstrated at the outset to bring a charge. Once this is established, it would be open to the insider to prove his innocence by demonstrating the circumstances mentioned in the proviso, failing which he would have violated the prohibition.

CIRCUMSTANCES OF INNOCENCE

- (i) the transaction is an off-market inter-se transfer between insiders who were in possession of the same unpublished price sensitive information without being in breach of Regulation 3 and both parties had made a conscious and informed trade decision.

Provided that such unpublished price sensitive information was not obtained under sub-regulation (3) of Regulation 3 of these regulations.

Provided further that such off-market trades shall be reported by the insiders to the Company within two working days. Every Company shall notify the particulars of such trades to the Stock Exchange on which the securities are listed **within two trading days** from receipt of the disclosure or from becoming aware of such information.

- (ii) the transaction was carried out through the block deal window mechanism between persons who were in possession of the unpublished price sensitive information without being in breach of Regulation 3 and both parties had made a conscious and informed trade decision. Provided that such unpublished price sensitive information was not obtained by either person under sub-Regulation (3) of these regulations.
- (iii) the transaction in question was carried out pursuant to a Statutory or Regulatory obligation to carry out a bona fide transaction.
- (iv) the transaction in question was undertaken pursuant to the exercise of stock options in respect of which the exercise price was pre-determined in compliance with applicable regulations.
- (v) **in the case of non-individual insiders:-**
- (a) the individuals who were in possession of such unpublished price sensitive information were different from the individuals taking trading decisions and such decision making individuals were not in possession of such unpublished price sensitive information when they took the decision to trade; and
- (b) appropriate and adequate arrangements were in place to ensure that these regulations are not violated and no unpublished price sensitive information was communicated by the individuals possessing the information to the individuals taking

trading decisions and there is no evidence of such arrangements having been breached;

(vi) the trades were pursuant to a trading plan set up in accordance with Regulation 5.

ANSWER 2.7(c)

Regulation 4(1) of SEBI (PIT) Regulations, 2015 read with its explanatory note provides that dealing in securities, whether direct or indirect, is not relevant, but that any insider, when in possession of UPSI, should not deal in securities of the Company to which the UPSI pertains. Hence, even while dealing in securities through the Discretionary Portfolio Management Scheme, the trades of an insider or their relatives would be assumed to be motivated by the knowledge and awareness of such UPSI, and therefore such trades **will not be in compliance** with the provisions of the PIT Regulations.

Case Study: 3

(A) *A company PQR Limited is planning an IPO of say, 100,000 shares, at a book-built price of ₹ 100, resulting in an IPO size of ₹ 100,00,000. As per the SEBI (ICDR) Regulations, 2018, the over-allotment component under the Green Shoe mechanism could be up to 15% of the IPO, i.e. up to 15,000 shares, i.e. Green Shoe shares. Prior to the IPO, the stabilizing agent (Mr. X) would borrow such number of shares to the extent of the proposed Green Shoe shares from the pre-issue shareholders. These shares are then allotted to investors along with the IPO shares. The total shares issued in the IPO therefore stands at 1,15,000 shares. IPO proceeds received from the investors for the IPO shares, i.e., 100,00,000 - 100,000 shares at the rate of ₹ 100 each, are remitted to the Issuer Company, while the proceeds from the Green Shoe Shares (₹ 15,00,000, being 15,000 shares x ₹ 100) are parked in a special Escrow Bank Account, i.e. Green Shoe Escrow Account. During the price stabilisation period, if the share price drops below ₹ 100, the stabilising agent (Mr. X) would utilise the funds lying in the Green Shoe Escrow Account to buy back these shares from the open market.*

(B) *PA Ltd. is a company engaged in assembly and distribution of Heavy Motor Vehicles (HMV). The company sources orders for such vehicles through network of marketing agents. Based on the order, requisite auto parts are imported from foreign suppliers and assembled into HMVs and delivered to the clients.*

The outbreak of second wave of COVID 19 pandemic had an adverse impact on the business volume. The outbreak not only caused operational hindrances for supply from European Countries but also low demand in the Indian Auto Market.

With the success of vaccination drive and relief in lockdown measures, the auto segment is promising growth and potential. The market expects more people to buy own vehicles or use private transport for their day to day conveyance needs rather public transport options which are crowded and pose contamination risk.

G India, a NOIDA based startup seeds an idea of using technology to connect with professional working class in Delhi-Faridabad-NOIDA route for their daily conveyance needs. G India has launched an App where such professionals can provide info about their work timings, location etc. so that they can be aggregated for conveyance through Private vehicles.

G India intends to ply 40 seater Air-conditioned luxury private Buses for such professionals for their daily work commute. The Buses are designed to provide Wi-Fi, laptop charging point and privacy curtains that the executives can utilize the commuting hours for work, calls, emails etc.

G India approaches PA Ltd. for procuring 50 such Buses for their start up. After understanding the requirement of G India, PA Ltd. proposes a 40 seater luxury Bus which shall be imported from Germany and assembled and delivered in India by PA Ltd.

G India likes the proposal and agrees on the design, layout and cost for the Buses. G India informs PA Ltd. about two issues faced by them:

- (i) They are located in a special economic zone and therefore exempted from Taxation, thus they cannot claim depreciation or any tax benefit on the Buses.
- (ii) They do not have enough capital to pay upfront for purchase of these Buses.

G India therefore propose if these Buses can be provided under a lease instead of an outright sale. PA Ltd. was not very comfortable with the idea as they have never done leasing of vehicles before, However, the company could not afford to loose business from G India. They agree to respond to G India on the proposal after checking with their financial advisor.

PA Ltd. approaches you for your advice on leasing the vehicles to G India. Below information is provided to you regarding imported Air conditioned luxury private Buses.

Particulars	Cost Involved
Cost of Import of parts for each Bus	EUR 50,000 (FX Rates EURUSD: 1:1.22 USD INR 1:73)
Custom Duty including GST	40%
Other technical cost of Assembly per Bus	INR 3,50,000
Overheads per Bus	INR 40,000
Local taxes per Bus	INR 30,000
Taxation rate for PA Ltd.	25% Corporate Tax
Rate of Depreciation	30% SLM
Estimated Life	5 years
Margin of profit	20%

The PA Ltd. received a rebate of an amount equal to the Other technical cost of Assembly from the State Government as part of the Make in India initiative. The rebate is received as soon as the Buses are led from the Assembly workshop.

A leading NBFC has agreed to provide finance to PA Ltd. @ 16% p.a. for 5 years over hypothecation of Buses.

Multiple Choice Questions:

- 3.1 For instance what would have been the annual lease payable if PA Ltd. is located in a special economic zone as well with no taxation for 4 years.
- (A) INR 24,56,978.86;
 - (B) INR 26,94,763.12;
 - (C) INR 27,03,271.96;
 - (D) INR 28,16,386.70. **(2 Marks)**
- 3.2 Where the Lessee has the right to purchase the leased assets after the expiry of initial lease period at an agreed price is:
- (A) Lease with lessee having residual benefits;
 - (B) Lease with purchase options;
 - (C) Lease with sale options;
 - (D) None of the options. **(2 Marks)**
- 3.3 From a Lessors' perspective the lease financing proposal should be accepted only if:
- (A) Computed IRR of cash flows is more than the required cut-off rate or Cost of Capital;
 - (B) Computed IRR of cash flows is more than the pre-tax cost of borrowing;
 - (C) Computed NPV of the cash flows is negative;
 - (D) Computed NPV of the cash flows is more than the sum of Initial Cash flow and Terminal Cash flow. **(2 Marks)**
- 3.4 What would be revised profit margin for PA Ltd. if G India agrees to pay not more than INR 9,90,000 as annual lease for each Bus:
- (A) 19.57%;
 - (B) 17%;
 - (C) 22.89%;
 - (D) Loss. **(2 Marks)**
- 3.5 What is the lowest annual lease PA Ltd. can quote to G India so as to not incur any loss on the transaction.
- (A) INR 12,76,465.48;

(B) INR 12,79,645.48;

(C) INR 12,75,922.48;

(D) INR 12,74,965.48.

(2 Marks)

3.6 What the annual lease per Bus shall PA Ltd. charge to G India so as to have no economic impact if an outright sale would have been executed. Assume lease is payable at the end of each year and life of each Bus is 5 years. **(6 Marks)**

3.7 Comment upon the three situations under Green Shoe Option:

- Situation #1 : where the stabilising agent (Mr. X) manages to buyback all of the Green Shoe Shares, i.e., 15,000 shares.
- Situation #2 : where the stabilising agent (Mr. X) manages to buyback none of the Green Shoe Shares.
- Situation #3: where the stabilising agent (Mr. X) manages to buyback some of the Green Shoe Shares, say 10,000 shares. **(9 Marks)**

ANSWER CASE STUDY-3

3.1 (D)

3.2 (B)

3.3 (A)

3.4 (D)

3.5 (C)

ANSWER - 3.6

Annual lease per Bus PA Ltd. shall charge to G India so as to have no economic impact if an outright sale would have been executed (Assuming lease is payable at the end of each year and life of each Bus is 5 years.

Let the annual lease payable be “z”. Discounting rate is 12% (i.e 16% X (1-25%))

Sale price= (z + annual tax benefit on interest and depreciation) x (DCF @ 12 p.a)

$$= 78,80,250 = (z + 2,52,168 + 4,72,815) \times 3.605$$

$$= 78,80,250 = 3.605z + 26,13,563$$

$$= 78,80,250 - 26,13,563 = 3.605z$$

$$= 3.605z = 52,66,687$$

$$z = 52,66,687 / 3.605$$

z= 14,60,940

Therefore, the annual lease per Bus that shall be charged by PA Ltd to G India is 14.60,940

Working Note -1

Calculation of Sale Price:

EURO Amount = 50,000;

USD Amount = Euro 50,000 X Euro USD Fx rate = 61,000

INR Amount = USD Amount X USD Fx rate = 44,53,000

Cost of import in INR = 44,53,000

Customs Duty (40%) = 17,81,200

Overheads and Local Taxes = 70,000

Cost of Each Bus = 63,04,200

Sale price with 20% margin = cost/ (100% - 20%)

Sale price of each Bus = **78,80,250**

Sale Price = z X (DCF @16%)

DCF = 2.798

28,16,386.70

Annual tax benefit on interest:

Interest cost - cost of assemble 16% p.a

=10,08,672.

Tax benefit on interest =10,08,672*25 % (Tax rate for PA Limited)

= **2,52,168**

Working 2

Annual tax benefit on depreciation:

Annual depreciation : cost of assemble * slm depreciation rate

= 18,91,260

Tax benefit on depreciation

18,91,260 25% (Tax rate for PA Limited)

= **4,72,815**

ANSWER - 3.7**Situation #1 - Where all Green Shoe Shares are bought back:**

In this situation, funds in the Green Shoe Escrow Account (₹15,00,000, in this case) would be deployed by the stabilising agent towards buying up shares from the open market. Given that the prices prevalent in the market would be less than the issue price of ₹ 100, the stabilising agent would have sufficient funds lying at his disposal to complete this operation. Having bought back all of the 15,000 shares, these shares would be temporarily held in a special depository account with the depository participant (Green Shoe Demat Account), and would then be returned back to the lender shareholders, within a maximum period of two days after the stabilisation period.

Situation #2**Where none of the Green Shoe Shares are bought back:**

This situation would arise in the (very unlikely) event that the share prices have fallen below the Issue Price, but the stabilising agent is unable to find any sellers in the open market, or in an event where the share prices continue to trade above the listing price, and therefore there is no need for the stabilising agent to indulge in price stabilisation activities.

In either of the above-said situations, the stabilising agent is under a contractual obligation to return the 15,000 shares that had initially been borrowed from the lending shareholder(s). Towards meeting this obligation, the issuer company would allot 15,000 shares to the stabilising agent into the Green Shoe Demat Account (the consideration being the funds lying the Green Shoe Escrow Account), and these shares would then be returned by the stabilising agent to the lending shareholder(s), thereby squaring off his responsibilities.

Situation #3**Where some of the Green Shoe Shares are bought back say 10,000 shares:**

This situation could arise in an event where the share prices witness a drop in the initial stages of the price stabilisation period, but recover towards the latter stages.

In this situation, the stabilising agent has a responsibility to return 15,000 shares to the lending shareholder(s), whereas the stabilising activities have yielded only 10,000 shares. Similar to the instance mentioned in Situation #2 above, the issuer Company would allot the differential 5,000 shares into the Green Shoe Demat Account to cover up the shortfall, and the Stabilising Agent would discharge his obligation to the lending shareholder(s) by returning the 15,000 shares that had been borrowed from them.

Both in Situation #2 and #3, the issuer Company would need to apply to the exchanges for obtaining listing/ trading permissions for the incremental shares allotted by them, pursuant to the Green Shoe mechanism. Any surplus lying in the Green Shoe Escrow Account would then

be transferred to the Investor Protection and Education Fund established by SEBI, as required under ICDR Regulations and the account shall be closed thereafter.

Case Study: 4

(A) Following are the financial details of DEF Limited for the year ending 31st March, 2021:

DEF Limited Balance Sheet as at 31st March, 2021

Particulars		As at 31st March, 2021 (₹ in Crores)
A	EQUITY AND LIABILITIES	
1	Shareholders' funds:	
	(a) Share Capital	1,500.00
	(b) Reserves and Surplus	3650.00
	Sub-total (1)	5,150.00
2	Non-Current Liabilities:	
	(a) Long-term borrowings	480.00
	(b) Other Long term liabilities	110.00
	(c) Long-term provisions	56.00
	Sub-total (2)	646.00
3	Current Liabilities:	
	(a) Short-term borrowings	33.50
	(b) Trade Payable	655.00
	(c) Other Current Liabilities	7.50
	(d) Short-term provisions	9.85
	Sub-total (3.)	705.85
	Total	6,501.85
B	ASSETS	
1	Non-current assets:	
	(a) Fixed Assets	
	(i) Tangible assets	2,400.00
	(ii) Intangible assets	186.55
	Sub-total (1)	2,586.55
	(b) Non-current investments	415.30
	(c) Long-term loans and advances	585.00

	(d) Other-non-current assets	155.00
	Sub-total (2)	1,155.30
2	Current assets:	
	(a) Current investments	13.00
	(b) Inventories	750.00
	(c) Trade Receivables	325.00
	(d) Cash and cash equivalents	986.00
	(e) Short-term Loans and advances	55.00
	(f) other current assets	631.00
	Sub-total (3)	2,760.00
	Total	6,501.85

Other Point: The Management of the DEF Limited discussed various issues associated with Buy-back of shares in their meeting of Board of Directors regarding compliance of SEBI (Buy Back of Securities) Regulations, 1998 and Companies Act, 2013 including filing of returns with SEBI and Registrar of Companies. The Board also discussed appointment of Merchant Banker(s)/Registrar. After appointment of Merchant Banker(s)/Registrar by the Board of Directors, the Merchant Banker(s) were asked to make presentation on Buy-back process. Subsequently the Merchant Banker made detailed presentations to the management on Buy-back of shares and specified securities detailing compliance of SEBI (Buy Back of Securities) Regulations, 1998 and Companies Act, 2013.

Final Points relating to buy-back of Shares:

- (1) *DEF Limited Issued 10% p.a. Bonds in 2005 at discount of 5% for total amount of ₹ 10,00,00,000/- (₹ Ten Crores) redeemable in 2025 i.e. for 20 years and interest is payable on yearly basis. Out of ₹ 10 Crores bonds company issued ₹ 1 Crore bonds under Call Protection. These Bonds have been shown under Long Term Borrowings.*
- (2) *Current interest rates are about to 7.5% p.a.*
- (3) *Share capital is fully paid up at ₹ 10 each.*
- (4) *DEF Limited's Shares are trading at BSE and NSE.*
- (5) *Reserve and surplus includes ₹ 1,200/- (Rupees one thousand twelve hundred Crores) free reserve of DEF Limited.*
- (6) *DEF Limited pass resolution at board meeting held as on 15th June, 2020 and passed special resolution of buy back of shares in general meeting held on 15th July, 2020 and giving result of postal ballot.*
- (7) *One of the Tax and Financial Consultants give knowledge of call features for bonds to DEF Limited. They told that DEF Limited can "call in" the bonds and repay them at*

predetermined price before maturity. Also giving knowledge that company can issue new bond with "call protection" i.e. they are guaranteed not to be called for five to ten years or other period specify.

- (8) DEF Limited wants to expand its business and starting new manufacturing of product X and for that it incorporates one new company i.e. KLM Limited and offers shares via book building method. KLM Limited appoints merchant banker as book runner lead manager. KLM Limited opened its offer for 5 days which may be extended to 10 working days for all corporate and for 3 days which is minimum working days for all non-corporates.
- (9) If DEF Limited buy back its shares via tender offer, then price will be ₹3 00 per share.
- (10) DEF Limited come to know that if we go for buy back we have to give disclosures under the Companies Act which contains full and complete material facts, necessity of buy back, the class of shares, amount to be invested, time limit of completion of buy back etc.
- (11) The management of DEF Limited was unaware of Escrow account, however the merchant 'banker have apprised the management regarding mandatory requirement of opening of Escrow account.
- (12) The management apprised the merchant banker that there is no requirement of extinguishment of shares and reporting requirement to SEBI as per SEBI (Buy Back of Securities) Regulations, 1998 and Companies Act, 2013.

Multiple Choice Questions:

4.1 DEF Limited shall on amount spent on shares buy backs will be shown in statement of cash flows in the:

- (A) Operating Activities;
 (B) Financing Activities;
 (C) Leasing Activities;
 (D) None of the options.

(2 Marks)

4.2 If the Extract of Balance Sheet of DEF Ltd. consists of:

Equity Share Capital ₹6,00,000 of ₹10 each

12% Preference Share Capital - ₹1,00,000 of ₹100 each

14% Debenture Capital ₹3,00,000 of ₹100

What is the maximum equity share capital and number of equity shares that can be bought back ?

- (A) ₹1,80,000 and 18,000 equity shares;
 (B) ₹1,50,000 and 15,000 equity shares;

- (C) ₹ 1,20,000 and 12,000 equity shares.
(D) None of the options. **(2 Marks)**
- 4.3 What is the maximum upto which DEF Limited can buy back ?
(A) ₹ 400 Crores;
(B) ₹ 600 Crores;
(C) ₹ 902.50 Crores;
(D) ₹ 670.50 Crores. **(2 Marks)**
- 4.4 What will be the last date of buy-back if DEF Limited buy back its shares amounting to ₹ 110 Crores ?
(A) 14th July, 2020
(B) 14th June, 2020
(C) 15th June, 2020
(D) 15th July, 2020 **(2 Marks)**
- 4.5 The components of the Escrow account may be maintained in an account.
(A) Credit, non-interest
(B) Credit, Cash Credit
(C) Saving, Current
(D) Cash, Interest bearing **(2 Marks)**
- 4.6 What in your opinion the merchant banker of DEF Limited would have apprised the management of DEF Limited in their presentation regarding conditions and requirements for Buy-back of shares and specified securities detailing compliance of SEBI (Buy Back of Securities) Regulations, 1998 and Companies Act, 2013.? **(5 Marks)**
- 4.7 From the case study given above answer of following questions:
- (a) What is the maximum amount by which DEF Limited can buy- back its shares from the open market? What will the maximum amount that DEF Limited can buy back without passing special resolution in general meeting and instead of passing special resolution for that what DEF Limited have to do? **(2 Marks)**
- (b) "The management of DEF Limited was unaware of opening of Escrow account, however the merchant banker have apprised the management regarding mandatory requirement of opening of Escrow account." Explain briefly. **(4 Marks)**
- (c) "The management apprised the merchant banker that there is no requirement of extinguishment of shares and reporting requirement to SEBI as per SEBI (Buy Back of Securities) Regulations, 1998 and Companies Act; 2013." Analyse the veracity of the statement. **(4 Marks)**

ANSWER CASE STUDY-4

4.1 (B)

4.2 (B)

4.3 NONE OF THE GIVEN OPTION IS CORRECT

4.4 NONE OF THE GIVEN OPTION IS CORRECT

4.5 (D)

ANSWER 4.6

Conditions and requirements of Buy-Back of shares and specified securities detailing compliances of SEBI(Buy Back of Securities) Regulations, 1998 and the Companies Act, 2013

Applicability

As per **Regulation 3 of SEBI (Buy Back of Securities) Regulations, 1998**, these Regulations shall be applicable to buy-back of shares or other specified securities of a Company in accordance with the applicable provisions of the Companies Act, 2013 as enshrined under Section 68.

CONDITIONS AND REQUIREMENTS

Regulation 4(i). The maximum limit of any buy-back shall be **twenty-five per cent or less** of the aggregate of paid-up capital and free reserves of the Company (based on both standalone and consolidated financial statements of the Company).

Explanation : W.r.t. to the buyback of securities in any financial year, the reference of 25% shall be construed with the total paid-up equity capital for that financial year.

4(ii) The ratio of aggregate of secured and unsecured debts owed by the Company to the paid-up capital and free reserves after buy back of shares shall :

- (a) **Be less than or equal to 2:1**, based on both standalone and consolidated financial statements of the Company. Provided that if a higher ratio of the debt to capital and free reserves for the company has been notified under the Companies Act 2013 the same shall prevail.
- (b) **Be less than or equal to 2:1** based on both standalone and consolidated financial statements of the Company, after excluding financial statements of all subsidiaries that are NBFCs and housing finance Companies regulated by the RBI or national Housing bank as the case may be.

4(iii) All shares or other specified securities for buy back shall be **fully paid up**.

4(iv) A company may buy-back its shares or other specified securities by any one of the following methods:

- a. from the existing share holders or other specified securities holders on a proportionate basis through the tender offer;
- b. from the open market through-
 - i. Book building method
 - ii. Stock Exchange;
- c. from odd-lot holders:

No offer for buy back from open market shall be 15% or more of the paid up share capital and free reserves of the Company from the open market.

4(vii) A Company shall not make any offer of buy-back within a period of one year reckoned from the date of expiry of buyback period of the preceding offer of buy-back, if any.

4(viii) A Company may undertake a buy-back of its own shares unless the consequent reduction of its share capital is effected.

4(ix) A Company may undertake a buy-back of its own shares or other specified securities out of:

- i. its free reserves;
- ii. the securities premium account; or
- iii. the proceeds of the issue of any shares or other specified securities Provided that no such buy-back shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

4(x) No Company shall directly or indirectly purchase its own shares or other specified securities:

- a. through any subsidiary company including its own subsidiary companies;
- b. through any investment company or group of investment companies; or
- c. if a default is made by the Company in the repayment of deposits accepted, interest payment,

redemption of preference shares or payment of dividend to any shareholder or repayment of any term loan or interest payable thereon to any financial institution or banking company Provided that the buy-back is not prohibited, if the default is remedied and a period of three years has lapsed after such default ceased to subsist.

GENERAL COMPLIANCES

The Company shall not authorize any buy back unless: the buy back is authorized by the Company's Articles and a special resolution has been passed at a general meeting of the Company authorizing the buy-back and the explanatory statement to be annexed to the notice of the general meeting shall contain mandatory disclosures.

Where the buy back is less than 10% or less of the paid-up capital and free reserves, then such buy back is authorized by the Board of directors by means of a resolution passed at its meeting. In such a case, no special resolution of the members is required.

ANSWER 4.7 (a)

The maximum amount that DEF Limited can buy from the open market :

Any amount less than Rs 405 Crores (15% of paid up capital and free reserves) can be bought-back from the open market by DEF Limited.

DEF Limited can buy back its shares upto **₹ 270 Crores** without passing special resolution in general meeting and for the same it has to **pass resolution only in board meeting.**

ANSWER 4.7 (b)

Mandatory requirements of Opening an Escrow Account

The Company shall as and by way of security for performance of its obligations under the Regulations, **on or before the opening of the offer,** deposit in an escrow account such sum as specified under SEBI Regulations.

The amount in the escrow shall be deposited in the following manner:

Amount of consideration and the percentage of amount to be deposited.

For Consideration not more than ₹ 100 crore - 25 per cent of the consideration payable;

For Consideration exceeding Rupees 100 crore - 25 per cent upto Rupees 100 crore and 10 per cent thereafter.

The escrow account referred to above shall consist of Cash deposited with a Scheduled Commercial Bank or Bank Guarantee in favour of the Merchant Banker, or the Company shall, while opening the account, empower the merchant banker to instruct the bank to make payment the amount lying to the credit of the escrow account, as provided in the regulations. Such bank guarantee shall be in favour of the merchant banker and shall be valid until thirty days after the expiry of buyback period.

Deposit of acceptable securities with appropriate margin, with the merchant banker, the Company shall empower the merchant banker to realise the value of such escrow account by sale or otherwise and if there is any deficit on realisation of the value of the securities, the merchant banker shall be liable to make good any such deficit or a combination of all ABOVE.

In case the escrow account consists of bank guarantee or approved securities, these shall not be returned by the merchant banker till completion of all obligations under the regulations. Where the escrow account consists of bank guarantee or deposit of approved securities, the Company shall also deposit with the bank in cash a sum of at least one per cent of the total consideration payable, as and by way of security for fulfillment of the obligations under the regulations by the Company.'

Note: The cash component of the escrow account may be maintained in an interest bearing account. However, the merchant banker shall ensure that the funds should be available at the time of making payment to shareholders. After the payment of consideration to all the securities holders who have accepted the offer and after completion of all formalities of buy-back, the amount, guarantee and securities in the escrow, if any, shall be released to the Company.

In case of non-fulfilment of obligations under the Regulations, SEBI in the interest of the securities holders, may forfeit the escrow account either in full or in part. Such forfeited amount may be distributed amongst the securities holders who accepted the offer and balance, if any, on pro rata which shall be utilised for investor protection.

ANSWER 4.7 (c)

The Management's statement that there is no requirement of extinguishment of shares and reporting requirements to SEBI as per SEBI (Buy Back of Securities) Regulations, 1998 is not correct. The correct legal position is as given herein under:

EXTINGUISHMENT OF CERTIFICATE AND OTHER CLOSURE COMPLIANCES

11 (i) The Company shall extinguish and physically destroy Securities Certificates which are bought back in the presence of the Registrars to the Issue / Merchant Banker and the Statutory Auditor within 15 days of the date of acceptance of the shares or other specified securities. Period of fifteen days shall not extend beyond seven days of expiry of buy-back period in any case.

(ii) The shares or other specified securities offered for buy -back if already dematerialized shall be extinguished and destroyed in the manner specified under SEBI (Depositories and Participants) Regulations, 1996 and the bye laws, the circulars and guidelines framed thereunder.

(iii) The Company shall, furnish a certificate to the Board certifying compliance as specified in sub-regulation (i) above and duly certified and verified by :

- (a) Registrar and whenever there is no registrar, by the merchant banker;
- (b) Two directors of the company, one of whom shall be a managing director, where there is one; and
- (c) the statutory auditor of the company

This certificate shall be furnished to the Board **within seven days** of extinguishment and destruction of the certificates.

(iv) The Company shall furnish the particulars of the securities certificates extinguished and destroyed under sub-regulation (i) to the stock exchanges where the shares of the Company are listed within 7 days of extinguishment and destruction of the certificates.

(v) Where a company buys back its shares or other specified securities under these regulations, it shall

maintain a register of the shares or securities so bought, the consideration paid for the shares or the securities bought back, the date of cancellation of shares or securities, the date of extinguishing and physically destroying the shares or securities and such other particulars as may be specified in Section 68(9) of the Companies Act, 2013.

Case Study: 5

Mr. AJ and Ms. SJ both engineers by profession conceived an idea to set up a project in the State of Uttarakhand. The project involves setting up of a manufacturing unit to produce polypropylene wheel cores that are used in castors and wheels and advanced perform making machines. The project also involves technological up gradation as it switches to use of state of art high speed injection molding machines using multiple strokes thus ensuring internationally acceptable quality standards. It has been 5 years and they are proud owners of a Company named HPL.

The project involves setting up of a manufacturing unit to produce polypropylene wheel cores that are used in castors and wheels and advanced perform making machines. The project also involves technological up gradation as it switches to use of state of art high speed injection molding machines using multiple strokes thus ensuring internationally acceptable quality standards.

Cost and Means of Finance

Cost of project		Amount (₹)
Land		2200000
Building		12500000
Plant & machinery, (imported)		
(i) PP wheel machine and mold USD 80000		
@ 70	5600000	
Duty & other expenses	840000	6440000
(ii) PET molding machine II with mold		4700000
(iii) PET molding machine-III with mold		2700000
Ancillary equipment's		4875000
Office equipment's		300000
Contingencies		500000
Initial working capital		500000
Total		34715000
Means of finance		
Term loan from Bank		23733250
Promoters contribution		10981750
Total		34715000

Working capital requirement (Estimated Figures)

		Margin	Prom.	Bank	Total
R.M STOCK	3000000	25	750000	2250000	3000000
F.G STOCKS	3500000	25	875000	2625000	3500000
DEBTORS	6000000	50	3000000	3000000	6000000
			4625000	7875000	
Less: own sources at the end of first year.				800000	
Net				7075000	

HPL has been getting bulk orders and generating revenue. With an employee count of 78 under the leadership of AJ and SJ, the Company has so far witnessed growth and profits.

In the meeting of Board of Directors held in the month of December 2020. The Board noted from MIS and realizes that as the business has expanded, they had less time available to focus on credit control. Collections from accounts receivable has deteriorated and despite high profits, Company is using more of Cash Credit facility of existing ₹ 1 Crore to pay for business expenses that became due sooner than they get paid. They need cash flow to pay employees, vendors and cover other business expenses. The Board of Directors decided to again approach their bank for assistance.

Brief financial information was placed in the meeting of Board of Directors:

Particulars	Amount (₹)
Projected Sales	900,00,000
Trade Receivables	100,00,000
Cash & Cash Equivalent	5,50,000
Trade Payables	25,00,000
Short Term Provisions	2,15,000
Short Term Borrowings	2,25,500
Estimated Current Assets (Total)	500,00,000
Estimated Current Liabilities (Total)	200,00,000

Other Information presented before the Board of Directors:

- Estimated Annual credit sales shall be ₹ 1.2 crore (approx.) and estimated average collection period is 50 days.
- The past experience indicates that bad debt losses are around 2% of credit sales.

- *The Board of Directors considers 365 days in a year.*

Based on the Company's performance record, the bank was ready to sanction additional fund-based working capital limit of 2 Crores and interest rate is Base Rate 15% +2% p.a., payable at monthly basis.

However, the Directors were not convinced with idea of additional cash credit from bank and insisted to look for other alternatives. They were referred to a local firm specializing in credit management consultancy DEF

Associates. It suggested that they either employ a credit monitoring manager or factor accounts receivable. Factoring was new the Directors of HPL. The DEF Associates suggested EA to HPL for factoring services who specializes in Domestic Factoring Services also suggested "In factoring, the factor not only finance trade debts but also performs various other functions". Secondly the factoring is expected to save ₹50,000 in administration costs and also to eliminate all bad debt losses. EA was known to provide factoring services involving advancing 80% of the receivables at 12% p.a. and 2% factoring commission.

Since the concept of Factoring is a new concept. During the meeting with EA, EA explained along with regulatory aspects of Factoring, the whole process to the Directors of HPL through steps as well as flow chart as given below:

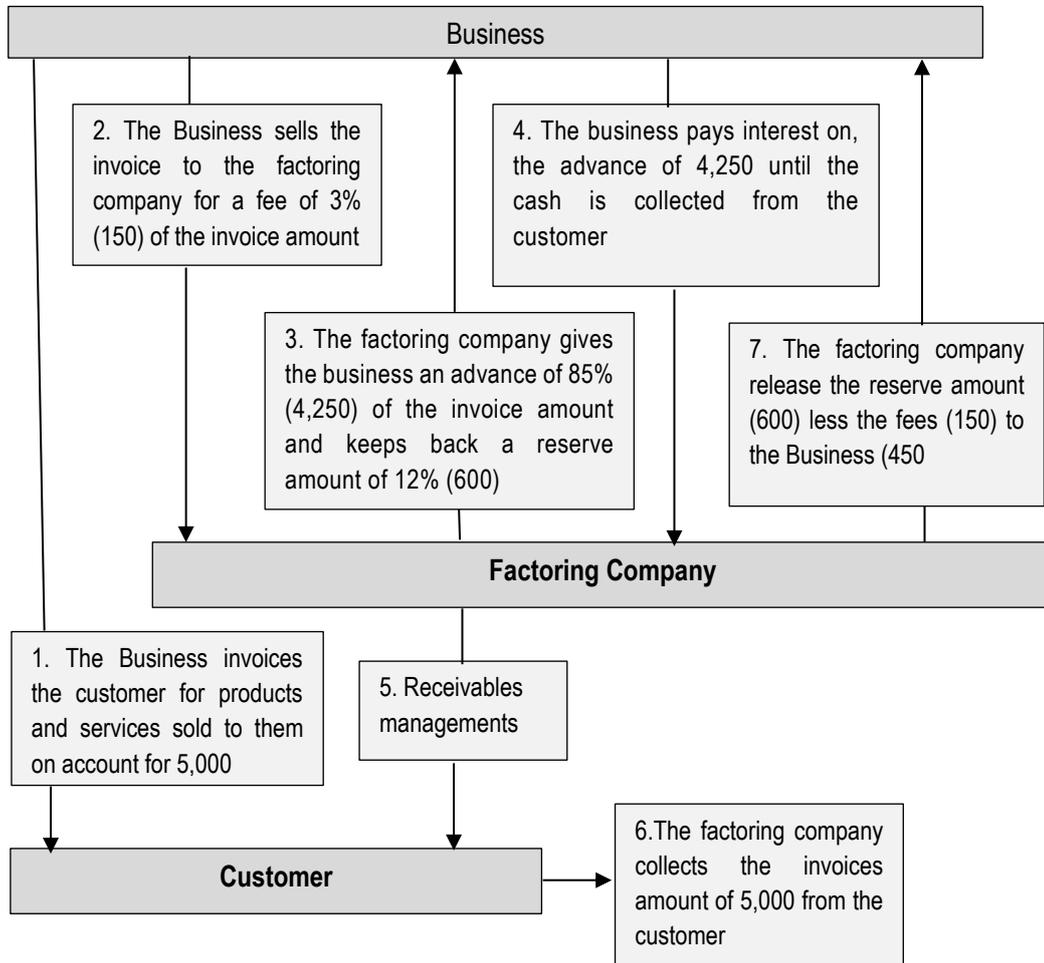
The process of factoring invoices includes the following steps:

- (1) Sell goods to customers on credit terms and generate invoices.*
- (2) Submit invoices to the factoring company.*
- (3) Factoring company advances your business cash based on a percentage of invoice value.*
- (4) The business pays interest on the percentage advanced.*
- (5) The factoring company manages the collection of accounts receivables.*
- (6) Factoring company collects the accounts receivable from the customer.*
- (7) Factoring company pays your business the balance of the invoice after deducting a commission fee based on a percentage of the invoice value;*

Flow Chart of Factoring Receivables Process:

To explain the process of factoring receivables, we have set out the seven steps involved in the flow chart diagram below using typical example values based on accounts receivables invoices of ₹5,000.

Factoring Accounts Receivable



While the discussion was going on with EA, HPL received an international order ₹ 5 Crores, big enough in terms of contribution to profits. This led the Company to approach GA, a firm specializing in international factoring services for hiring their services in context of international orders. The Board of Directors ratified the appointment of EA for Domestic Factoring Services without verification of regulatory requirements.

Provide the correct option to the following questions:

5.1 Based upon financial information which was placed in the meeting of Board of Directors of HPL held in the month of December, 2020, which statement is correct, assuming no current bank borrowing and ?

- (A) The fund-based working capital limit of additional ₹ 2 crore totalling ₹ 3 Crores is in congruence with turnover method;
- (B) The fluid-based working capital limit of additional ₹ 2 crore totalling ₹ 3 Crores is in congruence with Method 1 as per Maximum Permissible Banking Finance;
- (C) The fund-based working capital limit of additional ₹ 2 crore totalling ₹ 3 Crores is in congruence with Method 2 as per Maximum Permissible Banking Finance;
- (D) None of the options. **(2 Marks)**

5.2 Using the following figures, the gross working capital for HPL is:

Trade receivables	100,00,000
Cash and cash equivalents	5,50,000
Trade Payables	14,00,000
Short term provisions	2,15,000
Short term borrowings	2,25,000

- (A) ₹ 1,00,00,000;
- (B) ₹ 87,10,000;
- (C) ₹ 91,50,000;
- (D) ₹ 1,05,50,000. **(2 Marks)**

5.3 All the following statements are correct about two factor international factoring except:

- (A) The responsibilities relating to book-keeping and collection of debts remain vested with the import factor;
- (B) Import factor provides the credit protection in case of financial inability on the part of any of the debtors;
- (C) Factoring commission is shared by export factor with import factor at mutually agreed rate;
- (D) The export factor bases his credit decision on the financing standing of the availing bank. **(2 Marks)**

5.4 If another firm, True factor Financial Services agreed to factor HPL receivables involving advance 80% of the receivables at 10% p.a. and 2% factoring commission as per information available in case study. The amount remitted to HPL is:

- (A) 12,82,192;
- (B) 13,15,068;
- (C) 12,64,628;
- (D) 11,53,973; **(2 Marks)**

- 5.5 Net factoring cost in case of True Factor Financial Services above is:
- (A) 5.95%;
 - (B) 6.19%;
 - (C) (18.94)%;
 - (D) (2.56)%.
- (2 Marks)**
- 5.6 HPL received an international order, big enough in terms of contribution to profits. The factoring firm, EA, specialized in domestic factoring only. This led the Company to approach GA, a firm specializing in international factoring services for hiring their services in context of international orders.
- The Directors of the Company were skeptical whether it will be advantageous to hire the services of GA in respect of international orders or they should opt for Forfeiting. Explain in brief.
- (5 Marks)**
- 5.7 (A) While discussing about factoring, the manager of the local firm specialising in credit management consultancy mentions:
- "In factoring, the factor not only finance trade debts but also performs various other functions". Justify this statement.*
- (5 Marks)**
- (B) *"The Directors of HPL have not verified the regulatory requirements before appointing EA for Factoring Services". Justify this statement.*
- (5 Marks)**

ANSWER CASE STUDY-5

- 5.1 (D)
- 5.2 (D)
- 5.3 (D)
- 5.4 (C)
- 5.5 (B)

ANSWER 5.6

Forfeiting is a form of financing of receivables pertaining to International Trade. It denotes the purchase of trade bills/promissory notes by a bank/financial institution without recourse to the seller. The purchase is in the form of discounting the documents covering the entire risk of non-payment in collection. All risk and collection problems are fully the responsibility of the purchaser (forfeiter) who pays cash to the seller after discounting the bills/notes.

Difference between Forfeiting and Export Factoring

- (a) A forfeiter discounts the entire value of the note/bill. In a factoring arrangement, the extent of financing available is 75-80%.

- (b) The forfaiter's decision to provide financing depends upon the financing standing of the availing bank. On the other hand in a factoring deal the export factor bases his credit decision on the credit standards of the exporter.
- (c) Forfaiting is a pure financial agreement while factoring includes ledger administration as well as collection.
- (d) Factoring is a short-term financial deal. Forfaiting spreads over 3-5 years.

In the light of the above submissions, it will be advantageous to hire the services of GA in respect of International orders.

ANSWER 5.7(A)

The statement that in factoring, the factor not only finance trade debts but also performs various other functions is CORRECT.

The main functions of a factor could be classified into five categories:

(1) Maintenance/Administration of Sales Ledger:

The factor maintains the clients' sales ledgers. On transacting a sales deal, an invoice is sent to the customer and a copy of the same is sent to the factor. The factor also gives periodic reports to the client.

(2) Collection Facility:

The factor undertakes to collect the receivables on behalf of the client relieving him of the problems involved in collection, and enables him to concentrate on other important functional areas of the business. It also enables the client to reduce the cost of collection by way of savings in manpower, time and efforts.

(3) Financing Trade Debts:

The unique feature of factoring is that a factor purchases the book debts of its clients at a price and the debts are assigned in favour of factor who is usually willing to grant advances to the extent of 80% of the assigned debts.

(4) Credit Control and Credit Protection:

Assumptions of credit risk is one of the most important functions of the factor. This service is provided where debts are factored without recourse. The factor in consultation with the client fixes credit limits for approved customers.

(5) Advisory Services :

By virtue of their specialized knowledge and experience in finance and credit dealings and access to extensive credit information; factors can provide the following information services to the clients:

- (i) Customer's perception of the client's products, changing in marketing strategies, emerging trends etc.
- (ii) Audit of the procedures followed for invoicing, delivery and dealing with sales returns.
- (iii) Introduction to the credit department of bank/subsidiaries of banks engaged in leasing, hire-purchase and merchant banking.

ANSWER 5.7(B)**Regulatory Requirements in brief before appointing the factoring firm "EA" for Factoring Services pursuant to the Factoring Regulation Act, 2011**

- (i) No factor shall commence or carry on the factoring business unless it obtains a Certificate of Registration from the Reserve Bank of India to commence or carry on the factoring business under this Act. For the removal of doubts, it is hereby clarified that a Non-banking Financial Company engaged in factoring business shall be treated as engaged in factoring business as its "principal business" if it fulfils the following conditions, namely:-
 - (a) If its financial assets in the factoring business are more than **fifty per cent of its total assets** or such per cent as may be stipulated by the Reserve Bank; and
 - (b) If its income from factoring business is more than fifty per cent of the gross income or such per cent as may be stipulated by the Reserve Bank.
- (ii) The Reserve Bank may, if it considers necessary in the interest of business enterprises availing factoring services or in the interest of factors or interest of other stake holders give directions to the factors either generally or to any factor in particular or group of factors in respect of any matters relating to or connected with the factoring business undertaken by such factors. If any factor fails to comply with any direction given by the Reserve Bank, the Reserve Bank may prohibit such factor from undertaking the factoring business.

Every factor shall for the purpose of registration, file the particulars of every transaction of assignment of receivables to the Central Registry to be set up under **Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002** **within 30 days** from the date of such assignment or from the date of establishment of such registry.

As per the Non-Banking Financial Company - Factors (Reserve Bank) Directions, 2012, following additional points may be noted with relation to factoring in this regard:

- (i) An entity not registered with the Reserve Bank of India (RBI) may conduct the business of factoring if it is an entity mentioned in Section 5 of the Act i.e. a bank or any corporation established under an Act of Parliament or State Legislature, or a Government Company as defined under Section 617 of the Companies Act, 1956.
- (ii) Every company seeking registration as NBFC-Factor shall have a minimum **Net Owned Fund (NOF)** of **₹ 5 crore**. Existing companies seeking registration as NBFC-Factor but do

not fulfil the NOF criterion of ₹ 5 crore may approach the Bank for time to comply with the requirement.

- (iii) A new company that is granted Certificate of Registration (CoR) by the RBI as NBFC-Factor shall commence business **within six months** from the date of grant of CoR by the RBI.
- (iv) An NBFC-Factor shall ensure that its financial assets in the factoring business constitute at least 75 per cent of its total assets and the income derived from factoring business is not less than 75 per cent **of its gross income**.
- (d) Proper and adequate control and reporting mechanisms should be put in place before such business is undertaken.
 - a. NBFC-Factors should carry out a thorough credit appraisal of the debtors before entering into any factoring arrangement or prior to establishing lines of credit with the export factor.
 - b. Factoring services should be extended in respect of invoices which represent genuine trade transactions.
 - c. Since under without recourse factoring transactions, the factor is underwriting the credit risk on the debtor, there should be a clearly laid down board-approved limit for all such underwriting commitments.